SEVEN SUMMITS CAPITAL

1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

JUNE 2015 INVESTMENT COMMENTARY

THINKING ABOUT RIDING THE MARKET TO MORE HIGHS – THINK AGAIN

If you are counting on the stock market to continue to be the engine by which you grow your wealth or generate a total return in excess of your withdrawal rate in retirement, you will likely be disappointed. According to Ray Dalio of Bridgewater Associates, Warren Buffett, or market forecaster Jeremy Grantham, stock market returns are very likely to disappoint over the next five to seven years

As we enter the seventh year following the 2008 financial crisis, with the S&P 500 having posted six straight years of positive returns, five of which exceeded the long-term average return of this index, an investor who simply relies on the broad market for gains should begin to question what lies ahead.

At the beginning of last year, I began to write about stretched valuations at the market level and, in January, I spoke about mounting imbalances and distortions in the capital markets. My preference when managing money is to simply keep my head down, research investment opportunities in search of compelling risk/return opportunities, all the while ignoring the noise generated by those who obsess over the ups and downs of the market. However, as I have conversations with investors of all ages and levels of wealth, I listen carefully for signs of both complacency and the desire to chase the market.

What is interesting is that many investors who I have come in contact with recently possess two opposing forces, the desire not to miss out on market gains and the fear of losing portfolio value that has been generated over the last several years. On one hand, they fear another “2008-like” market crash and, on the other hand, they have become complacent with the highly marketed idea that by simply investing passively in the markets, one can successfully achieve superior investment outcomes. Thus, there appears to be a great dichotomy within the investing public today: 2008 is still fresh in the minds of investors, but, after six years of consistent positive U.S. stock market returns, the idea of “easy money” has become hard to resist.

Previously, I have written about the common, yet mostly misguided, fear that many investors have when it comes to investing in stocks. An equally misguided concept is the idea of earning “easy money” by simply investing in the broad markets. However, this idea of putting your money into a basket of securities and taking the good with the bad does not reconcile the seemingly innate fear of sharp market corrections and/or a full-fledged bear markets.

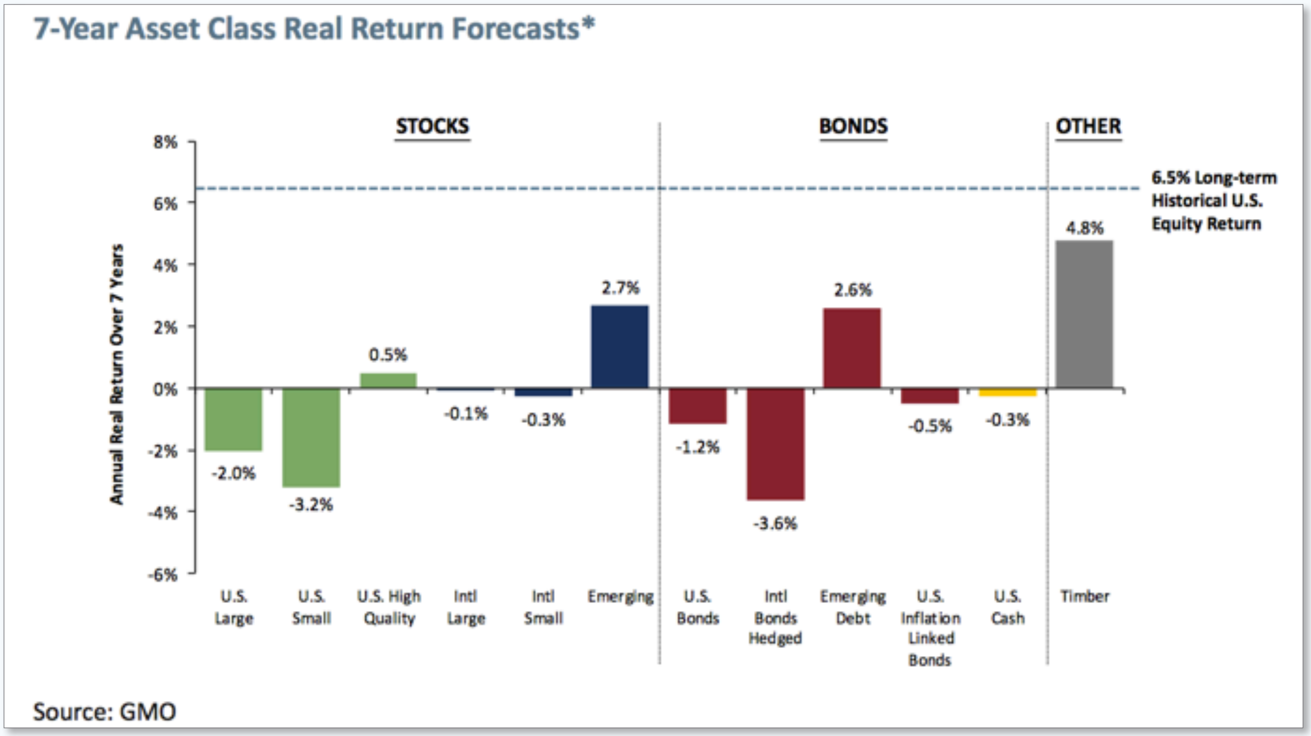
Index investing has been gaining popularity due to investors becoming accustomed to year after year of positive U.S. stock market returns. In reality, index investing guarantees assuming a full market risk and a below market return over time. The below market return is guaranteed because it is impossible to invest in “the market” without some level of expense. As an active manager, who manages risks in order to increase long-term investment outcomes, it is perplexing why an approach that turns a blind eye toward risk management, and surrenders to the idea of a below market returns, is as good as it gets in the eyes of many investors.

