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MARCH 2018 INVESTMENT COMMENTARY

INVALUABLE EXPERIENCE:

KNOWING THE DIFFERENCE BETWEEN A CREDIBLE SOURCE AND A NON-CREDIBLE SOURCE

Every year at the end of February those who strive to become ever better investors eagerly await the release of Berkshire Hathaway's Shareholder Letter penned by CEO Warren Buffett. I am one of those individuals who wakes up earlier than usual on the Saturday in February that the letter is published. I know from past experience that Mr. Buffett's words allow me to learn and reinforce the guiding principles of fundamental investing.

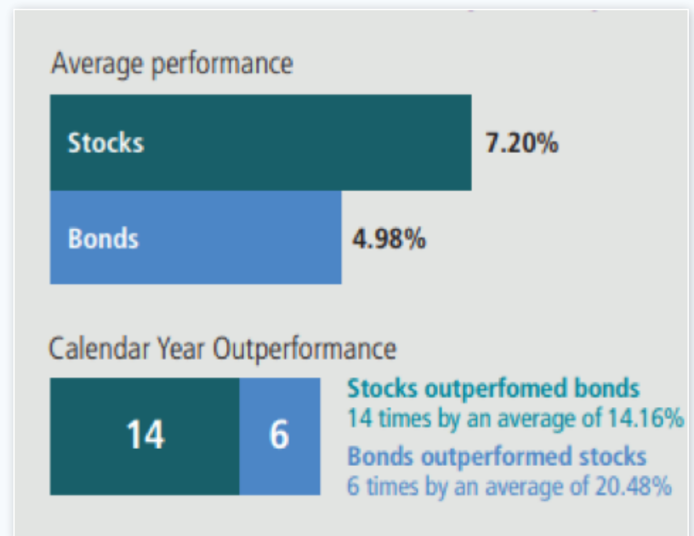
I am going to spare the readers of this commentary endless Buffett quotes from this year's letter. However, I always recommend that investors take fifteen minutes each year to read the entire letter. In this month's commentary, I am going take the spirit of Buffett's comments from this year's letter and attempt to apply them to what investors today should be thinking about rising interest rates, the pace of economic growth, the return of volatility in the equity markets, and fake news in the world of investing.

RISING INTEREST RATES

In the early 1980's Federal Reserve Chairman Paul Volker pushed interest rates in the U.S. into the high teens to break the fever of high inflation. Over the past 35 years interest rates and inflation have been trending downward. This trend effectively ended in the period that followed the 2008-09 financial crisis. As the world plunged into a high leverage induced unwinding of speculation and reckless credit, short-term interest rates in the developed world hit unprecedented levels nearing zero percent, or lower than zero in some cases. In the U.S., the Federal Reserve held its Discount Rate at zero from 2010 to 2015 in order to stimulate demand for risk assets and reignite inflation. See the Federal Reserve of St. Louis chart below which shows the Federal Reserve Fed Funds Rate from 1981 to present:

It is important to recall that bond prices rise as interest rates fall and prices fall as interest rates rise. What this means is that the U.S. has been in a secular bond bull market for 35 years in terms of bond prices. The Fed Funds rate being pushed to zero following the financial crisis marked the long beginning of the end of this secular bond bull market. The rise off of the zero percent mark that began in late 2015, continues today. The Federal Reserve is expected to raise the Discount Rate three to four times during 2018. Some people refer to this strategy of raising interest rates as "normalization," and others believe that the U.S. central bank is essentially building up "dry powder" to allow for monetary easing once again when the economy turns down. Either way, most economists expect the current tightening cycle to occur at an accelerated pace. What this means for existing bonds and high yield stocks is that their income yields become less attractive on a relative basis. The best case scenario for investors who are attracted to fixed income and high yield equities is that the current period turns out to be a cyclical bear market in the making for bonds. The worst case scenario is that, after a 35-year Bull Market created by falling interest rates, we may indeed be in the early stages of a long secular bear market in fixed income and high yield stocks.

