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MAY 2014 INVESTMENT COMMENTARY

FEELING DAZED AND CONFUSED? YOU ARE NOT ALONE.

Where did April go? Admittedly, last month's commentary was sent out a week late. But April seemed to fly by excessively fast. However, luckily, I had the opportunity to speak with several existing clients and many new prospective clients over the course of the last month. The one thing that struck me from these conversations was a general level of complacent confusion, a state of mind that I found unfamiliar. Complacency and confusion are common among investors, but usually they are mutually exclusive, with complacency occurring at times when the stock market has risen over a long period of time and volatility was muted, and confusion occurring when markets are directionless and volatility is heightened.

Today, I am witnessing a blend of these two states of mind. Investors are ecstatic over last year's stock returns and hoping for another good year. At the same time, many investors are making decisions that are excessively defensive out of confusion about where in the economic and market cycle we are today. This behavior is no more evident than in the area of the market made up of high multiple/high growth companies which have experienced a sharp correction over the last two months. Some of these stocks had valuations that were fundamentally unsupportable; however many have valuations that are deserved. The beneficiary of this correction has been the defensive slow growth/high dividend paying companies.

After a 30% advance in the broad U.S. equity market last year, investors appear to be hopeful, but at the same time uncomfortable and confused, which is leading to a multitude of poor choices that are currently affecting the markets. As said by Bob Arnott, an award winning author and well-known investment manager, "in investing, what is comfortable is rarely profitable".

Today's complacent and confused investor clearly appears in the latest American Association of Individual Investors (AAII) survey of investor sentiment that was released on April 30 with the following results:

SENTIMENT	LATEST READING	WEEKLY CHANGE	HISTORICAL AVERAGE
Bullish	29.8%	-4.7%	39.0%
Neutral	40.8%	+1.3%	30.5%
Bearish	29.4%	+3.4%	30.5%

Looking at the distribution of the responses to this poll, it is unsurprising that the market seems directionless and that corrections are not being bought as aggressively as they have been in recent years. At the beginning of the year, I discussed this possibility when I said, "Most economists expect the economy to remain stable and improving throughout 2014. Counter-intuitively, this better economic outlook may present a challenge for broad domestic equities because the contrarian investor, who has aggressively bought the (former anxiety ridden) market dips over the last several years, may be less inclined to buy those dips as enthusiastically". The only economic change that has occurred since the beginning of the year has been signs of sluggish U.S. growth in the first quarter of the year.

Most economic forecasts for 2014 are still calling for 2.5% to 3.0% GDP growth, in spite of a much harsher than expected winter that undeniably dampened first quarter GDP. Due to this economic slow-down, bond yields have fallen and growth companies, whose stocks performed strongly in 2013, have seen their stock prices correct sharply. Thus, this air pocket that the U.S. economy hit during the first quarter has seemingly surprised investors and caused them to question their previous assumptions.

Sensing somewhat stretch valuations, we began to harvest some profits in some of our big 2013 winners late last fall. With those proceeds we began to add a number of out-of-favor stocks to portfolios. We have continued making these purchases, while also adding to our high conviction growth company investments during the recent pull-back.

Due to our flexible investment style here at Seven Summits Capital, we have the ability to avoid style-box restraints and instead, seek value across the investment style spectrum. This flexibility allows us to seek out relative value. Below, are some examples of relative value, names of both growth and value companies, where we see opportunity at current price levels:

EXAMPLES OF SEVEN SUMMITS CAPITAL "VALUE" STOCKS:

COMPANY NAME	1 YR FORWARD P/E	FORWARD EPS GROWTH*	PEG RATIO*
Celgene	15.27	25.95%	0.78
General Motors	7.31	24.58%	0.30
NXP Semi-conductors	12.05	34.00%	0.40
Freeport McMoran	10.83	31.50%	0.34
Average	**11.36**	**29.00%**	**0.45**

EXAMPLES OF TRADITIONAL "VALUE" STOCKS:

COMPANY NAME	1 YR FORWARD P/E	FORWARD EPS GROWTH*	PEG RATIO*
Merck	15.56	05.21%	2.98
Exxon Mobil	13.38	06.41%	2.08
Duke Energy	15.36	08.22%	1.86
Proctor & Gamble	17.92	11.48%	2.12
Average	**15.55**	**07.83%**	**2.12**

** Dividend Yield is added to Long-Term EPS Growth Rate.*

In the above illustration, I contrasted a sampling of stocks that we have identified as under-valued on an absolute basis and very under-valued relative to their expected EPS growth rates. This relative value is illustrated using a price earnings ratio-to-growth rate (PEG) measurement. Since we are making a comparison to traditional value stocks, which are typically owned in part because of their above market dividend yields, the illustration adjusts growth rates for dividend yields (an adjustment used by Peter Lynch of Fidelity Magellan Fund fame).