In this commentary, we will examine the potential pitfalls of putting blind faith in the markets. Fundamentals and experienced judgment indicates that future broad market returns are very likely to be disappointing for the next several years. In a recent letter to clients from Ray Dalio’s Bridgewater Associates, the world’s largest hedge fund, the statement was made that: “We think asset prices are high and, as a result, the future expected returns of passive investing are likely to be low. But ... we do not see current conditions as a bubble.”

During Warren Buffett's recent annual Berkshire Hathaway meeting, he was asked by Becky Quick of CNBC if the stock market was over-valued. He responded that today's stocks are "definitely on the high-side of valuation" and that "if low rates persist, stocks will definitely look cheap," but if "interest rates normalize we'll look back and say that stocks weren't so cheap". From this typical Warren Buffett sound bite response, one can only conclude that he sees today's stock market close to fully valued. Furthermore, one can conclude that he believes that market returns over the next several years are much less certain than when market valuation levels were lower and the future of interest rates were more predictable.

One thing that I know from experience is that when the broad markets are, as Warren Buffett characterized them, "definitely on the high-side of valuation" either overall corporate earnings growth has to significantly accelerate, through higher than expected revenue growth and profit margin expansion, or price earnings multiples have to expand to support continued market appreciation. Given that price earnings multiples are already at the high end of normal with profit margins sitting at historically high levels and monetary policy moving to a lesser degree of economic stimulus, it is very challenging to put together an argument that supports anything other than low broad market return expectations. During the aforementioned CNBC interview, Buffett stated that if today's interest rates persist, stocks could again look cheap in upcoming years. However, this statement ignores the likely factors, such as low to negative economic growth and the absence of normal demand-generated inflation, which would lead to persistent low rates. If these factors were to occur over the next several years, this would certainly not bode well for corporate earnings growth, which is necessary to propel equity markets higher.

The investment professional who is probably the most watched when it comes to forecasting market returns is Jeremy Grantham. Grantham is the founder of GMO, a $118 billion dollar global asset management firm, and he is one of the most accurate and respected authorities for long-term market forecasting. In his most recent commentary titled "Are We The Stranded Asset," Mr. Grantham published his current 7-year Asset Class Real Return Forecast that paints a pretty dismal picture of future broad equity market returns. His illustration is provided below:



*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term infla¬tion of 2.2% over 15 years.

Since 2000, there has been a large quantity of academic research performed on GMO's published long-term market forecasts. The most cited work has been performed by Professor Edward Tower of Duke University. In a recent article written by Brett Arends and titled "A Stock Market Forecast with a 14-Year Winning Streak," Professor Tower's research is reflected in the following statement: "Since 2000, investors could have done very well imitating the investment fund GMO. Will the streak continue? Is the stock market really just guesswork, as so many people allege? Can you really not "beat" the indices? Would you really be better off just throwing darts at a list of stocks? Maybe not." Similar to Professor Tower, I have been paying close attention to GMO's forecasts for well over ten years. Unlike many "flash in the pan" forecasters, Grantham is neither a perennial bear nor bull. Instead, he follows valuations and mean reverting forecasted assumptions. Arends reminds readers that, "GMO's Grantham famously warned about the impending crashes of 2000-03 and 2007-09. And during the depths of the financial crisis in 2008-09 he also, famously, defied the doomsayers and turned aggressively bullish." Similar to this reminder, I give a lot of credit to Grantham's writings for helping me have the necessary conviction to begin to overweight equities at the depths of the crash in early 2009.

