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JUNE 2017 INVESTMENT COMMENTARY

BEWARE OF THOSE WHO ABDICATE DUE DILIGENCE AND PUT FAITH IN THE EFFICIENT STRUCTURE OF THE MARKET

How many of you are familiar with the term "due diligence"? As a professional who takes the idea of fiduciary duty very seriously, due diligence is something that I think about every day. This commentary is going to delve into one less obvious area of due diligence, but possibly the most important when it comes to investing and many other areas of life. Before I begin this discussion, I am going to share a passage from a very thoughtful article that I read last month. Investment research-oriented website Alpha Architect published an article on May 25, 2017, written by Aaron Brask, titled Trust But Verify: The Potential Problems With Blind Investing. In this article, Mr. Brask made a compelling case for being very cautious when investing in pools of assets in which the there is no due diligence, such as broad market index products, or third party managed products when due diligence is assumed. The article draws parallels between today's investment trends and what contributed to the last financial crisis and market crash. Part of that discussion can be found below:

"I believe the root cause or enabler of the credit crisis was the endorsement of the (conflicted) credit ratings agencies. Given the considerable complexity of these products (e.g., the 3-6% tranches of collateralized debt obligations backed by sub-prime mortgages or other derivative assets), what fiduciary in their right mind would have invested money without conducting due diligence? When investors stopped conducting their own due diligence and started relying on the rating agencies, it opened the door for conflicts of interest and capital misallocation – ultimately culminating in the credit crisis."

Based upon what occurred in 1999 and 2008-09 when investors put their blind faith in the market or in asset allocating advisors who assume a faceless third party is conducting due diligence, all investors should be uncompromising when it comes to knowing who is conducting due diligence on the investments that populate their portfolio.

Mr. Brask summed up what he sees today by stating, "I see investors once again ceasing due diligence. This time it relates to their overall investment strategies and there are no ratings agencies. They are simply placing their trust in market efficiency. If history is any indication, this will likely end in tears."

We seem to be living in a time when it is hard to know what individuals and institutions to trust. In many ways, my career has been defined by my ability to seek information, process data, and lastly assess character. My career began in credit analysis and commercial loan underwriting. As a credit analyst, I learned about the "Three C's," which stands for Collateral, Cash Flow & Character. The first two C's could be measured and verified but are subject to change and require a margin of safety. The third C, Character is not easily

determined but is generally not subject to change. I have spent the last thirty years attempting to improve my ability to judge character. I have had to be an effective judge of character to underwrite credit, analyze companies, choose private equity teams, navigate the public markets, and select colleagues. Some of you might find it hard believe that I included judging the public market in this list. One cannot look into the eyes of a market. However, the public markets are a direct function of collective human activities, and history can inform us about the character of the public markets. Many investors think about the market in much they same way that they think about the weather. Both the weather and the markets are difficult to forecast and subject to daily fluctuations. The main difference, however, is that the weather is not affected by the individuals who do the forecasting, whereas market fluctuations are directly influenced by investors taking action based upon their forecasts and emotions. In other words, the weather is naturally occurring, whereas the markets are both created by humans and directly a function of human behavior. Thus the market's character can be assessed.

With individuals, character can be measured by trying to understand motivations, listening to words and looking at actions to best determine whether words and actions are consistent. This is the reason that I find it very useful to listen to company conference calls, meet with senior management of private equity and private real estate teams, and study the behavior of the collective investor as reflected by the public markets. I am going to discuss the character of the markets and illustrate how getting to know the CEO of a private equity company paid off when unanticipated events dictated a major strategy shift.

I will start with the markets. I have had an intimate relationship with the public markets for almost twenty years. I arguably have spent more of my waking hours interacting with the markets since the beginning of my career in equity analysis and portfolio management in late 1997, than with my wife and daughter. Therefore, I know that I can speak with authority on the character of the public markets. One of the best descriptions of the public markets came from Benjamin Graham, Warren Buffet's mentor, and the author of the seminal book on value investing, The Intelligent Investor. Graham describes the market as an irrational and manic depressive individual named "Mr. Market". From my experience, Graham's description of the public market is very accurate.

Warren Buffett, writing about Mr. Market in his 1987 Berkshire Hathaway shareholder letter, said the following about how he thinks about investing and Graham's teaching about Mr. Market: "In my opinion, investment success will not be produced by arcane formula, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's *Mr. Market* concept firmly in mind. Following *Ben's* teachings, *Charlie* and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually, will confirm it." Anyone who knows me well would tell you that I seek to learn as much as possible from the most successful experts on whatever subject matter that I am striving to better understand. For this reason, I make it a point to supplement my first-hand experience in the markets with the teachings of those, such as Graham, Buffett, Klarman, Grantham, Dalio, etc.

