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DECEMBER 2016 INVESTMENT COMMENTARY

GOODBYE FINANCIAL ENGINEERING, HELLO CAPITAL INVESTMENT

Much time is spent by professional and amateur investors alike worrying about and attempting to navigate factors and events which are inherently fluid and unpredictable. These things include politics, commodity prices, geopolitical events, and cyclical economic activity. Since these factors are not knowable and predictable, investors gravitate to short-term strategies such as technical trading and options gambling.

I have never been one to base an investment decision on a guess or one to react to an unanticipated event. I am by nature deliberative and process based. Being deliberative and process based provides a thesis and justification upon which to base decisions. Although it seems that our society is becoming less fact oriented and more emotional as highlighted during the recently concluded election cycle, I am hopeful that the markets will provide a counter-balance and become more rationally oriented once again.

Why would markets become more rational at a time when society is becoming less so? Markets have a conscience that is a reflection of the participants. These market participants, of which we are all a member, express their mood based on the type of transactions in which they engage. This behavior can be significantly affected by investor sentiment that vacillates between extreme caution and exuberance. Over the last six years or so that markets' mood has been somewhat bipolar, at times exhibiting extreme caution, while reflecting an odd sense of complacency. The one common denominator during this period of time was short-sightedness. The main reasons for this short-sightedness, in my opinion, was slow economic growth and the absence of a coherent fiscal policy in the U.S. and many other economies around the world.

Prior to the election, it appeared that a long-term commitment to fiscal spending was about to re-emerge in the United States, regardless of the outcome. Given that the most traditionally pro-business party won back the White House and retained control of Congress, markets appear to be looking forward to a high probability of meaningful long-term oriented fiscal spending, as well as business-friendly tax reform and regulatory policy.

The most important factor for long-term equity investors is capital investment. Return on capital investment can be measured in varying ways, however, in the absence of meaningful capital allocation to plant, equipment, and R&D, equity investors resort to shorter-term strategies. This is exactly what has transpired over the last three to four years. After the initial strong rebound in stock prices following the 2008-09 financial crisis, the U.S. and European governments saw their debt levels balloon as a result of the extraordinary spending and lower tax receipts that occurred during the crisis period. The reaction to these higher debt

levels was to retrench and cut government spending and investment. This retrenchment (austerity) occurred at exactly the time when these economies needed long-term investment. Therefore, most developed countries starved their economies of much-needed fiscal spending on long-term investments. In the absence of long-term investment by governments, we saw central banks step in and provide extraordinary monetary accommodation to keep these economies from falling back into recession.

These extraordinary monetary policy measures were the only available means of much needed economic stimulus and by themselves proved insufficient to raise growth rates much above two percent. The resulting below-trend growth rates around the world were not constructive for private businesses to make significant capital investments. In spite of record high-profit margins at many companies, excess cash flow was not directed toward capital spending. Instead, companies redirected excess cash flow to non-productive stock buybacks and higher dividends. This financial engineering helped mask slow organic growth, and it was used attract income-starved investors.

I am looking forward to 2017 being the beginning of a return to public and private capital allocation to growth and productivity enhancing investments. Equity markets cannot work efficiently if market participants cannot adequately discount future returns on investment. The cycle of capital investment between public and private organizations is intertwined. Public investment in infrastructure and research provides an improved business operating environment and important basic research that will lead to commercial opportunities in the private sector. I am hopeful that the stock market's reaction since the election is foreshadowing a robust public and private investment cycle that will awaken the recently dormant capitalist animal spirits.

Although I am bullish regarding pro-growth tax reform and increased capital spending, I do not see clear sailing in the markets and economy as we shift away from government gridlock and zero interest rates. It is likely that once the markets begin to adjust to the reality of both higher inflation expectations and rising interest rates, concerns will emerge. Additionally, the unpredictable, contradictory and impulsive populist rhetoric of the new President will create many challenges for investors. The incoming administration is led by a populist, whose skill-set centers around promotion. This businessman-President will be a challenge for markets as he will be prone to over promise and under deliver. Markets will find it hard to resist the prospect of big promises and this may set-up an environment of mini boom/bust cycles and investors who are not pragmatic and circumspect will likely bear the brunt of this new environment.

Not dissimilar to the noise that came from sparring politicians over the last six years, investors will have to largely tune out much of the incoming President's populist banter and instead focus on what I hope will be a reemergence of cogent investment decision-making. I cannot stress enough that capital investment will be very constructive for traditional long-term investing.

The inflection point within the markets that has seemingly occurred since the election has not exclusively affected the stock market. Interest rates, as represented by the 10- year Treasury Note, rose over 0.60% within thirty days. This type of rise in long-term rates results in a significant loss of value for long-term bonds, ETF's and mutual funds. Fixed income investing will continue to be precarious due to low single digit yields for securities with high-quality credit profiles combined with a secular rising trend in interest rates. In other words, continued low-income yields during a period where investor expectations reflect the belief that interest rates will be higher six months, one year, three years, and five years from now, will make fixed income investing very challenging. When the expectation that tomorrow's rates are higher than today's rates, investors will bid down the price paid for a given bond to obtain a higher yield that reflects investor expectations of higher interest rates in the future.

Few investors living today have experienced an extended period of rising interest rates. This environment requires either settling for very low total returns or turning to a non-traditional approach to fixed income. At Seven Summits Capital, we have access to non-traditional forms of fixed income such as private pools of debt instruments which are far less subject to those market forces which depress security prices as interest rate expectations move from "low for longer" to "low, but rising." These private investments pay a monthly income distribution and have annual yields ranging from 8-10%. We also utilize select specialized fixed income mutual funds that invest in areas of fixed income which do not exhibit significant interest rate sensitivity. Lastly, we still have access to both taxable and tax-free individual bonds and will acquire these bonds as they become available at a price level that generates a yield that helps satisfy a client's overall investment objective.

In summary, Seven Summits Capital is uniquely positioned to serve our clients' needs during a time when capital investment is on the rise in both the public and private sector and when the fixed income markets are challenging for traditional bond investors. Our approach to assessing the attractiveness of a security's current market price versus a fair present value of projected future cash flows should uncover an increasing number of attractive investment opportunities within this environment. Regarding fixed income, the environment that we appear to be finally entering represents the end of extraordinarily low-interest rates and the beginning of what the markets have been anxious over for the last couple of years. We are ready and well positioned for this new environment. We will be opportunistic, but we will not be fooled into becoming blindly exuberant.

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