As I have determined over time, GMO's forecasts are most useful when forecasting broad asset class returns, as opposed to more narrow classifications, such as the one provided in the above graph. Mr. Arends ends his article by referring to the Duke University research again, stating that "the Duke research also found that GMO was better at predicting the overall returns from stocks than it was at predicting returns for one class of stocks versus another". I view GMO's forecasts as a highly reliable barometer that measures fundamentally driven expected returns for all major asset classes.

Last year, I wrote about the broad equity market and specific high-yield sectors, such as utilities, and, this year, my comments echo similar thoughts. At the beginning of 2015, I became more concerned with certain imbalances that were manifesting themselves in the capital markets. For 2014, the broad large-cap U.S. equity markets ignored valuation concerns and posted returns in excess of 13%. Some of last year's winning sectors, such as utility stocks, have paid the price for their 2014 over-shoot, as those sectors are this year's worst performers. For a value-oriented investment firm like Seven Summits Capital, the recent reversal of many of last year's high-flyers was not surprising.

If besting the broad market on a quarterly or annual basis were the focus of Seven Summits Capital, this commentary would not share the cautionary words of Bridgewater Associates, Warren Buffett, or Jeremy Grantham. Instead, we would use this opportunity to write about how well (on a relative basis) many of our client portfolios performed in the first quarter of 2015 and year-to-date. I cannot stress enough that such short-term performance is not important, whether it is characterized as outperformance or underperformance, when managing wealth with an objective to achieve strong risk-adjusted returns over five, seven, and ten year periods. What is important, however, is that we can recognize imbalances, unsustainable valuation levels, and minimize the future adverse impact of certain parts of today's market that are miss-priced relative to probable future growth expectations.

There is something so simple about looking objectively at a security or a broad market and recognizing that price levels matter and that they need to reasonably reflect realistic future expectations. But, what is simple is not always easy. It is not easy because it requires thinking about what drives valuation multiples and asset price levels. Furthermore, it requires putting those considerations ahead of the feeling that you are losing the race against the market when the valuations are leaping ahead of fundamentals. Successful investors are able to take this simple concept and apply it in practice easily without letting their decisions be manipulated by the market.

One of the most successful value investors is William Nygren and he manages a fund known as the Oakmark Fund. Since 2000, this fund has outperformed the S&P 500 by over 100% cumulatively. This is an impressive achievement and to truly understand how he managed such a feat, one must study how Mr. Nygren's fund performed in years when the broad stock market was "fully valued". In 1999, when value-oriented managers, such as Nygren and Buffett, seemed "out of touch", the S&P 500 posted a 21.04% total return and Nygren's Oakmark Fund lost 10.47%. In 2007, just prior to the financial crisis and stock market crash, the S&P 500 was up 5.49% and reached an all-time high; however, the Oakmark Fund lost 3.64%. In 2014, when the S&P 500 confounded value-oriented investors and posted a 13.69% total return, the Oakmark Fund under-performed by 2.18%. Other funds, such as Mairs & Power Growth, Dodge & Cox Stock, and Sequoia, which have similar long-term outperformance records against the S&P 500, also under-performed the S&P 500 in 2014, with total returns of 8.12%, 10.40%, and 7.53%, respectively. Undoubtedly, these funds likely experienced redemptions related to this under-performance. Investors in mutual funds tend to chase market beating performance and run away from under-performers, which is exactly the opposite of what they should do if they are seeking disciplined investment managers. The fear of missing a super-charged market seems to trump the appreciation for risk management skills of a proven investor like Nygren.