Warren Buffett, in his latest shareholder letter, made a forceful argument directed at long-term investors regarding bonds. He made the argument that Treasury Bonds and High-Grade Corporate bonds will, under the best conditions, always under-perform stocks over the long-term. I believe that this is a powerful statement considering that we have just lived through a 35-year bull market in bonds culminating in bond yields bottoming out at zero percent. To illustrate Mr. Buffett's point, I show below an illustration comparing 20-year stock returns and bond returns. It is important to note that during this 20 year period, ending December 31, 2017, bonds were in a bull market, while stocks suffered from the Dot.com bubble bursting, the 9/11 terrorist attacks, the worst financial crisis since the Great Depression, and two recessionary periods:



Stocks are represented by the S&P 500 Index, which measures the broad US stock market. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index, which measures the US bond market. Past performance is no guarantee of future results. Source: SPAR, FactSet Research Systems Inc. As of 12/31/17.

I have always contended that most investors intuitively know that stocks will always outperform bonds over the long-term. However, those same investors, even when making allocation decisions within retirement accounts where the time horizon is 20, 30, and 40 years, desire to diversify their stock exposure with fixed income. This objectively inefficient capital allocation decision can have significant adverse consequences on long-term returns and the ability to grow accumulated assets in real inflation-adjusted terms. The typical investor has learned this behavior passively through generic advice that, almost without exception, espouses diversification for the sake of diversification. This advice is repeated over and over again without much discussion regarding expected " real" returns.

As a portfolio manager who has managed "balanced" accounts for over 20 years, I always calibrated my allocation to stocks and non-stock asset classes based upon expected "real returns." What this means to me is that if I can invest in bonds, looking at a tax effective yield, where the yield-to-maturity produces a 2% or better inflation-adjusted expected return, I will consider allocating portfolio assets to bonds. If an inflation-adjusted return is less than 2%, I will

typically avoid investing in bonds and instead seek out other non-stock investment options to manage systematic equity-market risk.

THE RETURN OF VOLATILITY

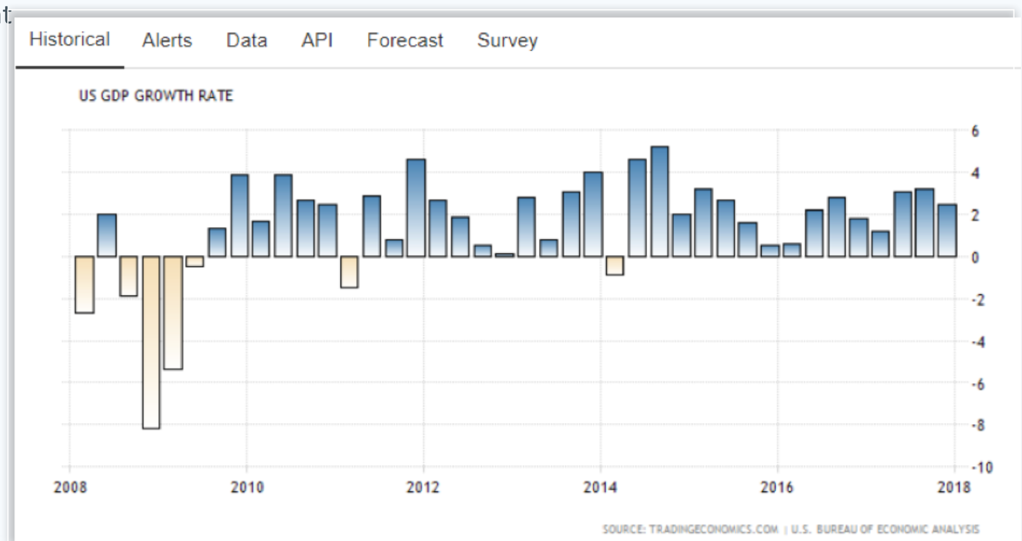
As a portfolio manager charged with managing risk for clients, the concept of risk is more than simply volatility. Volatility, in fact, is the most benign type of risk. However, volatility becomes riskier regarding its impact on the future value of a portfolio's assets when systematic cash distributions are paid from the account. During an investor's accumulation phase, volatility is nothing more than an emotional risk that can induce irrational decision-making. The most serious risks in investing are permanent impairment of value, followed by insufficient inflation-adjusted returns over time to meet a strategic objective. Strategic objectives typically take the form of the ability to replace occupational income, grow sufficiently to alleviate the risk of outliving one's assets, and/or to leave a legacy to one's heirs. Any factor which jeopardizes one or more of these long-term strategic objectives is a risk that must be managed. Therefore, investors must first understand risk and then guard against being influenced by "dumbed down" advice distributed to a generic audience.

