SEVEN SUMMITS CAPITAL

1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

APRIL 2015 INVESTMENT COMMENTARY

THE MARKET CORRECTS -- WHAT DOES THIS MEAN?

Broad market indices began sliding on Monday, March 23rd and the sell-off gained momentum over the next two days as the calendar approached month-end and quarter-end. This is the third month in a row that market averages showed significant weakness during the last week of the month, each time bringing the Dow Jones Industrial Average and S&P 500 back to breakeven for 2015.

During times like this much discussion ensues in the financial press about what the "price action" is foreshadowing. However, from my experience, short-term price action is not meaningful at all. In fact, price action up or down in any week, month, or quarter is typically random and completely unpredictable. Anyone who tries to assign meaning to the price action is guessing, at best.

A stock price tends to move up or down based upon the vagaries of money flow that typically cannot be attributed to any particular company specific factor. Over consecutive weeks, months, and quarters, stock prices reflect what market professionals call "price discovery". What is very important to understand with stock prices is that price discovery is unending until such a time that a company leaves the public markets through acquisition, going private, or going out of business. Thus, being in the public markets exposes the investor to continuous and unending price discovery.

At Seven Summits Capital, we recognize short-term price action for what it is – noise. We embrace the process of price discovery as an inherent opportunity to capitalize on the inevitable value over-shoot and under-shoot tendencies inherent in the public markets. This continuous flow of information manifests itself into the price of a stock because it adds to the mosaic of what is known and this dictates broad investor sentiment toward a given stock. Often, a single piece of information is not pertinent to the value of the company, but more times than not a single press release or rumor will move the stock due to many market participants constantly seeking a reason to trade.

For Seven Summits Capital, price action in itself does not motivate us trade. However, price action can prompt us to reassess assumptions and the resulting valuation metrics for our stocks. In terms of the broad stock market, we honestly do not know how to perform a valuation analysis in order to determine if a "market" is over-valued or under-valued. One cannot simply look at the S&P 500, absolute or relative, valuation metrics and discern any useful information. Right now, there are numerous dynamics, such as the strength of the U.S. dollar and the sharp sell-off in oil prices, which are significantly distorting headline P/E ratios and EPS growth expectations for the S&P 500.

Financial data aggregator, Factset Corporation, analyzed S&P 500 growth and valuation metrics on March 20th and made the following observation: "The estimated earnings growth rate for the S&P 500 (ex-energy) is 3.1%. For companies (ex-energy) that generate more than 50% of sales inside the U.S., the estimated earnings growth rate is 5.9%. For companies (ex-Energy) that generate less than 50% of sales inside the U.S., the estimated earnings decline is -1.3%". These observations by Factset provide an investor with useful information that goes beyond the simple valuation of the entire S&P 500 index. Factset indicates that expectations for the S&P 500's earnings growth for the first half of 2015 have come down rapidly over the last two months. Accordingly, Factset stated: "For Q1 2015 and Q2 2015, analysts are now predicting year-over-year earnings declines of 4.8% and 2.0%, respectively. On December 31, analysts were projecting growth of 4.0% and 5.2% for these same two quarters. Much of the decline in the expected earnings growth rates for both quarters can be attributed to analysts lowering earnings forecasts for companies in the energy sector".

This change in expectations begins to explain why many large U.S. stocks, as well as the S&P 500 itself, have had a difficult time sustaining stock price gains this year. From our perspective, this type of information helps us understand and rationalize the price action that we see in the markets day-to-day. Having this perspective is important, however, this broad market data does not yet provide actionable information that will help us make long-term investment decisions.

In order to begin to derive actionable information from market data sets, we need to further analyze the Factset's data, especially regarding sector specific valuation information. On March 20th, Factset reported: "The (S&P 500) current 12-month forward P/E ratio is 17.0. This P/E ratio is based on Thursday's closing price (2089.27) and forward 12-month EPS estimate ($123.03). At the sector level, the Energy (26.9) sector has the highest forward 12-month P/E ratio, while the Financials (13.4) and Telecom Services (13.8) sectors have the lowest forward 12-month P/E ratios. Nine of the ten sectors have forward 12-month P/E ratios that are above their 10-year averages, led by the Energy (26.9 vs. 12.1) sector. The only sector with a forward 12-month P/E ratio below the 10-year average is the Telecom Services (13.8 vs. 14.8) sector". With this information, we are able to begin assessing where we may find valuation driven opportunities and where we may want to review the valuations of certain companies within our portfolios.

