SEVEN SUMMITS CAPITAL

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SEPTEMBER 2015 INVESTMENT COMMENTARY

THE STOCK MARKET - UNDERSTANDING SHORT-TERM PRICE ACTION:
WHO IS RESPONSIBLE? WHAT DRIVES THEIR ACTIONS? WHAT IS A VALUE-SEEKING INVESTOR TO DO?

After almost nine months of extremely low volatility within a very narrow band in the U.S. equity markets since the end of 2015, volatility came roaring back into the markets during the last ten days of August. Over the last week of August, the U.S. and international broad equity markets fell into panic mode with 3% to 5% single day swings on very high volume. These types of swings provide further support that public markets are anything but efficient in the short-term. Over the short-term, traders and market-tracking investors control prices of public securities, whereas over longer periods of time, rational valuation based upon the underlying real world fundamentals drive price levels.

The last ten days of August woke investors up from a long period of complacency; however, the U.S. stock market had been drifting down since the beginning of June. The S&P 500 fell 8% from June 1st through August 27th. This decline was mild compared to the performance of some of the highest quality companies within the broad market as exemplified by the three month returns of the following stocks:

Apple (AAPL)	- 16%
Disney (DIS)	- 11%
Caterpillar (CAT)	- 14%
ExxonMobil (XOM)	- 15%
Walmart (WMT)	- 13%
IBM Corp (IBM)	- 13%
Time Warner (TWX)	- 15%

At Seven Summits Capital, we spend a lot of time monitoring the price levels of the stocks that we hold, as well as one's that we are hoping to buy if the price falls to a level that we find compelling. The price action of many stocks held in portfolios or on our watch list has recently experienced a heightened level of volatility. It seems appropriate, given the recent market volatility, to discuss the difference between price action/volatility versus value.

Price action and volatility garners all of the attention of financial journalists, TV personalities coving the markets, and the majority of investors. In fact, Bill Griffeth, CNBC's co-host of Closing Bell, admitted to viewers during one of the more volatile days of August that he was a long-term investor, but, as the host of a CNBC program, he must spend most of his time discussing the short-term aspects of the trading day. He clarified that CNBC focuses on short-term market action because discussing the attributes of long-term fundamental investing cannot compare to the excitement of tracking the price action throughout a trading day.

Price action, as we have witnessed recently, can be very disorderly. Given this reality, it is very important that one understands who is actually behind all of these trades that make the market go up and down every day.

On April 19, 2013, SEC Commissioner Louis Aluilar gave a speech titled, "Institutional Investors: Power and Responsibility." In this speech, Commissioner Aluilar stated that "institutional investors are dominant market players" and cited a study from 2010 that concluded that institutional investors held 67% of all U.S. publicly traded securities. The speech touched on the effects that an increasing dominance of institutional investors have on the markets. The Commissioner stated that this increased institutional participation has "resulted in huge increases in trading volumes. For example, in 1990, the average daily volume on the NYSE was 162 million shares. Today, just 23 years later, that average daily volume is approximately 2.6 billion shares — an increase of about 1,600%." The Commissioner's speech was careful to point out that not all institutional investors are the same and that "they have a wide variety of distinct goals, strategies, and timeframes for their investments. As a result, their interaction with, and impact on, the market occurs in many different ways." Due to the fact that institutional investors employ a wide variety of different strategies and tactics, if we are to put short-term market volatility into proper context, the influence of these dominant forces on the markets must be understood.

In a May 2014, the Brookings Institute published a paper written by Robert C. Pozen, titled, Curbing Short-Termism in Corporate America: Focus on Executive Compensation, in which Mr. Pozen cited the work of Dr. Brian Bushee, Professor at the University of Pennsylvania, Wharton School of Business, who divides institutional investors into three categories, "quasi-indexers," "dedicated investors," and "transient."

