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MARCH 2014 INVESTMENT COMMENTARY

INTRODUCING SEVEN SUMMITS CAPITAL · PROCESS VS. OUTCOME · WHERE IS THE ECONOMY HEADED?

This month marks a milestone for StaufferWilliams Asset Management. Two years ago, StaufferWilliams Asset Management was founded, marking the realization of my vision of what an independent asset management firm should be.

I welcomed Jonathan Williams to join me in the building of a firm that married a fundamentally centered process to a customized portfolio management approach which was then individually applied to every client. With this approach, the company has all but doubled assets under management over the last year, kept client turnover very low, and expanded portfolio strategies to include dividend growth stocks.

However, in December, I communicated Jonathan's decision to take a different professional path. This change, along with expanding business opportunities and a greater use of non-traded alternative investments, created the impetus to rename StaufferWilliams. After much thought and consultation, I have decided to change the name of the company to Seven Summits Capital. This choice of name reflects my desire to draw attention to process, risk management, and goal setting. Similar to succeeding in asset management, setting a goal to reach the summit of a mountain is a commitment that can only be fulfilled through disciplined training, careful planning, patience, and the management of ever-present risk.

PROCESS VERSUS OUTCOME INVESTING

During the process of deciding on the name of Seven Summits Capital, I spent a lot of time thinking about how goal setting and process-based investing go together. In a recent article published in The Washington Post by Barry Ritholtz, Mr. Ritholtz classifies investors as outcome or process investors. He states that process investors are in the minority and that, unfortunately, most individual investors are outcome focused. Mr. Ritholtz points out that outcome-oriented individuals are "gamblers, many (but not all) sports fans and, of course, speculators." On the other hand, he sees process-oriented people as "airline pilots, professional sports coaches and, of course, long-term investors." From my experience, I believe that the vast majority of investors have been conditioned to elevate the importance of short-term outcomes over long-term oriented investment strategies.

Mr. Ritholtz's article also accurately points out that outcome investors, who Wall Street favors, place a high value on knowing last year's fund rankings, as well as last year's best performing sectors and asset classes. These backwards-looking metrics coincidentally are what Wall Street uses to market investment product. Readers of investment oriented periodicals know that Wall Street fund companies and the financial media are very helpful in providing outcome-oriented investors a short-term scorecard as each calendar quarter and year-end passes. At Seven Summits Capital, we save a lot of time by largely ignoring the plethora of outcome-based articles published at any given time. As process-based investors, we recognize that following a process leads to quantifiable and repeatable outcomes, whereas short-term outcomes rely much more on random luck and are not easily repeatable.

I have observed that many of today's process-based investors are prone to being passive asset allocators who follow a top-down, macro driven sector selection process. This is where we separate ourselves. Unlike many of our competitors, we value a process that pertains to the buy/sell discipline, management of correlations, and risk/reward assessment. Not only do we merge the aforementioned process-based disciplines with objective research and an opportunistic, value-oriented, investment style, but we also predominately utilize individual securities to design and build portfolios based upon fundamental criteria and client need. The use of individual securities provides us with the ability to enhance long-term performance and manage risk in a much more granular fashion than those who simply rely upon "broad-brush" ETF's and index funds.

Over time, I have learned that not all people appreciate our approach because they believe that a process that cannot readily be measured in short-term intervals is too much of a departure from how they have been conditioned. This conditioning comes from what is known as the "sell-side" of Wall Street, or the brokerage business. Many sell-side professionals are incented to short-term oriented because their sales quotas, commission payouts, and promotions are all determined month-to-month or quarter-to-quarter. However, due to realizing that the only true measure of success is through long-term client retention, Seven Summits Capital does not operate based upon sales quotas and short-term incentives that often lead to an overall financial disappointment for the client.

With over 15 years of securities research and portfolio management experience, I know that the common practice of short-term benchmarking of a portfolio requires an investor to build a high level of market correlation into the portfolio, ultimately leading to "closet indexing." Closet indexing is a very common practice within large investment institutions and, based upon my observation of this practice, closet indexing is not a strategy designed to be in the client's long-term best interest. Instead, this portfolio strategy is designed to create operational scale and reduce client turnover based upon the premise that if you never under-perform or over-perform the index by more than a couple of percentage points, the client will be content and not seek alternatives. Yet, the travesty of this business strategy is that the clients are paying a fee that is commensurate with true active portfolio management, but over the long-run, the process that they are paying for has a very small chance of adding value beyond the alternative of simply using low-cost index funds and ETF's. Thus, after fees are deducted, a client subjected to closet indexing is very likely to experience disappointing results.

While on the subject of process, I want to discuss a financial decision that I have thought about every day for the last six months – my sale of Tesla Motors stock last year. I purchased this stock in growth oriented client portfolios at roughly $45 per share; at a time when the company's business model was misunderstood and its success was being doubted. In April 2013, I announced to my clients that I was buying Tesla after spending a lot of time analyzing its business model and potential competitive advantages. Within several months of purchasing Tesla's stock, it proceeded to almost double in price due to company specific events that I had anticipated through my analysis, prompting me to sell the stock on valuation concerns. I had placed, what seemed at the time of purchase, an aggressive target value on the company of approximately $65 per share. Currently, Tesla Motor's stock is trading in excess of $230 per share. I continue to follow the company very closely and I remain very bullish on the company, its business model, and its opportunities. In my opinion, due to the company's unparalleled technology and engineering, the company's stock cannot be adequately valued within the constraints of my investment process. Due to the discipline built into our process, I cannot currently justify the ownership of Tesla stocks, in spite of my belief that the company has a very bright future. I can only hope that I get the chance to re-purchase the company again in the future when I can be confident that the share price will offer my clients an attractive entry point and a quantifiable margin of safety from a fundamental valuation standpoint. Until then, I suppose that I will have to continue, as a non-investor, to marvel at this paradigm shattering company.

