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MARCH 2015 INVESTMENT COMMENTARY

LONG-TERM INVESTMENT TIME HORIZONS, THE DECEPTIVE NATURE OF THE HERE AND NOW, & A PEEK INTO WARREN BUFFETT'S ANNUAL SHAREHOLDER LETTER

On many occasions, when speaking to investors and clients, it has occurred to me that it is not an uncommon occurrence for individuals to lose focus when it comes to their investment time horizon. Since most investors that I come in contact with have a long-term investment time horizon spanning more than 10 years, I spend most of my time executing portfolio strategies that promote long-term wealth creation and/or inflation adjusted value preservation.

A wealth creation strategy typically pertains to those investors who will not be accessing the value of their investment portfolio(s) for at least 10 years. This group of people would include individuals who are still working full-time, and expect to remain working for at least 10 years, or retirees who have sufficient fixed sources of income to allow them to continue to invest with an emphasis on growth.

Even with a wealth preservation strategy, an investor still should have a long-term growth objective; however, these investors often have to balance the need to draw an income from the portfolio to supplement other guaranteed sources of income. The necessity for growth for this type of investor is important to prevent the long-term erosion of purchasing power due to inflation.

LONG-TERM TIME HORIZONS

Thus, as a portfolio manager and investment strategist, it is crucial that I remain focused upon the long-term attributes of a given portfolio strategy. The focus on these long-term attributes can sometimes conflict with the here-and-now world in which we are all confronted with daily. This conflict can manifest itself when a portfolio of individual securities, designed to support a long-term investment strategy, is not in sync with current drivers of broad market indices. If the here-and-now market is rising faster than a portfolio of long-term investments, it is tempting to begin to question the wisdom of the long-term strategy. When this happens, and it routinely will with an actively managed portfolio, one must refocus on the long-term view represented by your investment time horizon. For investors who have not been actively participating in the markets over many market cycles, it is challenging to resist veering off course in order to briefly ride the market's momentum in the moment. Only through experience, and the discipline that comes from investing through many market cycles, can one remain focused on his or her appropriate investment time horizon.

Staying focused on the appropriate investment time horizon may be the single most important determinant of success when it comes to executing an investment strategy. The definition of the word strategy, according to the Merriam Webster dictionary, is: *a careful plan or method for achieving a particular goal usually over a long period of time*. It should be intuitive for most people, if a strategy is being executed to achieve a certain set of investment objectives, that deviating from the strategy periodically due to the influences of short-term stimuli, such as market dynamics, geopolitical flashpoints, or opinions from "experts" who do not know your situation, will undermine the long-term success.

With any strategy, there are tactics. Tactics in long-term investing are not actions that are taken every day, week, or even month, but, instead, are defined by an adherence to a discipline that is supportive of the long-term objective. For Seven Summits Capital, that discipline is an adaptive valuation framework that drives the buy, sell, and hold decisions within a portfolio. Therefore, when the stock of a company that we have researched, and now understand, is inexpensive relative to an intrinsic value determination or a normalized valuation, we are buyers of that stock.

Inexpensive is defined by an expected total return of more than 30% over a two or three year period of time. Conversely, when we own a stock and the price has risen significantly, we apply the same intrinsic or normalized valuation test to it looking out two or three years. If the stock cannot reasonably produce the desired 30% total return, we will look to replace that position with another company that can hopefully provide the desired return expectation. We truly adhere to the idea that, if we look hard enough, we can find stocks to meet our criteria in almost any period during a market cycle. Another aspect of these buy/sell tactics is the ability to make contrarian decisions. These decisions fall under Warren Buffett's axiom to "*be* fearful *when others are* greedy*, and be* greedy *when others are* fearful". The only investors who can successfully follow Mr. Buffett's advice are ones who have a high level of conviction in their research process and have a strong belief in their strategy.

We employ the same effort when it comes to bonds. We first attempt to purchase bonds when we believe that the credit risk is understood and manageable, without significant reliance upon third party rating agencies. Secondly, we look to purchase these bonds at price levels that reward the investor with a yield that is at least 2-3% higher than a comparable risk-free Treasury security. Lastly, should interest rates fall during the time that we own such a bond, resulting in price appreciation, we will routinely test whether it makes sense to sell the bond, lock in the premium capital gain, and replace it with a bond that has a higher yield to maturity.

