SEVEN SUMMITS CAPITAL

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MAY 2016 INVESTMENT COMMENTARY

MORE TIMES THAN NOT, WHEN INVESTING, BEAUTY IS IN THE EYE OF THE BEHOLDER

On April 26th, Apple disappointed the market with a year-over-year decrease in the units sold of the company's dominant iPhone. Also, the company recently announced a lower price point smaller iPhone, known as the iPhone SE. The year-over-year contraction in iPhone sales and the new lower-priced iPhone SE raised concerns over the company's ability to generate growth, as well as the sustainability of the company's profit margin. The resulting media buzz that accompanied the release of Apple's quarterly results was swift and pessimistic. These quarterly results were treated as an inflection point that marked the beginning of the end of Apple's legacy of innovation, growth, and strong stock performance. Apple's stock reacted in kind by dropping over 10%, back to levels not seen since the end of 2014.

At Seven Summits Capital, we will never be accused of being a cheerleader for any particular stock, and we will not start with Apple. Apple is a core holding within many Seven Summits Capital client portfolios. It was initially purchased over a year ago, at a level similar to where the stock trades today. That reentry into Apple stock came after several years of not owning it due to concerns over the lofty expectations that fueled a doubling of the stock price from the beginning of 2011 to the end of 2014. Momentum investors had pushed Apple's stock too far, too fast based upon the euphoria associated with a fixation on quarter-to-quarter performance. My reason for staying away from Apple for many years was a concern regarding the challenges of being a $600-$700 billion market cap company, along with the phenomenal success of the iPhone in taking market share, and what that size and success portend for the company's future growth potential.
The most recent Apple quarterly results reflect the impact of my concern about the company's growth challenges. Apple stock, at current levels, is again trading at a significant discount to the overall market, and expectations for future growth potential are now more reasonable. Compared to other high quality, high cash flow American consumer products companies such as Coca-Cola, Proctor & Gamble, and McDonalds, the market is awarding Apple a valuation that is 40% to 50% lower. My assessment is that this growing disparity makes Apple stock very compelling today.

It would be a fair question to ask why Seven Summits Capital purchased Apple stock over the last 18 months if we anticipated the current growth challenges that are coming to light. To us, the answer to such a question would be that our investment thesis for owning Apple was one of slow revenue growth, a fortress balance sheet, sustainable cash flow, and an increasing dividend. Thus, Apple was purchased as a value driven investment, as opposed to a growth driven investment that the market had still held out hope that it would be once again. We felt that the price that we paid reasonably reflected Apple's true prospects. The broad market was very stubborn in its willingness to capitulate to this reality. As Apple investors, we did not have high hopes that Apple's stock would rise 20% to 30% over the coming 18 to 24 months and thus we are not disappointed or surprised at Apple's recent stock performance. The broad market is just now coming to grips with the fact that Apple can no longer be the high growth type of company that it was for most of its existence. This transition, in the minds of investors, from a growth-driven investment to a value driven investment, for companies such as Apple is a process that is difficult to time. For instance, there was a time when Coca-Cola and McDonalds were high growth companies, and their stocks were highly sought after by high growth-seeking investors. The history of companies such as Coca-Cola and McDonalds provides an important lesson for investors - great success leads today's growth stocks to become tomorrow's value stocks.

It is our belief that Apple will continue to innovate and thrill consumers with product enhancements and occasional new product categories. However, unlike the past, Apple's innovation and new products cannot generate enough incremental revenue growth to push growth rates back to the sustainable 10% to 20% levels necessary to become a "growth company" once again. However, what Apple has become is exciting in its own right. Apple has become a blue-chip company that will continue to return excess capital to shareholders through consistent dividend growth and share buybacks. Once the market begins to compare Apple stock to company's such as Coca-Cola, Apple stock should find a new constituency of investors that will be willing to pay a much higher multiple for the quality of Apple's balance sheet, the consistent return of capital and the durability of its brand.