This anecdote is important because although I often share stories of how our well-disciplined process produces the desired results when it comes to individual stock selection, Tesla provides a different example. My history with the Tesla stock reveals how disciplined our process is when it comes to following a valuation criteria and sell discipline, even when great admiration exists for the underlying company. Therefore, at Seven Summits Capital, we limit counter-productive actions by remaining dispassionate regarding our investments and this helps enable objective decision-making.

WHERE IS THE ECONOMY HEADED THIS YEAR?

Many years ago, I used to quote Paul Kasriel, the former Chief Economist of Northern Trust, regularly in my commentaries as a trusted source for making sense of contradictory economic data, such as in 2008 when he was the first credible economist to publicly warn of an impending recession. He wrote in January 2008:

> *"The Index of Leading Economic Indicators [LEI] fell 0.2% in December after a similar decline in November... the LEI has now declined in four out of last six months... The quarterly average of the LEI is down 0.6% from a year ago. Historically, negative year-to-year changes in the quarterly LEI are associated with recessions with the exception of the drop in 1967 when the economy was weak. Larger declines will be necessary to confirm that a recession is underway. However, the fact that the LEI has now declined in two out of last three quarters on a year-to-year basis is a strong signal that should be watched."*

This analysis and insight into the reliability of the LEI was very instrumental in shaping how I thought about the U.S. economy in the context of the worrisome real estate trends and balance sheet risks within the banking system.

We now know that the last recession officially began in January 2008 and ended in June 2009. Not only did Mr. Kasriel shape how I looked at the U.S. economy at the beginning of 2008, but he also helped solidify my outlook at the bottom of the market a year later in 2009. In February 2009, when many economic headlines were full of dire outlooks, Mr. Kasriel again provided those, like me, who followed his very valuable insight, an accurate forecast during a very uncertain period. He stated in February, 2009:

> *"I believe that large increases in federal government spending (the 2009 stimulus plan) that are monetized by the Fed (quantitative easing) and the banking system will result in a recovery in real economic activity." He went on to layout the timing of the recovery by stating, "The economic data are likely to be abysmal through the first half of this year. The popular media will reinforce the gloom of the data. The same pundits who did not see this downturn coming will not see the recovery coming either. My advice to you is to keep your eye on the index of Leading Economic Indicators."*

After reading this from Mr. Kasriel in February 2009, I wrote a March 2009 commentary titled: The Market Strikes a Somber Tone, We are Finding Rainbows and was able to confidently position portfolios, at time of extreme fear and economic uncertainty, to fully take advantage of the impending bull market in stocks that recently drove stock market values back to all-time highs.

Today's doubts about the durability of the economy are taking center-stage once again, therefore I find myself turning to Mr. Kasriel once again for clarity. Going into 2014, Mr. Kasriel was very optimistic regarding the momentum behind U.S. GDP and was predicting the fastest GDP growth since before the financial crisis. However, after the Federal Reserve announced its bond purchase tapering plan in December, he became much more cautious in his outlook. The Fed tapering announced by Chairman Bernanke in December was much more "aggressive" than Mr. Kasriel expected. In his January 14, 2014 blog titled "Fed Tapering—Shades of 1937?" he made the following statement regarding his much more tempered 2014 outlook: "if the Fed were to follow through with its announced tapering plan, then, all else the same, this would represent a significant tightening in U.S. monetary policy, with negative implications for the behavior of the U.S. economy and U.S. risk-asset prices starting sometime in the second half of 2014 and extending into 2015." If Mr. Kasriel's economic outlook was reflected in the form of a traffic light, the light changed from green in December to yellow in January.

Although Paul Kasriel is currently tempering his enthusiasm for 2014 and 2015, he goes out of his way to say that he is not seeing a recession on the horizon at this juncture. Like Mr. Kasriel, I will keep my eye on the Index of Leading Economic Indicators (LEI) for signs of weakness. In the February 20th, 2014 release from the Conference Board, which compiles and publishes the LEI, it is stated “the U.S. Leading Economic Index continues to fluctuate on a monthly basis, but the six-month average growth rate has been relatively stable in recent months, which suggests that the economy will remain resilient in the first half of 2014 and underlying economic conditions should continue to improve.” This is comforting data because it filters out all of the short-term volatility that is inherent in month-to-month economic statistics.

The aforementioned discussion of Paul Kasriel and the Index of Leading Economic Indicators was my way of validating why I am not, currently, changing my investing posture due to the well-publicized concerns of a deceleration of economic growth in the U.S. However, as discussed over the last several months, the attention that I give to equity valuations has significantly increased over the last several months. Valuation levels alone will not typically cause a stock, or the market, to correct sharply. But, experience teaches us that the higher valuations get, the higher the bar of expectations becomes. These increased expectations are what heighten the risk of disappointment induced re-pricing, which is another way of saying prices will fall.

Active management and fundamental analysis underpin what we do at Seven Summits Capital. These attributes enable clarity and purpose at times when others have a blurred outlook which can cause the abandonment of a long-term strategy. We successfully strive for greater certainty in the midst of what many see as an increasingly uncertain and a hostile investment environment.

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