SEVEN SUMMITS CAPITAL

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APRIL 2017 INVESTMENT COMMENTARY

IN THE AGE OF FAKE NEWS, WE KEEP IT REAL (THE INVESTMENT PROCESS, THAT IS)

Last month a client who was about to leave on vacation asked me to recommend a book on investing? I did not even think twice before suggesting that he read Howard Marks' book, The Most Important Thing. This discussion prompted me to go back through this amazing book and review my notes and highlights. Marks is the highly acclaimed founder of Oaktree Capital, and he and Warren Buffett have a mutual admiration for each other. Buffett once stated about Marks that "when I see memos from **Howard Marks** in my mail, they're the first thing I open and read."

Since the markets were relatively flat during March, and no economic data or legislative action occurred over the last month to change the cautious stance that I announced in March's commentary, I decided to take the opportunity to share some quotes from Marks' book. I will attempt to discuss the principles that Marks espouses as they relate to my career and the Seven Summits Capital investment process.

Almost 30 years ago I was fresh out of college and working in Lancaster, PA for CoreStates Bank as a Credit Analyst/Commercial Lending Trainee. CoreStates had one of the top training programs in the country at the time for commercial bankers. I worked for two years supporting local commercial bankers and credit officers in the preparation of loan underwriting "write-ups." I learned much more during these two years than I ever realized at the time. I remember scoffing at a Senior Vice President who, in his address to my class of trainees, told us that what we were learning was so valuable that we should be paying the bank. One of the most valuable lessons that I learned, beyond how to analyze financial statements and size up management, was the explanation given to me by a Senior Credit Officer on what was the difference between a good loan and bad loan. At the time, I thought that it was pretty evident that a good loan is one in which the borrower pays a loan as agreed. Conversely, it seemed obvious to me that a bad loan was one in which the borrower defaults on the loan and the bank is unable to recover what it was owed in full. It turns out that I was wrong. This Senior Credit Officer explained that it was the thoroughness of the underwriting that dictates whether the bank made a good or bad loan. He went on to state that banks can and do lose money at times on good loans and that this type loss is both anticipated and accepted. This brings me to the most important thing that I learned during my time as a credit analyst. The Senior Credit Officer explained that a bad loan is one in which the underwriting is flawed and that just because such a loan ends up paying as agreed, this does not turn a bad loan into a good loan. He ended this lecture by stating that a loan officer does not lose his or her job when a good loan goes bad. However, he emphasized that there is no better way to abruptly end your career as a corporate lender than to make a bad loan in which the bank ends up losing money.

The lesson that I learned about what distinguishes a good loan from a bad loan three decades ago has direct applicability to my role as an investment portfolio manager. In Howard Marks' book, The Most Important Thing – Illuminated, which I will be quoting from throughout, he referred to one of the first things that he learned at Wharton, which was that "the quality of a decision is not determined by the outcome." He went on to explain, "a good decision is one that a logical, intelligent and informed person would have made under the circumstances as they appeared at the time before the outcome was known." Marks summarized this concept very well in the following passage, "Let's say you make an investment that works out as expected. Does that mean that it wasn't risky? Who knows? Perhaps it exposed you to great potential uncertainties that did not materialize. Thus, its real riskiness might have been high. Or let's say the investment produces a loss. Does that mean it was risky? Or that it should have been perceived as risky at the time it was analyzed and entered into? If you think about it, the response to these questions is simple: The fact that something – in this case, loss – happened doesn't mean it was bound to happen, and the fact that something didn't happen doesn't mean it was unlikely." I have found that my early training, which stressed discipline and process, over eventual outcome, has shaped the investment professional that I am today.

Anyone who manages an individual security portfolio faces many decisions every day when it comes to portfolio action or inaction. The only effective way that I know of to approach these daily decisions is to acknowledge that there are only a few things that can be controlled. As I have become more experienced managing portfolios, my decision-making process is built upon confidence resulting from experience, logic, and informed judgment. This confidence comes from reconciling that I can control the decision-making process, but that I have no control of what happens the next day. This admission that you have no ability to know the future is why an investment decision, as it pertains to individual securities, is not binary. Individual securities require ongoing monitoring, research, and reassessment.

Howard Marks' concluded his comments on decision making in The Most Important Thing – Illuminated, by stating, "in the long run, there's no reasonable alternative to believing that good decisions will lead to investment profits. In the short run, however, we must be stoic when they don't." All good investors must be cognizant that It is easy to confuse interim price volatility, in either direction, as a sign of failure or success. When prices move decidedly in one direction or another on events, a good investor must avoid being reactionary. Instead, a good investor will revisit what is known, analyze the impact of any new information, and lastly, decide whether or not the reason behind the price move and new valuation level changes one's ongoing investment thesis associated with the given security.