The aforementioned tactics serve to manage risk and enhance long-term returns within the constraints of a given strategy. Tactics many times end up being universally applicable across varying portfolio strategies. For example, Seven Summit Capital client portfolios have more energy stock exposure in them today than they did just six months ago. This is simply because the forward-looking two to three year total return outlook for energy stocks has improved as prices have fallen with the sharp sell-off in oil prices since July 2014. Virtually every strategy being employed on behalf of clients can benefit from this value dynamic.

Having stated that tactics can be applicable across many different types of strategies, a portfolio's strategy is driven entirely by a client's unique situation and long-term objectives. Strategy drives asset allocation decisions, and to a lesser extent, sub-asset class decisions. These top-down decisions play a significant role in determining things such as dividend yield, volatility, and exposure to degrees of speculation. Therefore, it is possible that two clients, who look very similar on paper in terms of age, income, and net worth, have very different investment objectives. For this reason, we take the time to understand the nuanced differences of clients and incorporate these differences into the strategy that we will best execute on their behalf.

Summarizing the difference between strategies and tactics, a strategy is a broad set of parameters that are matched to a unique long-term objective and a tactic is a relatively short/intermediate-term action that is constrained by the boundaries stipulated under the strategy.

THE DECEPTIVE NATURE OF THE HERE AND NOW

A recent example of a tactic used across many Seven Summits Capital portfolios, which encompassed intrinsic value determination, contrarian decision-making (looking through the here and now pessimism), and high conviction, is a stock that was first purchased thirteen months ago. In order to illustrate how Seven Summits Capital's process and discipline generates an idea that goes on to become a broadly applied tactic, below is a list, in chronological order of what went into this decision, plus a sampling of the news flow surrounding the company, which I will name at the end of this section, subsequent to the initial investment:

- In late 2013 we began researching a company that had been struggling to leverage its strong brand name, as well as downsize and refocus its business in order to return to consistent profitability after over ten years of persistently poor management execution and significant financial losses.
- By January 2014, we felt confident that a durable turnaround was highly likely under new senior management. We saw a new resolve to make hard, but necessary decisions that had been absent in the past.
- We assessed that due to deep long-standing investor pessimism, the company's stock contained around a 60% discount to the bottom range of its intrinsic fair value. This meant that if new management could just implement some of the turnaround plan that was laid out, and then investor sentiment would shift from extreme pessimism toward hope. We felt that if this happened, then the stock could reach our initial target price within one to two years.
- We established our initial positions in this stock in January, 2014 at approximately $17 per share. Over the next twelve months, the stock traded as low as $15.93 and as high as $20.00 per share. The news

that was reported on the company during this twelve month time was as follows:

- February 6, 2014 - Stumbling consumer electronics giant XXXX has confirmed it will axe 5,000 workers worldwide and offload its loss-making PC business to private equity firm Japan Industrial Partners (JIP).
- April 11, 2014 - Analysts point to structural problems behind XXXX's record loss
- May 1, 2014 – XXXX Slashes Earnings Guidance After Nightmare Losses
- September 17, 2014 –XXXX Plunged the most in more than three years in Tokyo trading after the consumer-electronics maker widened its net loss forecast and said it won't pay an annual dividend for the first time since its 1958 listing.
- October 31, 2014 - XXXX reported a quarterly loss that was seven times greater than a year earlier as the company loses ground in the smartphone market to Apple Inc. and Chinese rivals.
- October 31, 2014 - Major rating agencies Fitch and Moody's have downgraded the company to "junk" status.
- December 15, 2014 – XXXX (computer) hack sends stock down 10% in past week

A little over a month into 2015 and our investment thesis on Sony Corporation (SNE) were proven correct. Sony's management reported a strong rise in quarterly profit for the fourth quarter of 2014 and increased the profit outlook for 2015 and beyond. On February, 4th, Eric Pfanner wrote an article for MarketWatch.com titled "Why Sony's Lost Decade May Be Coming To an End". In this article, Mr. Pfanner stated, "Net profit more than tripled in the October-December quarter to Yen 89.0 billion from Yen 26.4 billion a year earlier. It was also nearly triple the profit forecast by analysts surveyed by financial data provider Quick".

