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MAY 2017 INVESTMENT COMMENTARY

WITH THE MARKETS RUNNING HOT ON SENTIMENT ALONE, WE FALL BACK ON FUNDAMENTALS

I will once again invoke a passage from Howard Mark's book, The Most Important Thing – Illuminated, which I recently reread and quoted from extensively in last month's commentary. Toward the end of the book, Marks wrote about the futility of attempting to time shifts in market cycles by stating, "It's impossible to know when an overheated market will turn down, or when a downturn will cease, and appreciation will take its place. But while we never know where we're going, we ought to know where we are. We can infer where markets stand in their cycle from the behavior of those around us. When other investors are unworried, we should be cautious; when investors are panicked, we should turn aggressive." As of the writing of this commentary, the implied volatility of the U.S. stock market, otherwise known as the VIX, recently hit a 24 year low. The VIX is one of the most reliable measures of both market complacency and fear. At a 24 year low, the VIX is indicating an extreme level of investor complacency at present the present time.

When market sentiment changes in a noticeable way or indicators such as the VIX are at extremes, an investor must ask what fundamental changes have occurred to support current sentiment? Being aware of the juxtaposition between sentiment and fundamental realities helped me to avoid becoming defensive over the last nine years when confronting market moving events such as the 2011 debt ceiling negotiations, the 2012 Arab Spring/Greek Debt related sell-off, and the 2014 Ebola virus market correction. Market sentiment is unpredictable, fragile and is usually perpetrated by herd behavior. I have a habit of poking fun at myself when I am seemingly stoic in the face of market exuberance or panic by analogizing this non-reaction as "spock-like." However, in reality, my reaction or in most cases non-reaction is simply driven by avoiding being seduced by sentiment changes that are unsupported by fundamentals.

Just recently, on May 12th, CNBC published a story titled "Goldman is Starting to Get Worried Wall Street is Acting to Calm About Trump." This article stated, "Goldman noted policy uncertainty is growing as the Republican-led Congress tries to tackle a number of issues, including tax reform, with the House being in session for just 39 days before the August recess. But the CBOE Volatility Index (VIX) Wall Street's preferred fear gauge, posted its lowest closing level since 1993 on Monday, as most investors still believe the White House and the GOP will be able to move forward with tax reform. This dichotomy gives Goldman "cause for pause." I rarely discuss technical indicators such as the VIX because I largely am able to look through short-term shifts in market sentiment. However, I do take notice when such indicators reach extremes, such as the VIX hitting a 24 year low. For me, a fear index hitting a multi-decade low is a flashing yellow light, just as the VIX hitting multi-decade highs in late 2008 and early 2009 represented a flashing green light.

For me, being contrarian in the face of extreme pessimism or optimism comes naturally and stems from a focus, when it comes to equities, on present day value as a function of normalized long-term fundamental assumptions. Cyclical highs and lows in stock prices, driven by both the business/economic cycles and vacillations in market sentiment, are expected and are simply links in a chain of events that move a stock price in what becomes a price discovery mechanism that is continually seeking a fundamentally supported equilibrium. The best way to illustrate this is to look at the history of successful company's stock price. For example, let's examine Sony Corp. (ADR) using Morningstar.com charts below:

Seven Summits Capital initially established positions in Sony Corp. in the early months of 2014 between $16.00 and $17.00 per share. The chart above represents the time period between September and December 2014.

When doing the initial research on Sony Corp., prior to the purchase of the stock, I had established an intrinsic value price target of around $28.00 per share. The chart below represents the summer months of 2015.

Over the first couple of months in 2015, Sony Corp. turnaround was finally beginning to get investors' attention, and the sentiment on the stock improved greatly. This improved sentiment helped the stock rise to over $30 per share by June of that year. By this time I had already pushed the top of my price target range to $35 per share. However, in many accounts, I did begin to trim the now over-weight sized positions while the price hovered around $30 per share. The $30 price level was fleeting as the stock sold off almost 20% over the Summer months.