In general, Seven Summits Capital did not come close to outpacing the S&P 500 in 2014. Our discipline held us back, similar to how the value discipline of aforementioned fund managers held them back last year. When we look at the current price of a stock, we do not place much emphasis on what today's valuation is relative to today's financial performance. We are much more interested in comparing today's valuation to growth projections in order to measure what level of future growth and profitability is priced into the stock. What this does is provide us with a glimpse into whether the market is pricing in reasonable growth expectations or not. Thus, we are informed as to whether there is a mismatch between growth expectations and what is discounted into current price levels. Below, are a couple examples using our equity research engine, The Applied Finance Group (AFG) and their dynamic "value curve" analysis:

COMPANY	MARKET PRICE IMPLIED 5-YEAR GROWTH RATE	CONSENSUS WEIGHTED SALES GROWTH RATE ESTIMATE
BE Aerospace (BEAV)	1.25%	9.26%
Team Health (TMH)	- 5.43%	15.85%
Duke Energy (DUK)	19.95%	1.89%
Proctor & Gamble (PG)	12.37%	- 4.24%

BE Aerospace and Team Health are new companies that have been added to many of our client portfolios over the last year. They were added because we have determined that the market is incorrectly valuing future growth expectations. The opposite is occurring with Duke Energy and Proctor & Gamble, where the market is pricing in growth rates that do not even resemble future growth rate expectations. Measuring value in this way not only helps us uncover under-valued companies, but it also helps us avoid the temptation of investing in popular stocks whose prices have become disconnected with forward expectations.

I have utilized AFG as the backbone of my research process for almost ten years. In order to illustrate the effectiveness of AFG's valuation process, AFG has tracked the performance of the stocks that rank the highest in its value process versus the Russell 1000 index since September 30, 1998 through May 15, 2015. Below is the average annualized result, comparing the broad U.S. large-cap market with a portfolio made up of AFG's highest ranked U.S. large-cap equities over a 16-plus year time period:

AFG "Buy" Highest Rank List
Since 09/30/1998: 13.61%

Russell 1000 U.S. Large Cap Index
Since 09/30/1998: 6.89%

I shared this AFG data in order to illustrate how important that valuation and forward expectations are in ultimately determining long-term performance. As measured by the Russell 1000, the stocks that scored the highest within the AFG universe provided almost double the annualized performance of the 1000 largest U.S. companies. The sixteen year period above encompassed some of the scariest times in U.S. stock market history, such as the tech bubble bursting, 9/11, and the financial crisis/Great Recession. However, AFG's continually updated list of the most attractive stocks posted results over the course of that period that were anything but scary.

Last month, I discussed the fear that many investors have when it comes to investing in equities and I argued that the fear is misplaced. I make this argument because I have not encountered very many investors who are afraid of owning shares in a particular company. Instead, I contend that the fear of investing in equities is not a fear of owning stocks at all; it is a fear of the unknown when it comes to the stock market itself. I believe that most investors would jump at the chance to invest in a great private company if they were given the chance. Such a private company investment, outside the stock market, would be based upon the growth and profitability fundamentals of the specific company, as opposed to the daily fluctuations of a stock price.

At Seven Summits Capital, we look at equity investments as if they were private companies, but we accept that ownership shares are traded within the inherently unpredictable and irrational public stock market. We view daily volatility, which comes along with being a publicly traded company, as an opportunity to purchase from, or sell to, a less informed or distressed investor. This ability to take advantage of the irrationality of the public markets is one of the primary sources of opportunity to create wealth over time for an active investor. Unlike the broad markets, which are represented by index funds and ETF's where material mispricing occurs infrequently, an active manager is given the opportunity to look through the broad markets at individual securities within which mispricing can be found everyday if identified correctly.

This commentary argues that our broad equity markets are at best fully valued today. At such a valuation level and given a probable set of assumptions going forward, the rich valuation of the aggregate market significantly reduces the expected returns over the upcoming years for a passive investor. Given the assessment that broad stock market returns going forward will be restrained by valuation and growth considerations, I illustrated how several active investors successfully outpaced the market by essentially ignoring it and sticking to their discipline. Lastly, I used data from the past sixteen years to validate the long-term effectiveness of AFG's valuation model. This ability to compare value to imbedded growth expectations is essentially at the core of security selection for most successful value investors, although each may employ their own unique quantitative methodology. Although using value as a guide has proven to be effective in security selection, it is not a method useful in besting market averages over short time periods, especially ones characterized by high market valuations. With that in mind, we will be purchasing shares (within accounts that utilize mutual funds) in either Oakmark or Mairs & Power funds following their under-performance last year relative to the broad market. History has shown that when good value-managers under-perform versus the broad market, this is a good time to become more value conscience within portfolios.

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com