Typically, when value managers are measuring stocks using a PEG ratio, a PEG ratio under 1.00 is considered very attractive and a PEG ratio over 2 signifies over-valuation. As seen above, the Seven Summits Capital examples exhibit forward EPS growth expectations that are 3.70 times higher than the growth rates expected from the "traditional" value stocks. This is to be expected because our stock selection process generally seeks to identify growth companies. However, at the same time, we seek out attractive relative valuations. The illustrated Seven Summits Capital equity examples are selling at a price that translates into a PEG ratio that, on average, is very low at .45:1; whereas the traditional value examples are selling at a price that translates to a PEG ratio of 2.12:1.

So where's the opportunity in a collection of value stocks with an average P/E of 15.55 and a dividend adjusted PEG ratio above 2.00:1? We do not currently see a compelling case to owning such stocks. Seven Summits Capital's unconstrained stock selection process allows us to invest in stocks beyond the typical large and mega-cap U.S. equity market.

Although the four illustrated equities are each large-cap stocks, an example of our unconstrained process is a micro-cap company that was purchased last year. This company will go unnamed, but has an expected long-term EPS growth rate of 17%, a dividend yield of 5.30%, a forward P/E of 13.61, and a "dividend adjusted" PEG ratio of 0.61. This micro-cap stock is not a high beta biotech or technology stock, but a low beta consumer staple company.

Finding and investing in a stock, such as the aforementioned micro-cap company or the other illustrated Seven Summits Capital equities, requires one to think as a long-term investor. Long-term investors identify value by using a discounting methodology of future earnings or cash flow, and at times, the sum of the parts of a business using normalized growth and profit margins. Once these determinations are made, an investment can occur using a risk-controlled discipline. However, that is the easy part. The hard part is to make such investments without constraining the investments arbitrary time horizons. In other words, identifying value and executing a buy process is only the beginning of a successful investment. The more difficult aspect of making a successful investment is having a strong enough conviction in the investment in order to give that investment a sufficient amount of time for the market to also recognize the value that you see. The qualitative part of this analytical process is coming to grips with the realization that the investment time horizon is unknowable.

We have discussed and illustrated why true "value" is not always found within stereotypical "value" stocks. This is a challenging concept for a lot of investors. However, another challenging task for a lot of investors today is attempting to make sense out of the continual flow of economic data. For example, the Federal Reserve is stating that the economy is getting stronger, which contrasts with the first quarter U.S. GDP report that showed an economy growing at 0.10%. The last three months of job creation averaged 237,000 per month, which was the best three month period of job creation since the financial crisis ended, but falling bond yields and copper prices are signaling weakness. These seemingly contradictory data points can certainly cause confusion when viewed in real time, without the benefit of trend analysis and an understanding of the limitations of these statistical based estimates that will be revised over and over again for up to two years.

The last five years have been very difficult for many investors because of crisis induced uncertainty. During these years the market volatility was heightened because of the uncertainty over very worrisome problems. Today uncertainty still exists, but in my opinion, today's uncertainty is less caused by worry and more so by confusion. From my perspective, this confusion is causing investors to pull back from many investments that require looking beyond the next 30 days or even 30 months and seek refuge in either cash or investments which are blindly thought of as safe. E-Trade recently conducted a poll of 900 of their individual investors and asked them to name a movie title that best summed up how people currently feel about the market. The number one response was Dazed and Confused.

At Seven Summits Capital we work very hard to be informed and focused enough to avoid being confused about important things such as where to find value and what constitutes economic reality. To us, value is not a fluid concept that changes based upon the level of comfort that we may feel at a given time in the market.

When we look at the economy in order to gauge its strength and direction, we base our outlook on longer-term trends which minimize the distortion in investor sentiment that can be caused by recent data releases that do not meet expectations.

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