A common theme that runs through much of the information compiled by Factset, pertaining to growth and valuation, is the precipitous drop in the earnings expectations from the companies within the energy sector. This drop in earnings expectations has caused significant price declines for many energy related stocks, but overall, those stock price declines have not been nearly as steep as the decline in near-term earnings expectations. This is why the S&P Energy Sector's P/E ratio looks more expensive today than it did six months ago when oil and energy stock prices were much higher. What is occurring with stock valuations in the energy sector is counter-intuitive. Individual energy stock prices are down in many cases, between 30% and 80%, over the last six months to eight months; however, Factset is reporting that the energy sector's average P/E ratio is 26.9 versus a 10-year average P/E ratio of 12.1. With this information, one may then wonder if energy stocks are attractive investments today because they have come down significantly in price or if they are expensive because their average P/E ratio is more than twice as high as its trailing 10-year average? From a long-term investor's standpoint, more work would have to be done to answer that question on a company-by-company basis. However, based upon our experience with commodity based stocks following a steep sell-off like the energy sector experienced in 2014, we have little doubt that there are some very compelling values that can be found within this sector. However, if an investor's time horizon were months or quarters, as opposed to years, the answer would likely be that energy stocks are far too risky and expensive based upon their very poor short-term outlook for earnings.

The take-away from this discussion is that data is just a tool; it is not typically actionable by itself for a long-term investor. Different types of investors can draw entirely different conclusions from the same set of data simply due to different time horizons. For example, short-term investors speculate and react to real-time data flow while long-term investor's layer data, smooth trends over time, and utilize various types of information in order to form assumptions and make actionable forecasts. Accurate data is useful, but even though data is factual, its relevance to an investor is entirely subjective.

At Seven Summits Capital, our shortest investment time horizon for an individual investment is eighteen to twenty-four months. Therefore, what looks very expensive based upon six to twelve month forecasts can begin to look extremely compelling when certain forward-looking data inputs are normalized and applied over longer-term periods of time. Some might say that what I just described is speculation and they would be correct. Since the concept of future expectations is inherent within any investment that contains an element of risk, speculation is a given. However, all speculation is not created equal. Speculating on the outcome of a roll of the dice is far more risky than speculating on a well-researched outcome within the realm of publicly traded securities, especially if an informed level of speculation is spread across an entire portfolio of securities.

Instead of using data points to form a long-term investment thesis, many investors react to new data because they have no long-term thesis in the first place. Without a long-term thesis, the over-riding goal is to attempt to avoid downside stock volatility. In trying to accomplish this, investors like to believe that the market reacts in real-time to financial inflection points and then, they attempt to time their investments around these inflection points. However, many times the market, and the price of a stock, does not follow any predictable pattern. Therefore, attempting to time these market inflection points is generally futile. Thus, we do not pretend to time our investments. Instead, we do the necessary work to establish an eighteen to twenty four month outlook that helps us determine what price range is attractive relative to our target valuation and then, we establish an initial position within our portfolios. Once the initial investment is made, we will typically purchase additional shares during periods of price weakness, assuming our long-term thesis remains intact.

The bottom line is that the recent stock market weakness is not telling us anything useful. April stock prices in general will be determined, not by the weak price action at the end of March but, instead, by the unknowable market reaction to the jobs report, which will be released on Friday, April 3rd, unpredictable geopolitical events, first quarter 2015 corporate earnings relative to expectations, and other unforeseeable data and events.

Successful long-term investors are not fooled into believing that the price action of a market or a stock is a barometer that can inform them about the attractiveness of a given investment. Below are a couple noteworthy quotes from proven successful long-term investors on the subject of what volatility means:

"For some reason, people take their cues from price action rather than from values." Warren Buffett

"Volatility is a symptom that people have no idea of the underlying value." Jeremy Grantham

"We are convinced that the average investor cannot deal successfully with price movements by endeavoring to forecast them." Benjamin Graham

The last quote that I will close with is my reverse adaptation of a line I once heard a short-term trader state regarding how he makes investment decisions – Invest in what you see, not what you think:

"Invest in what you think, not what you see." Curt Stauffer

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com