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JANUARY 2015 INVESTMENT COMMENTARY

BUOYANT MAJOR U.S. STOCK INDICES ARE A BY-PRODUCT OF GROWING GLOBAL IMBALANCES

This year's solid stock market performance, as measured by the S&P 500, Dow Jones Industrial Average and Nasdaq 100, is concealing mounting imbalances within the global capital markets. The fact that these broad indices have been hitting new record highs makes it difficult for many investors to see these imbalances.

In early 2009, after an almost 40% drop in the major U.S. stock market indices and the most apocalyptic economic headlines of my lifetime, it was a time when most investors learned whether they had enough resolve and conviction to invest contrary to their emotions. For those who could see fear as an opportunity in 2009, the investment decisions that needed to be made were very apparent. The opportunity to profit from deeply discounted equities and distressed debt was as great as they had ever been.

Now, I find myself thinking about the type of investor who will be viewed as prescient when we look back on 2015 years from now. Today is a much different emotional exercise and, arguably, a more difficult exercise than it was in early 2009. In many ways, investor sentiment and security pricing was reflecting such a dismal future in early 2009 that investing contrary to that extreme pessimism was rationally not a difficult decision. However, as we enter 2015, with five straight years of positive stock market gains behind us and the U.S. economy outperforming every major developed economy in the world, conventional wisdom points to continued bullishness with a substantial bias toward U.S. equities. Thus, in today's environment where investing success comes easy, it is much more challenging to take the less traveled road as a contrarian.

First, let me clarify that being a contrarian investor does not mean that I will automatically buy whatever is out of favor. Nor does it lead me to seek shelter in gold or cash. Instead, I have to quantify a fair or intrinsic value of what I am to invest in before leaning against today's winners in favor of those securities that have under-performed. Thus, right now, buying out of favor European stocks or under-performing U.S. blue chip companies such as IBM is not necessarily a prudent contrarian decision. I cannot yet convince myself that the European markets have overshot on the downside given the region's challenging economic, political, and demographic fundamentals. Similarly, IBM has been in the process of remaking itself for 15 years. Therefore, investing in IBM after two consecutive under-performing years is not contrarian without evidence that the company has finally found a business mix that will enable the company to grow again; it would simply be a contrarian speculation.

Relative to the Seven Summits Capital's Core Equity process, what I look for when it comes to seeking out contrarian opportunities are areas of irrational pessimism. For example, irrational pessimism occurs when a cyclical company's stock is being priced as though cyclical trends will no longer reoccur. This often takes places amongst companies that operate in the basic commodity markets, such as oil and copper. These commodity oriented companies tend to trade far too cheaply during the trough periods of the cycle and, conversely, trade too richly at the top of the cycle. Currently, there are many contrarian opportunities within the energy and basic material sectors of the market due to the sharp sell-off in oil and basic metals markets over the last six to twelve months. Although investing in such companies does not necessarily guarantee stellar price performance in the near-term, it is very likely that, within three years, these investments will substantially reward the early contrarian investor.

The aforementioned examples of cyclically driven contrarian opportunities are just one example of areas that contain irrational pessimism. However, many times opportunities are stock specific, as opposed to sector specific. One type of opportunity that can be found is among stocks that have substantially underperformed another peer company. This type of divergent opportunity requires an investor to quantify the reasons for the variance in the stock's performance in order to determine whether or not the price divergence is for fundamental reasons or not before investing. Another example of irrational pessimism is with companies whose stock prices fall in sympathy with another company or industry group. Opposite of the previous example, this type of irrational pessimism occurs because the market has a tendency to "shoot first and ask questions later", which causes a mistaken association of one company with another or one sub-industry group with another. Currently, this type of irrational price movement can be found amongst integrated solar companies whose stocks have sold off sharply as the price of oil has fallen. We find that these types of opportunities are far easier to recognize than attempting to guess which areas of the broad market will perform best in the upcoming year.

I never try to predict how the broad U.S. equity markets will perform over a given time period. Therefore, I stick with the practice of locating areas within the market where irrational pessimism is present, which provides a certain level of confidence due to being grounded in quantifiable valuation metrics and the lessons of history. It is history that tells us that the current degree of performance disparity that we have seen between the U.S. large cap indices and other global markets is unsustainable. It is also history that teaches the lesson that the longer these imbalances persist, the more severe the rotational correction will be.

