SEVEN SUMMITS CAPITAL

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JANUARY 2018 INVESTMENT COMMENTARY

2017 MADE MARKET HISTORY

ONLY WITH THE PASSING OF TIME CAN HISTORY PROVIDE VALUABLE LESSONS

2017 was unquestionably one of those years, like 2013, when investors benefit from above average equity returns. There were many reasons at the start and throughout 2017 to be defensive in one's portfolio positioning, however market sentiment remained buoyant, and volatility seemingly disappeared from the broad markets last year. Following the passing of the tax reform legislation, which had been hurriedly pushed through Congress at the end of the year, the first week of trading in 2018 saw continued equity market gains.

Market history teaches investors many lessons. However one of the most valuable of those lessons was best articulated by Warren Buffett, who said: "Be greedy when others are fearful and be fearful when others are greedy." This quote comes from the greatest investor in U.S. history and arguably one of the greatest investors of all time. What I have come to take from this quote is that market sentiment is the best barometer for indicating when a long-term investor should be increasing or decreasing Beta Risk in a portfolio. What this means in practice is that with imperfect timing, as market sentiment sours, an investor should be seeking to capitalize on the market opportunities created as a result of lower prices, and conversely, when market sentiment is becoming exuberant, an investor should be selling high priced securities to those who are mesmerized by the prospect of continuing easy price gains.

What experience and the observation of the practices of the best long-term investors have taught me is that it is virtually impossible to time these shifts in portfolio positioning with any precision. However, it is not that difficult to read market sentiment and recognize fully or overpriced securities. For many investors what gets in their way of heeding Warren Buffett's simple, but difficult to implement in practice, advice is the very human reaction of not wanting to miss out on the excitement of a party in full swing. I like a good party as much as the next person. However, I have learned to be self-aware enough to know when to pace myself so that I am still on my feet when the party eventually ends. This is exactly how I have been approaching Seven Summits Capital client portfolios over the last year or so. Established portfolios have benefited from not leaving the party, but they have enjoyed the exuberant atmosphere without getting carried away.

As bull markets mature and market sentiment accelerates upward, finding suitable high-quality investments becomes ever more difficult. For this reason, I have been investing more heavily in research capabilities to assist in identifying mis-priced and under-valued investment opportunities. Beginning on January 1, 2018, Seven Summits Capital will be utilizing, not only Valuentum Institutional, but another quantitative and qualitative service in order to expand the universe of securities from which we draw ideas. This new service relies heavily on an algorithmic methodology developed by a 30-year veteran CFA securities analyst who has authored a well known investing book called, Mycroft's

Blue Book, and has written extensively on his study of the investment processes of legendary investors such as Warren Buffett, Ben Graham, and Philip Fisher. The algorithmic process that Seven Summits Capital now has access to is a proprietary set of sixty-six GAAP accounting derived ratios focused on cash flow, return on invested capital, and other management efficiency measures. Many of these ratios are built upon financial measurement metrics that have been espoused by Buffett, Graham, Fisher, and other legendary long-term investors. The algorithm analyzes up to ten years of financial data covering over 4000 publicly traded companies, resulting in over twenty-six hundred calculations per company on a daily basis.

Having two third-party research partners who not only add significant analytical rigger to the Seven Summits Capital equity selection process but are readily available to discuss elements of their analysis and examine new ideas, greatly enhances my process. The result of combining my portfolio design and security selection experience with two distinct, but philosophically aligned research processes will result in better and more timely security screening and selection capabilities.

I strongly believe that when the broad markets are generally over-valued, and investor sentiment is beginning to show signs of exuberance, that ensuring the security selection process emphasizes quality, consistency and attractive valuation is very important. I do not pretend to know what 2018 will have in store for investors, but one thing that I am certain about is that when it comes to the public markets, expect that unexpected. Ben Carson, CFA, wrote in his January 7, 2018, Wealth of Common Sense blog, that