Sony's stock currently trades between $27 and $28 per share, which is around 60% higher than it was trading when we first purchased it in January, 2014. Now, at a time when investor sentiment has swung from pessimistic to hopeful, we have begun to selectively reduce the size of the stock position in portfolios after the stock outpaced the broad market by almost 50% since the initial investment was made. Sony stock has grown to be one of the largest holdings within many client portfolios. We will not exit this stock as we believe that the success of the turnaround, which is just now getting attention, will be underestimated for a while. Therefore, the stock still meets our criteria on a go forward basis.

The profits from the shares that we do sell in Sony will be able to be reinvested in a newly identified company that we believe is similarly under-estimated in the way Sony was a year ago. This is active management, this is value seeking, and this is the type of tactical decision making that supports a long-term wealth creation/wealth preservation strategy. Active management does not need signs from the "market", such as technical indicators, or buy ratings from big brokerage houses to find value opportunities. Successful active managers march to the drum dictated by their process. Due to this independent thought process, a successful active manager's performance should not closely track an asset class specific benchmark like the S&P 500 or Dow Jones Industrial Average.

I shared the Sony stock story in this commentary because the purchase of Sony was the quintessential value seeking/value creating opportunity that only a long-term oriented investor would have been able to identify and profit from. Although the Sony investment was a tactical decision within portfolios, it constituted virtually everything that goes into being a long-term wealth creating investor – seeing value where others do not, being greedy when the consensus is fearful, having conviction in your investment thesis in the face of here-and-now dire headlines, and importantly, giving an investment time to work. With Sony we forecasted up to two years for the restructure to get recognized by the markets and we were pleasantly surprised that this happened much sooner. Some investments payoff sooner than expected and others take longer than expected. This is why portfolios need to be diversified in order to spread the uncertainty of timing across twenty-five or thirty investments.

When we look a back on this Sony investment many years from now, it will appear as though we picked the bottom in that stock in early 2014. However, bottom fishing is not a primary focus within our process. The fact that we came close to picking the bottom is where experience, hard work, and luck converge. Luck is getting a 60% return by being in a position to make that initial investment in January as opposed to April or October when the entry price would have been $19 to $20 per share. Had we entered the stock at those higher levels, this would have reduced our short-term returns from 60% to 30% or 40%. In the context of owning Sony shares over the next several years, the difference between buying at $17 per share versus $20 per share will prove insignificant if our thesis continues to be correct on the company's turnaround.
If you are a Seven Summits Client, the next time that you look at your stock portfolio, instead of taking note of what went up or down from the previous month, think about Sony and how for almost twelve months the stock

price bounced up and down between a small loss and a small gain. Reflect on the fact that those twelve months provided no predictive value whatsoever in terms of whether or not the investment thesis ultimately proved correct. A stock investment is not a "what have you done for me lately" proposition, it is instead a two to five year value creating tactic within the context of your overall ten plus year investment strategy. Every security in a Seven Summits Capital portfolio enhances the diversification of risk and has a well-defined value target with time being the necessary catalyst to realize the desired wealth creation.

A PEEK INTO WARREN BUFFETT'S SHAREHOLDER LETTER

I will end this month's commentary with a couple excerpts from Warren Buffett's 2014 Berkshire Hathaway letter to investors that was just released on February 28th. I marvel at the simplicity of Warren Buffett's wisdom which he conveys in his annual letters. Here are just a few passages that pertain to the general subject matter that I covered this month:

"For the great majority of investors, however, who can – and should – invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities (cash and bonds)".

"It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents."

Toward the end of the letter Mr. Buffett reminds investors who might be thinking about purchasing new shares of Berkshire Hathaway that "since I know of no way to reliably predict market movements, I recommend that you purchase Berkshire shares only if you expect to hold them for at least five years. Those who seek short-term profits should look elsewhere."

Although at Seven Summits Capital we set equity target prices based upon an 18 to 24 month time period, we remind clients that to own stocks in a portfolio, the money invested should not be needed for at least five years because of the uncertainties that come with investing in the public markets.

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