Sony's stock weakened further as 2015 came to an end. 2016 saw a trading range between the low $20's and low $30's, which provided opportunities to add to some existing positions, as well as the ability to establish some new positions in accounts that previously had not had the opportunity to purchase Sony stock.

The chart at the bottom of the previous page shows Sony's stock price from June of 2014, approximately five months following our initial purchases. Those first five months contained no good news coming from the company, and its stock continued to vacillate above and below our initial purchase prices. Nonetheless, I kept a watchful eye on all of the news coming from the company and remained ever confident that the current stock price level was grossly depressed due to very pessimistic market sentiment surrounding this company. Once again sentiment provided opportunity.

By March 2015, I was ready to address the Sony investment in that month's commentary. I stated, "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%." I communicated this success to illustrate the success of our process. I went on to say, "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."

I will always take the opportunity to illustrate the power of research, discipline, and conviction when it comes to investing in a market that over short periods of time, is largely driven by sentiment.

Looking at the interim charts of Sony shown above, one can see, when viewed three to six months at a time, that sentiment was driving stock price volatility, while fundamental continued to improve. Only research, a focus on fundamentals and a little luck can provide a clue as to how a stock should be priced in the future. In the aforementioned March 2015 commentary, I concluded the discussion of Sony by stating, "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." Over the last several years Sony has not been the only stock which validated the Seven Summits Capital investment process. There were many others such as Whitewave Foods, NXP Semiconductors, Jazz Pharmaceuticals, Coresite, Iron Mountain, and many others. As I look at portfolios today, I see many success stories, as well as some big disappointments that will haunt me for a long time. However, I know that two years from now many of the more recent positions will provide me the opportunity to illustrate once again the power of following an ever-improving process built upon discipline and conviction.

An investor that lacks a process and a discipline that he or she can believe in is by definition, not a professional investor. The lack of a process and discipline renders an individual rudderless and subject to looking to market sentiment for guidance, instead of fundamentals. I will always ensure that Seven Summits Capital remains grounded in a fundamentally driven discipline which allows us the luxury of looking through short-term swings in market sentiment. Today's sentiment is indicating that we are in the midst of a new and more vibrant bull market. For many reasons, I am not going to join the horde of investors who are more than willing to ignore all of the signs that this overly bullish sentiment might be a false signal. It is very easy to follow the herd when markets are rising. 2017 will be a year of caution and prudence for Seven Summits Capital.

It is important to recognize that caution does not mean lack of participation. If the indicators that I see which are flashing yellow turn out to be incorrect, Seven Summits portfolios will not be caught uninvested or substantially hedged. However, if those flashing yellow indicators are correct, we will not be riding the largest wave when conditions worsen. Therefore, we will avoid being pulled so far under that we cannot easily recover.

The current bull market in stocks, which began in March 2009, is one of the longest and most durable bull markets on record. The apparent sentiment that last year's election breathes new vigor into an eight-year-old bull market is hard to quantify given an elevated level of fiscal policy and geopolitical uncertainty. So far, the U.S.'s first quarter GDP reading resembles the last several year's sub one percent readings, and the monthly employment figures have not meaningfully accelerated over the trends that had been established before the election. Business capital investment and productivity readings are failing to register any meaningful uptick since the beginning of the year. We have seen corporate profits improve after a year and a half pause. However, this was predicted long before the results of last November's election were known. The corporate profit "recession" that began in 2015 was largely the result of a late 2014 crash in oil prices and the resulting losses experienced by the energy sector and related industries. Recovering oil prices put an end to the "earnings recession", not some magic "animal spirits" elixir unleashed post-election.

Until such time when sentiment and fundamentals are better aligned, I am compelled to discount swings in sentiment and keep my focus on hard data such as the financial reporting of the companies that we hold in portfolios, economic trends, bank lending, and the balance between fiscal stimulus and monetary contraction. I expect the current period of muted volatility, and the complacency that has symbolized the post-election market sentiment to come to an end sooner than later.

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