The first rule of investment success is to approach investment decisions objectively based upon an assessment of expected returns and risk of permanent loss. The key to making all important decisions is to put emotions and biases aside and keep the focus on facts, probabilities and a healthy dose of common sense.

THE ECONOMIC CYCLE AND THE PACE OF GROWTH

As I was writing this commentary, Anthony Scaramucci was being interviewed on CNBC about the announced resignation of WH Chairman of the Council of Economic Advisors, Gary Cohn, over his disagreement with the President of imposing import tariffs on steel and aluminum (I side with Gary Cohn on this subject). Mr. Scaramucci, who is known for his highly charged language, is also reportedly a successful hedge fund manager. Therefore, on the subject of the markets and economy, this his experience should give him a certain level of credibility on these issues. In the midst of this interview, Scaramucci was making the case that our economic growth since the 2016 election is incredibly strong. He attributed this statement to the fact that the U.S. economy posted two consecutive quarters of better than three percent annualized GDP growth during 2017. He then contrasted this achievement with his assertion that over the preceding eight years there were only two-quarters of GDP growth above 3.0%. Such an assertion caught my attention; not in a good way. If I were an average person who most likely does not follow economic statistics and trends very closely, I would have taken from Mr. Scaramucci's comments that the U.S. economy has definitely shifted into a higher gear at face value. The only problem with formulating such a thesis, using Mr. Scaramucci's statement, is that his knowledge of GDP growth rates over the last eight years was grossly in error.

Looking at the quarterly GDP annualized growth rates over the last ten years shows an entirely different picture than Mr. Scaramucci was painting:



FAKE NEWS IS NOT NEW TO THE INVESTMENT BUSINESS

Early in my career as an analyst and portfolio manager, I quickly learned to be very skeptical of the recommendations and forecasts of others. Today, during a time of "alternative facts," I believe that it is more important than ever to validate statements, conclusions, and forecasts of others, even when the source is someone who seemingly should have the requisite experience necessary to be credible. Today, it seems that everyone has an opinion. However, the veracity of the underpinnings of those opinions always should be questioned, even if they conform to what you believe to be true.

Fortunately, after 20 years of reading investment commentary's, economic papers, and the forecasts of market strategists, I have learned to trust only a small handful of "experts." Having spent 20 years assessing the reliability of information, I have developed a very keen sense of what are legitimate fact-based opinions and conclusions, and what are poorly constructed arguments or biased opinions.

Coming back to Warren Buffett, the reason that I get up first thing in the morning on the day that Berkshire Hathaway releases Mr. Buffett's shareholder letter is that he has earned a place on my very short list of experts who I implicitly trust when it comes to the subject of investing fundamentals. We all should consider ourselves very fortunate to be alive and investing during a time when luminaries such as Buffett are sharing their wisdom.

There is an almost infinite number of voices who are eager to provide investors their opinions. As long as we are so lucky to have voices such as Warren Buffett to listen to, it does not make a lot of sense to fall prey to those unproven voices who claim to have come up with a "better mousetrap" for growing and preserving wealth. Over the last 20 years, those people promising a "new" way to invest have come and gone, leaving the job of imparting valuable wisdom to the likes of Buffett, Grantham, Gabelli, Swensen, and Marks. The "new mousetrap" people rely on the recency effect. Following scary times in the market, they will tell you how they can protect your downside at exactly the time when you should be thinking about the upside opportunity. Conversely, when momentum dominates the stock market, as it has over the last couple years, these same types of people will be telling you how you can "play" the market to juice your returns at exactly the time that you should be concerned about downside risks. This type of advice is disingenuous at best and downright irresponsible at worst.

You are probably reading this commentary because you already understand that knowing who you can trust when it comes to your investments is a precarious exercise. I have always sought out investors who are skeptical and place a high amount of value on relationship and trust. If we currently work together, thank you, and I very much value the relationship that we have developed. If you are not currently working with Seven Summits Capital and you are uncertain because you have been underwhelmed by your past investment advisory experiences, do not hesitate to reach out to me. If desired, I will put you in touch with a couple of existing Seven Summits Capital clients who will hopefully help alleviate what I am sure are well-deserved concerns.

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