Last January, I wrote about caution after I began to see signs of the previously mentioned distortions. Now, twelve months later, many areas of the market that were strong performers in 2013 have broken down. Specifically, this refers to the areas of emerging markets, Europe, U.S. small cap stocks, and, of course, oil. To me, this means that large, globally oriented investors capitulated and abandoned traditional diversification in favor of chasing the perceived safety and strong relative performance of the large-cap U.S. stock indices. This is a worrisome trend that market insiders sometimes call a "crowded" or "lopsided" trade. Crowded trades can persist for much longer than most prudent investors believe possible and are excused by many who think that "it is different this time".

The S&P 500 is not necessarily over-valued by historical comparison; however this popular index contains sectors which are exhibiting all of the classic signs of being crowded trades. With a forward P/E of 16.6 the S&P 500 is trading at a healthy 1.50 forward PEG ratio. However, to see the distortions within sectors one has to look inside the index. The sector P/E ratios and the more telling PEG ratios clearly show that something unusual is occurring that cannot persist indefinitely. See the table below:

INDEX/ SECTOR	P/E RATIO	PEG RATIO
Utilities	17.7	4.08
Consumer Staples	19.5	2.30
Telecom	13.6	2.10
S&P 500	**16.6**	**1.50**
Materials	16.2	1.30
Info. Tech.	16.2	1.31
Consumer Disc.	18.3	1.16

Most Expensive by PEG Ratio

Least Expensive by PEG Ratio

Note: Data was sourced from Yardeni Research, Inc.'s year-end 2014 market data.

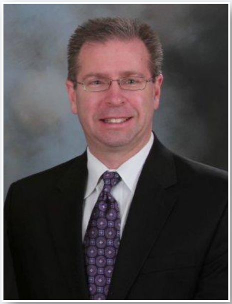
Due to the crowding effect of investors seeking both the relative safety of the big-cap U.S. indices and dividend yields as a substitute for bond income, the perceived safest and slowest growing sectors of the index have become extremely over-valued. This over-valuation is most apparent when comparing the PEG ratios to other traditionally faster growing sectors, such as Information Technology and Consumer Discretionary.

If there is one investor characteristic that I strongly disfavor, it is chasing crowded trades. This aversion can probably be traced back to my early years in the business during the tech bubble. The bottom-up stock selection strategy that is utilized at Seven Summit Capital is designed to be blind to momentum measures, which helps us avoid performance-chasing tendencies. Additionally, we avoid chasing crowded trades by not comparing our portfolios to a particular benchmark. This process will often lead us to investing in stocks that are exhibiting weak price performance in the short-term. With the tendency to buy into weakness without ever knowing for sure what price level constitutes the bottom, we often get the opportunity to average-down when prices fall further than we anticipate. Thus, in these situations, we actually relish the opportunity to lower a client's cost basis relative to what we believe is a fair or normalized price that we have set as our target price.

One of our competitive advantages and the common advantage among successful long-term investors is the ability to fixate on a time horizon that is much longer than that of the average investor. We know that stocks on average rise over time; this is a proven fact. Furthermore, most investible companies will remain solvent and individual stocks will either rise above or below the market average return within a given period of time. As with any average calculation, constituents being measured will either fall above the average or will fall below while very few will actually achieve the average. At Seven Summits Capital, we strive to identify and own equities at prices that provide an increased likelihood that the equities will be in the above average category over the period of time in which we own them. However, the only way that we can operate in this way is with like-minded clients who do not apply pressure to outperform a particular index on a quarter-to-quarter or year-to-year timeframe.

I enter 2015 more convinced than I was last year that our major U.S. broad markets are being distorted by income starved investors and by virtue of being the only "safe" stock markets in the world that are located within a growing economy. I am not complaining about a rising market and I am not raising these issues in order to be an alarmist. Instead, I feel obligated to allow my clients to see the markets through my eyes instead of through the financial media that more times than not report on the markets in much that same way that Sports are reported.

The Seven Summit Capital equity process will strive to find opportunities in areas within the capital markets where the conditions are temporarily challenging and/or the fundamentals are under-appreciated. When the major markets eventually breakdown, we expect that these areas will be where value-seeking investors will look for opportunity. Since the U.S. economy appears to be on fairly solid ground, in the short and intermediate term, we do not expect major equity markets to sell-off in anticipation of an economic contraction any time soon. However, a more likely manifestation will be major rotations from the popular to the unpopular areas of the market. Rotations occur within the context of the inevitability of commodity cycles, value-seeking tendencies, and the concept of reversion to mean. When an investor knows to look for irrational pessimism and accepts that this pessimism is almost always temporary, this takes much of the guess work out of investing for the long-term. Market rotations are the corrective measures that sort out temporary distortions. Unfortunately, these rotations are impossible to predict and time, therefore, we will be patient and give the market adequate time to sort out these imbalances.



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