The bottom line on this topic is that I subscribe to the idea shared by Graham, Buffet and many other

legendary investors that the public markets have a very flawed character and cannot be trusted. I occasionally get questioned by clients who during certain periods in the stock market believe that they are missing out when I seemingly ignore market momentum and do not chase after highly priced market leaders. In a timely article from May 29, 2017, Barron's Up & Down Wall Street column, Randall W Forsyth wrote in his weekly space an article titled 21st Century Tulips, "What's striking is the role played by the biggest technology leaders, again reminiscent of the dot-com era. According to Bespoke Investment Group, Apple (AAPL), Facebook (FB), Amazon.com (AMZN), Microsoft (MSFT), and Alphabet (GOOGL) accounted for 4.6 of the 7.89 percentage-point gain this year in the S&P 500." The next Barron's column from the same week's publication is Streetwise, and its article for the week was titled, Who's Afraid of Missing Out?. Kopin Tan wrote in the Streetwise column." the fear of missing out has investors flocking to recent big winners." Mr. Tan went on to remind his readers that "Today, tech stocks make up 23.1% of the S&P 500, above the historical average of 15.4%, and fast catching up to the 26.5% combined weight for the six smallest sectors. While 23% still looks innocuous compared with the 34% weighting at the tech-bubble peak, Bespoke Investment Group reminds us that tech's weight didn't exceed 23% until September 1999, and has spent only a few months above 23%." Sir John Templeton is famous for his Bull Market Lifecycle description, in which he described a bull market in stocks as "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." The one common characteristic of the euphoria stage is the investor psychology which causes the average investor to become agitated and anxious about missing out on recent stock market gains.

I am very aware that I have been striking a cautious tone for the last six months in the monthly commentaries. This cautious tone does not mean that Seven Summits Capital clients are seeing their portfolios changed in any dramatic fashion. What this cautious tone does mean for a particular portfolio is that your portfolio may be holding slightly more cash than normal, profit-taking trades may be more commonplace, and new stock positions are more likely than not to be companies that historically are less correlated to the broad markets. I will stress that trimming winning positions, holding slightly more cash and establishing new positions in lower correlated stocks is not what one would do if he or she were concerned about missing out on a rising market. However, these actions are exactly what a professional money manager does who understands that it is far more important to manage risk than try to chase markets that are flashing warning signals.

I mentioned at the beginning of this commentary that I recently had my emphasis on assessing character validated with a situation involving at private equity investment firm with which many clients are invested. This firm had an investment which involved a significant construction project that was supposed to have been underway by the end of 2016. This construction project would have spanned 12-18 months and subjected the partnership to significant bank indebtedness. During 2016 the market for the services that the newly constructed building would have served changed significantly from a competitive standpoint. The President and founder of the private equity company, who I have had the pleasure of getting to know over the last three years, delayed the construction project in order to reassess the entire risk/return metrics of the project in order to best protect and position the limited partners' capital going forward. His determination following this reassessment was that moving forward with the construction project subjected the investors to undue risk that was not present at the onset of the fund. This was not an easy decision, and such a decision required this individual to scrap several years of negotiation and hard work that were necessary to

position the firm to be able to offer the opportunity to investors.

The respect and admiration for the President of this private equity fund that I have developed over the last several years were validated with his willingness to put the interests of his investors ahead of his ego and unwind several business relationships that were initially leveraged to move forward with the original plans. I am confident that by reversing course, lowering the risk profile of the investment, and working to harvest the value that has been created through a very opportunistic land purchase, that investors will be very well served in spite of the advent of unforeseen competitive changes to the market. This experience validates my belief that making a character judgment is equally as important, if not more important than more quantitative assessments.

My promise to my clients is that I will never ignore character in any investment decision that I make on their behalf. Although, I will occasionally find it difficult to develop the relationship or gain sufficient insight necessary to vet a decision maker's character fully. When I find my ability to make a character assessment to be substantially hindered, I may decide to pass on a particular investment opportunity, in spite of compelling quantitative attributes. I will admit that one area where I have, at times, been too eager to trust in one's character has been with certain colleagues. Over the last 20 years, I have at times found that my belief in always putting the client's interest ahead of self and business considerations is not always fully shared by a colleague. As demanding as I am when doing the due diligence and research on a particular investment, I have found that I have generally put too much trust into the words, and even actions, of close colleagues, only later to come to realize that certain ideals that I hold firmly can easily become inconvenient for others.

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I will make all reasonable attempts to organize my business in a manner which best reflects my strong belief in the literal definition of fiduciary duty, the highest legal standard of care between a trusted professional and a beneficiary/principal. (SEC Fiduciary Duty Definition is printed below):

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