SEVEN SUMMITS CAPITAL

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MAY 2015 INVESTMENT COMMENTARY

UNDERSTANDING THE BASIC PRINCIPLES OF VALUATION REMOVES THE FEAR OF INVESTING IN EQUITIES

Surprise! Last year's worst performing sector, Energy, has been the best performing sector during the past month. This strong performance for the Energy Sector in April means that year-to-date, through April 27th, energy stocks within the S&P 500 are only slightly trailing the index itself by 0.30%. Although oil prices still remain over 40% below the prices seen just 10 months ago, economic growth is tepid, both domestically and abroad, and energy related stocks have performed very strongly since the beginning of 2015. Many traders and market watchers missed this turn because instead of focusing the "real" value of the company behind the stock, they instead were focused on technical trading levels of the stock itself or held overly pessimistic short-term forecasts of oil prices.

On the opposite end of the spectrum, as I cautioned readers many times in the months leading up to the end of 2014, the Utility Sector was grossly over-valued. Unsurprisingly, year-to-date through April 27th, this S&P 500 sector was by far the worst performer, with a negative 4.90% price performance since the beginning of the year.

As readers of this commentary know, Seven Summits Capital does not spend any time valuing sectors or attempting to forecast such returns. However, as a result of continuously sifting through publicly traded companies looking for investment opportunities that meet our criteria, we sometimes end up inadvertently seeing valuation extremes across entire industry sectors. This is what occurred, when late last year we concluded that the Energy and Utility Sectors of the S&P 500 had reached opposite extreme valuation levels. The Energy Sector experienced such a sharp sell-off during the second half of 2014 that valuations, based upon even a conservative assumption of normalized earnings in the future, looked extremely attractive. Conversely, with a 29% advance in 2014, on top of already stretched valuations due to investors "reaching" for yield over the last several years, almost all traditional utility companies that we looked at appeared over-valued based upon almost any historical measure.

Much like how searching for suitable investments among the universe of publicly traded companies can inform you about the attractiveness of entire sectors, the same exercise can also inform you about the broad stock market itself. For example, beyond the extreme under-valuation conditions that existed among energy stocks, since the beginning of the year it has been becoming increasingly difficult to find 25 to 30 sufficiently under-valued companies at a given point in time. Instead, we find that we need to be more patient than usual and wait for periods of broad market weakness or short-term company specific driven stock price declines in order to find an acceptable entry point when putting new money to work. Times like this inform us that broad markets are mostly fully valued.

A fully valued broad stock market does not mean that a large correction is right around the corner. Historically speaking, a large correction is just one way that market valuations can be lowered. Another way that valuations can decline is a period of below trend price appreciation relative to corporate earnings increases. Thus, sideways stock prices over a period of growing earnings can sufficiently lower market valuation metrics and make the market and stocks themselves attractive again. Such a market would be characterized as "sideways" and instead of P/E multiple expansion, the opposite would occur. Given the current state of the economy and corporate profit margins, a less likely way for valuations to become more attractive is for broad corporate earnings to be unexpectedly strong for a sustained period of time.

Many investors will automatically characterize a fully valued S&P 500 as dangerous for fear that such a valuation level increases the risk of a large correction or worse. As long-term investors, we do not fear corrections and a more severe downturn would only typically accompany a deep recession, which appears to be a remote probability. In order to adjust for rising valuation levels across the broad market, we continually work to calibrate our portfolios by replacing high valuation positions with ones where valuations create a more acceptable risk adjusted return expectation. Many times this means selling or reducing strong performers and buying into companies whose stocks are out of favor. By adding to weak stocks during periods of extreme pessimism, such as with energy companies five or six months ago, or building a position in a very out-of-favor company like Freeport McMoran during a cyclical downturn, we add balance to a portfolio. These portfolio tactics are often challenging for some investors to understand because human nature dictates that one seeks out the comfortable choice over the uncomfortable. However, for Seven Summits Capital nothing is more comfortable than using profits from a strong performing stock that is now trading at or above a fundamentally justified valuation level, to buy shares in a temporarily out of favor company at extremely attractive valuation levels. These tactical portfolio moves lower the valuation profile of the portfolio and provide exposure to stocks that will tend to outperform the market when concerns over valuation and earnings are heightened. April was one of those months when these tactics paid off. Energy was one of the best performing sectors during an otherwise flat broad market month and previously out of favor Freeport McMoran rose 18%. The axiom that all investors know that calls for buying high and selling low makes a lot of sense to most investors in theory, but in practice very few investors can actually execute such a simple tactic.

After 20 years of managing portfolios through some of the most volatile markets that have occurred over the last 70 years, I have learned that there is very little to fear from the stock market if one maintains a focus fundamental valuation. Valuing a stock based upon fundamentals means that one focuses on the cores strengths of a business and "normalized" earnings and growth. This means that one has to avoid extrapolating current peak or trough level earnings into the future, which is a common error that many investors make. Companies represented by publicly traded shares have intrinsic value underpinned by asset values, goodwill and competitive advantages. However, for most investors, these factors are overshadowed by the short-term price gyrations caused by the volatility of the market itself. Counter to what many investors believe, stock prices are generally not a great proxy for intrinsic value. Many investors fear stock price volatility because they do not know what information is important and thus, they do not know what to unpin their investment decision upon. The inability to know what should unpin an investment decision creates fear of the unknown. Take away this fear of the unknown and the fear of the markets dissipates. A colleague of mine likes to say that F.E.A.R. stands for ***False Evidence Appearing Real***. Experiencing first-hand how an otherwise rational thinking person can become irrational in the face of negative market or individual security price action, I completely concur with this acronym.

Over the last 12 months I wrote about the intrinsic value that was not being reflected in Sony stock when it was trading in the mid-to-high teens, as well as what I saw as fair value estimates for our core holding in Facebook, looking out over the coming years. Over the last twelve months, and after an 80 percent plus appreciation in Sony Corp. stock, the valuation of this under-appreciated franchise is now within 10% of my initial assessment of fair value. In terms of Facebook, since writing about lowered price appreciation expectations in November 2014 for the company's stock over the upcoming 18 months, the stock has traded in a narrow range between roughly $75 and $85 per share. Our fair market value for Facebook's stock in 2015 is $77 per share, $85 in 2016, and up to $109 per share in 2016. These estimates are not static and I can and will revisit them many times as new information on the company's business execution becomes known.

The aforementioned focus on fundamental value in the case of Sony and Facebook are just two examples of how we underpin our investment decisions with fundamental metrics, eliminating much of the uncertainty that can create fear among many retail investors when it comes to owning equities. In practice, the examples above informed us to take an above average size position in Sony within portfolios and reduce and hold Facebook stock as an under-weight core holding. These informed decisions enabled portfolios to benefit from large gain in Sony stock over the last 15 months and allowed for a portion of a 200% gain in Facebook stock to be reinvested in other opportunities.

The ability to make informed decisions gives our clients' portfolios purpose. This purpose can generally be thought of as long-term wealth creation, with each client's unique goals and time horizons dictating the delicate balance between short-term volatility and long-term return. Everything that was discussed in this month's commentary is unique to active management. I am a strong believer in active management when it comes to building wealth; however I believe that active management is most effective during times of extended valuation or significant under-valuation within the broad markets. In my opinion, we are currently much closer to a valuation level in the broad markets that justifiably can be characterized as extended.

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