Investing is at its core all about the future and one's perspective about expected outcomes. Therefore, beauty is in the eye of the beholder. There are scores of Apple investors who expected stock return outcomes similar to the one's that Apple stock produced over the preceding 10-15 years who have been very disappointed with the recent stock performance. We have not been disappointed because our perspective on Apple matched the company's slow growth, dividend raising, stock buy-back oriented, current state. In fact, Apple is in such a strong position that our research provider, Valuentum Institutional, stated the following regarding this quarter's financial results: "on the trailing six-month relationship between free cash flow and cash dividends paid, Apple can raise its dividend at a 10% compound annual growth rate for the next 18 years, and that doesn't assume any improvement in free cash flow generation on the basis of the current six-month run rate or consider its $161 billion net cash position, which covers current annual dividend payments nearly 14 times by itself. Apple is going to be raising its dividend for a very, very long time". Apple may no longer be the growth stock that it once was. However, it has become, with very little fanfare, a fantastic dividend growth story.

Many Seven Summits Capital portfolios own stocks like Apple, which are not expected to produce eye-popping share price gains, but instead are expected to be safe and steady companies that produce significant cash-flow which can support impressive returns of capital through dividends and share buy-backs. Many of those same portfolios also own growth stocks such as NXPI Semiconductor, Whitewave Foods, and Celgene. Virtually all Seven Summits Capital equity investments, value or growth, have one thing in common. That one thing is that they are sustainable businesses and innovative leaders within their respective industries.

We believe that most investors benefit from the diversification of owning sustainable businesses across varying industries, representing differing stages of the corporate lifecycle. Thus, a well-diversified portfolio will include companies with a market cap as small as several hundred million dollars, all the way up to a company such as Apple, which is the largest company in the world. It would be far easier if there were a plentiful supply of "growth at a reasonable price" stocks, however with today's economic backdrop, what growth companies exist have stocks that are anything but reasonably priced.

With today's very low U.S. and global economic growth, finding companies that can generate organic growth more than 10% is becoming more difficult, especially among large and mega-cap enterprises. Therefore, core total return portfolios are becoming more barbelled, meaning that more small and mid-cap companies are needed to represent true growth-oriented equity investments while much larger companies are integral in providing a return of capital in the form of growing dividends. It is becoming more and more challenging to find sustainable business models that can deliver higher than market earnings growth, a relatively low valuation, and a growing stream of dividend payments. As discussed above, Apple stock currently meets that criterion. Other stocks exhibiting the factors that we saw in Apple within Seven Summits Capital portfolios include Honeywell and Abbvie.

Occasionally I identify a company's sustainable attributes before the majority of market participants. If I am fortunate to remain invested in such a company through periods when the stock exceeds any valid definition of being reasonably priced, a very profitable investment usually ensues. The most recent example of such an investment is Facebook, which has quadrupled since we originally added it to portfolios. The consensus when we originally acquired our stake in Facebook was one of skepticism. However, within months of making our original investment, Facebook began what would be an unprecedented explosion of growth and profitability that continues today. Unlike other high growth favorites such as Netflix, whose stock has performed very strongly over the last couple years, Facebook's financial performance and balance sheet strength has underpinned the lofty expectations that are reflected in its stock price. Because Facebook's financial performance has been so consistently strong, I view its lofty valuation as far less speculative than many other hyper growth companies.

We believe that investing is about identifying value based upon the relationship between current prices of a stock and a future value derived from reasonable expectations. The stock market is very good at convincing participants that investing should be seen as a game of timing and momentum. I always have disavowed such attempts at gaming the market. From Warren Buffett's Q&A during the Berkshire Hathaway Annual Meeting on April 30th; Mr. Buffett commented that "you don't want to get into a stupid game just because it is available." He was referring to the market's short-term fixation and all of those who get caught up in that game.

The market's reaction to Apple's quarterly results gave me a reason to talk about investing in companies where we see a sustainable business model and future value. Many clients know first-hand that when I get started on topics that involve individual businesses that, it is hard for me to stop. Therefore, I will impose self-control and end this discussion at this point.

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