Howard Marks, in his book states that there is one emotional reaction, more so than any other, that will undermine the abilities of a professional investor. That emotional reaction is the fear of looking wrong. Marks writes, when discussing contrarianism, that "you must do things not just because they're the opposite of what the crowd is doing, but because you know why the crowd is wrong. Only then will you be able to hold firmly to your views and perhaps buy more as your positions take on the appearance of mistakes and as losses accrue rather than gains." For any professional portfolio manager who buys and sells individual securities, confidence inspired conviction is a state of mind that is an absolute requirement for success. This state of mind enables the investor to weather the inevitable risk associated with the unknowable randomness of market-driven volatility, unexpected company announcements or competitive disruption.

Investing is inherently all about the future. Therefore all opportunity and all risk occur in the future. Since the future is unknowable; risk and opportunity are equal components of all investing. Therefore, being mentally prepared for risk is a skill all successful investors must perfect. This skill begins with the acceptance of risk and an understanding of what truly constitutes the idea of risk. For many investors and financial academics, investment risk is summarized as volatility because volatility is convenient and measurable. For Howard Marks, the idea of risk and volatility being synonymous is a misnomer. Instead, Marks discusses different types of risks that an individual investor must contend with, but plainly states that "volatility may be the least relevant of them all." Marks discusses different, more personalized categories of risks, such as falling short of one's goals and illiquidity. Marks concludes that the one risk that every investor inherently should worry about is the risk of permanent loss. Marks has an intriguing point of view when it comes to what leads to a permanent loss. Marks' view is as follows: "First, risk of loss does not necessarily stem from weak fundamentals. A fundamentally weak asset – a less-than-stellar company's stock, a speculative grade bond or a building in the wrong part of town – can make for a very successful investment if bought at a low-enough price. Second, risk can be present even without weakness in the the macro environment. The combination of arrogance, failure to understand and allow for risk, and a small adverse development can be enough to wreak havoc. It can happen to anyone who doesn't spend the time and effort required to understand the processes underlying his or her portfolio." To me, an actively managed individual security portfolio is inherently fraught with risk and teeming with opportunity. The term active management is not indicative of tactical trading. Instead, "active" describes a dynamic process of reasoned decision-making on the front end of a decision and continual monitoring and reassessment in order to re-orient assumptions regarding risk and opportunity as the future unfolds.

Reasoned decision-making on the front-end inevitably leads to a buy or don't buy action. One of the concepts that many new clients of Seven Summits Capital have to get accustomed to is establishing a new position or adding to an existing position as the stock price is falling. For many, this action feels counter-intuitive. Howard Marks discusses this concept at length in the book. He starts by dispelling the notion that the market is rational. He states, "if markets were rational, such that nothing would sell for less than its "fair value," we could say the bottom has been reached when the price arrives at that point. But since markets overshoot all the time – and price declines continue long after they should have stopped at fair value – there's no way to know when the price has reached a level below which it won't go. It's essential to understand that

"cheap" is far from synonymous with "not going to fall further." This statement is a perfect articulation of logic behind buying a security that is falling in price. I have joked at times, when the phrase "don't catch a falling knife" is uttered that am unafraid of bloody hands. Marks' addresses the falling knife phrase as follows: "The good news is that if we buy while the price is collapsing, that fact alone often causes others to hide behind the excuse that "it's not our job to catch falling knives." After all, it's when knives are falling that the greatest bargains are available. We give up on trying to attain perfection or ascertain when the bottom has been reached. Rather, if we think something is cheap, we buy. If it gets cheaper, we buy more." When I first read Marks' book, The Most Important Thing – Illuminated, I was struck by how my process of thinking aligned with what he had written over the years. I am not in any way comparing my abilities to Howard Marks. However, our critical thinking regiments and professional temperament appear to have a commonality that originates from the discipline developed through early career training and practical application of both credit and equity analysis.

My rationale for writing on this particular subject at this time stems from my ongoing desire to help clients become better investors and for many, that requires a reorientation of how one thinks about investing. Secondly, I firmly believe that the clients, whose assets are managed by Seven Summits Capital, should strive to understand the logic and process which underpin's the portfolio construction process and the ongoing portfolio action that impacts their managed assets.

For any Seven Summits Capital client who wishes to read the Howard Marks book that I extensively quoted from for this commentary, I will send you this book at your request. The book is not at all technical and is written in such a way anyone who has a genuine interest in becoming a better investor will find it very fulfilling, if not life changing. The book is only 223 pages, and as far as I am concerned, it is the most impactful book on the principles of investing that one can read. Simply send me an email and let me know that you would like to read Howard Marks' book.

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