According to Dr. Bushee, sixty-one percent of institutional shareholders are "quasi-indexers", eight percent are "dedicated" investors, and thirty-one percent are "transient investors." Dr. Bushee's definitions of these investor categorizations are shown below:

- Transient institutional investors hold well-diversified portfolios of publicly traded securities: they pursue short-term profits through high turnover of their portfolios and heavy use of momentum trading.
- Dedicated institutional investors have substantial investments in a relatively small number of portfolio companies; they hold a high percentage (often over 75 percent) of their portfolio shares for two years or more."
- Quasi-indexers fall between the two other categories of institutional investors; they have highly diversified portfolios of publicly traded securities, and also a high degree of ownership continuity since they seldom trade."

Thus, according to Mr. Pozen and the Brookings Institute, ninety-two percent of all institutional investors are either short-term traders (transient) or index trackers (quasi-indexers). Combining the aforementioned data from the SEC Commissioner in 2010 with the work of Mr. Pozen, it appears that only eight percent of what the SEC Commissioner called "dominant market players" would be classified as fundamentally oriented long-term investors.

At Seven Summits Capital, we fall into the category of a "dedicated" investor. This means that on any given day, we belong to small group of investors that constitute less than ten percent of security ownership. Therefore, we know that the bulk of short-term market price action will be driven by the other ninety percent of institutional investors. Knowing this makes it very easy to rationalize our indifference toward short-term market volatility. With roughly ninety-two percent of institutional market participants focused on short-term trading or market-following strategies, the resulting volatility and momentum that occurs will be either ignored or capitalized on by longer-term oriented investors, such as Seven Summits Capital.

The purpose of illustrating what type of investors drive short-term price action is to highlight why we are not surprised or alarmed by large swings in the market and will typically use such periods to take profits on the upside and add to under-valued securities on the downside. The only way that we know to be able to determine when to buy and when to sell is by having a good sense of security valuation levels.

The exercise of security valuation is only truly relevant to the "dedicated investor." Quasi-indexers do not consider valuation factors because they are locked into following the market wherever it may take them, such as when quasi-indexers followed the markets in 1999 by significantly over-weighting technology stocks. The transients, or short-term traders, are not driven by valuation considerations because they are mostly playing a speculative game of betting on near-term price action and are driven by technical price action factors, not fundamentals of the underlying entity. Only the dedicated, long-term investors, who focus on time horizons beyond two years, are concerned about valuing the underlying enterprise represented by the stock. It is this knowledge about valuation that underpins the long-term investor's conviction to hold or buy shares when the market is sending the opposite short-term message through price action.

The biggest difference between a "dedicated" investor, like Seven Summits Capital, and the other two categories is that we focus on the company versus they stock itself. Focusing on the company means assessing measurements of management efficiency, such as the company's return on invested capital, as well as the study of cash flow and profit margins versus peer companies. Unlike short-term trading oriented investors, we are more interested in comparing balance sheet and income statement metrics between like companies versus studying stock metrics, such as relative strength and moving averages.

Once we are satisfied that a company is well managed and efficiently allocating it's capital, we then determine whether the market has efficiently priced the company's stock relative to the attributes that we have identified. One way that we do this is using the analytical tools available to us through our affiliation with The Applied Finance Group. We can quickly determine whether future growth and profit expectations are properly reflected in the stock price.

Our work, as described above, is a broad generalization because each type of company requires a different approach to valuation. For larger and more mature companies, valuation is more straightforward; however, for smaller and faster growing companies, like Zillow (discussed last month), we must modify our approach.

Given the current heightened volatility within the markets and the sometimes extreme price movements that result among individual company stocks, it is very important to differentiate between current price action and long-term value. As a client of Seven Summits Capital, it is equally important to have an understanding that your portfolio holdings are purposefully owned and not subject to being traded based upon price action alone. We truly view market based volatility as extemporaneous and not overly meaningful relative to how we build and manage portfolios. Therefore, we don't look at price action as meaningfully indicative to future value; instead, it is something that we observe and take advantage of in order to enhance our clients' long-term wealth creation.

The recent spike in volatility has at times resulted in intra-day swings in the market that have been unprecedented and I chalk this up to an increase in automated trading. I have been extremely impressed by my clients who did not panic and in some cases contacted me to deploy additional monies to equities during this sell-off.

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