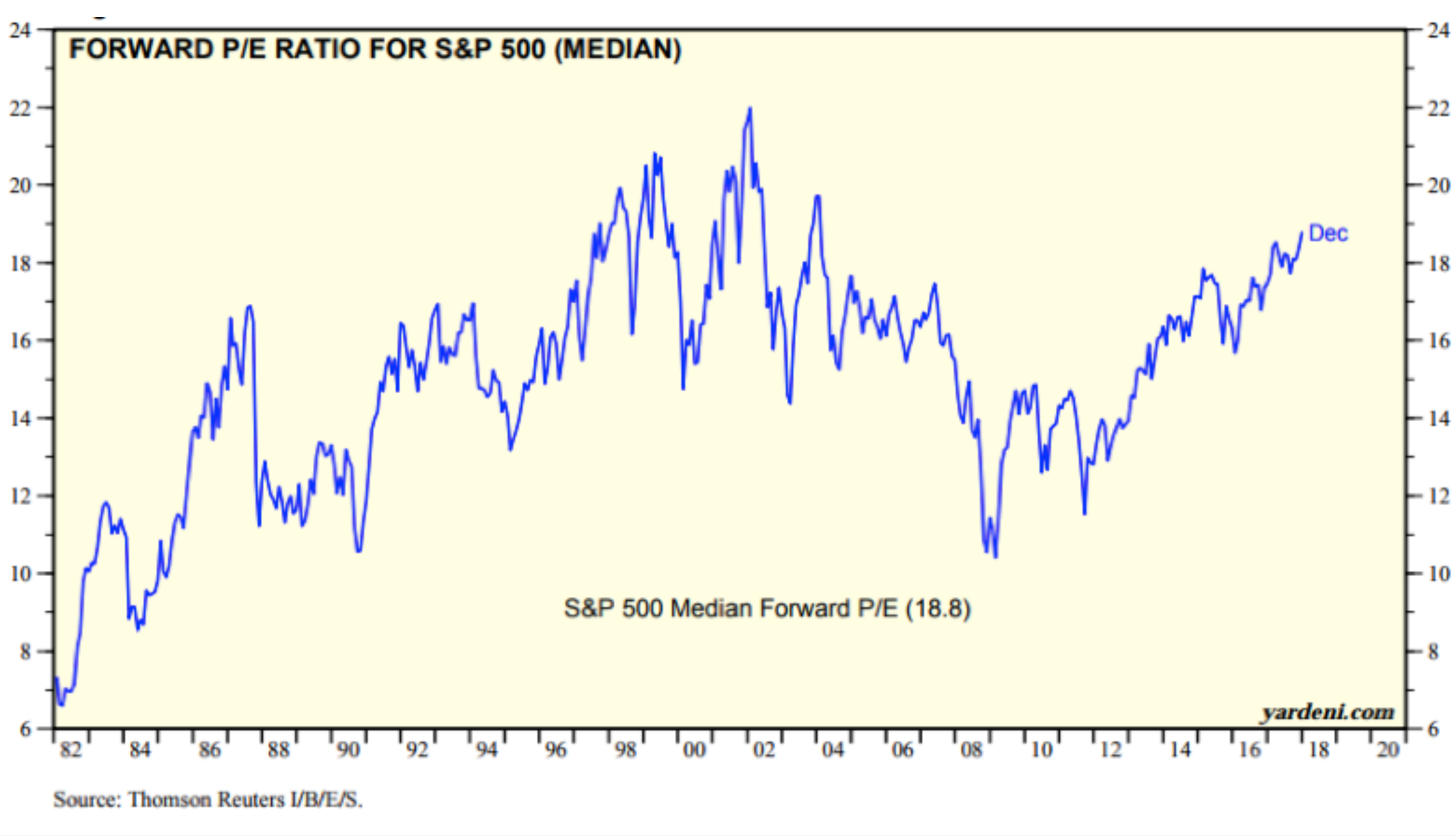
> *"There's sure to be something that catches investors off-guard in 2018. Something is bound to defy expectations whether it involves geopolitics, irrational market movements, corporate takeovers, huge gainers, huge losers, or any number of crazy news, events, or performance. I've learned I'll almost always be surprised by markets to some degree so the trick is not to be surprised that you're surprised because these things can be extremely random."*

In 2017 a 20% plus gain in the large-cap equity area of the stock market accompanied by historically low levels of market volatility defied expectations and caught many investors off guard. As we begin 2018, the recently passed tax reform legislation will have its most dramatic and immediate impact on the earnings outlooks of most publicly traded companies, particularly those with the highest percentage of revenues derived domestically. Assuming market multiples remain where they ended 2017 or rise, this one-time upward adjustment in companies earnings will translate into higher stock prices. With the biggest "known risk" to both the equity and bond markets being rising inflation and interest rates, it is difficult to make a case that equity market multiples will rise in 2018. Thus, focusing just on earnings and market multiples, the performance of the broad equity markets in 2018 will hinge on the balance between the growth in earnings and the level of earnings multiples. Those who see another year of above-trend market performance believe that earnings multiples can generally remain at current levels and those who are predicting below trend or negative market performance in 2018 see multiple contraction mitigating the higher corporate earnings that will result from the recently passed corporate tax cut.

If this stock market party continues well into 2018, we will continue to enjoy price levels created by the exuberant herd. However, should the time come when a "designated driver" is needed, we aim to make sure that our clients stay squarely on the road toward their long-term financial goals. No matter what, Seven Summits Capital will "soberly" use all of its research capabilities to continuously measure value and optimize portfolio structure for quality and total return characteristics.

There continues to be a lot of discussion among investment strategists, and within financial media outlets, how long this Bull Market will last, as it approaches a nine-year anniversary. This question confounds and divides the professional investment community. One thing that we know for sure is that when markets are roaring higher, the majority of investors and strategists adopt a “the trend is your friend” mentality to justify why the gains will continue, ignoring that due to high valuations, long-term return expectations are poor. Conversely, when the markets are careening downward as they were in late 2008 and early 2009, only a small minority of these same investors and strategists voice the unwelcome advice that markets are cheap and long-term return expectations are above average.

What I know is that while the trend can be your friend in the short-term, it is irresponsible to ignore valuation fundamentals and what they mean for long-term return expectations. Below is a chart produced by Yardeni.com that illustrates the S&P 500 median forward P/E ratio over the last thirty-five years:



The chart above shows that the median S&P 500 forward P/E ratio stands at 18.8 at the end of 2017. This P/E level is unquestionablely bumping up against the same measure of market P/E’s that existed in bubble years of the late 1990’s. Since the mid-1980’s we have had three Bear Market’s and each of these Bear Markets began at times when the Median P/E of the S&P 500 exceeded 17X. The year the Bear Market began, the peak to trough drawdown, and the duration of Bear Market in days is shown to the right (Yardeni):

YEAR	DRAWDOWN	DURATION (Days)
1987	33.5%	101
2000	49.1%	929
2007	56.8%	517

The valuation and Bear Market data above (previous page) cannot be used to pick market tops with any precision. However, the data should not be ignored in terms of what it shows an investor in regard to when to be aggressive in terms of allocation and security selection and when to be cautious. At Seven Summits Capital we are cautious because I respect that lessons of history.

I wish everyone a very Happy New Year, and I look forward to another year of seeking investment opportunities and managing both known risks and the inevitable unknown risks that will unfold over the next 12 months.

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