SEVEN SUMMITS CAPITAL

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MARCH 2016 INVESTMENT COMMENTARY

THE MARKET CRIES WOLF AGAIN, WARREN BUFFETT, AND A DEEP DIVE INTO PASSIVE INVESTING

As I sit down to write this month's investment commentary, I am reflecting upon the stock market sell-off that began on the first trading day of 2016 and ended approximately six weeks later. Since the sell-off ended, we have seen many of our clients' holdings recoup earlier losses. On average, February was a zero sum month for most broad account allocations, with closing balances slightly below or slightly ahead of where they began at the start of the month.

March is off to a strong start as the market's sentiment has emerged from the depths that it fell to during January and early February. A month ago, much of the financial media's discussions centered on 2016 recession risks - only to have the talk of recession disappear as quickly as it emerged. Unsurprisingly, market sentiment is driven by fleeting worries or euphoria and can shift unexpectedly. Security price movement, day-to-day and month-to-month, is more of a reflection of the ever vacillating market sentiment than the type of information and judgement that we, at Seven Summits Capital, base our investment decisions upon.

I am more optimistic, after the first two months of the year, that the broad market environment will reward the value-seeking/opportunistic equity strategy that is employed at Seven Summits Capital. We do not consider ourselves to be traditional value managers by a long-shot, given that one of our biggest holdings is Facebook. However, seizing on opportunities to capture value when it presents itself regardless of the type of company, is what we strive to do on any given day. The March 14, 2016 Barron's cover story is titled "It's Time for Value" and author Andrew Bary quotes JPMorgan strategist Dubravko Lakos-Bbujas as saying that "momentum stocks trade at an extreme premium to value stocks, with the valuation spread the highest since 1980, except for during the tech bubble". I began my investment career during the tech bubble and I am very cautious when it comes to momentum stocks. When you begin your investment career during the craziest irrational market of all times you heed those lessons learned.

When it comes to executing portfolio management strategies, we believe that the broad market is, as described by Warren Buffett, a "drunken psycho". He states that, "This imaginary person out there -- Mr. Market -- he's kind of a drunken psycho. Some days he gets very enthused, some days he gets very depressed. And when he gets really enthused, you sell to him and if he gets depressed you buy from him". We have seen many bouts of extreme pessimism since the end of the financial crisis and I believe that this past January and early February was a period when the market was again very depressed. In general, we heeded Mr. Buffett's advice and were net buyers. Beyond the broad market, Mr. Buffett's philosophy also applies to categories of stocks as well. For example, many pharmaceutical and biotech stocks are being bludgeoned by the markets due to the election rhetoric pertaining to drug price controls. However, we are more than happy to buy into parts of this over-sold sector, thus taking advantage of the negative sentiment and resulting values that we see.

WARREN BUFFETT – ANOTHER BRILLIANT ANNUAL SHAREHOLDER LETTER

I sent an email to clients after reading Warren Buffett's annual shareholder letter. If you have never read one of Buffett's annual letters, I cannot stress how much of a financial education one can obtain at no cost. Each one of his annual letters is full of useful financial insight, however, I highly recommend that you read his latest letter in which he explains how the value of his company, Berkshire Hathaway, can become more valuable during a year when its stock price declines by 12%. Warren Buffett's letters always highlight the major business lines of Berkshire Hathaway. However, the aspects of his letters that are the most interesting to read are his comments about the economy, the price versus value of his related investments, and commentary on other timely subject matter. This year he took on the common angst regarding the health of the U.S. economy, slow growth rates and income inequality that is dominating political discussion. You can always count on Warren Buffett to be the voice of rational optimism during times when the sentiment of Americans turn negative. Buffett has always put his money where his mouth is when he opposes the conventional pessimism of the moment and, instead, points out why it is unwise to bet against America. For example, coming off the depths of the market crash and Great Recession in 2009, when many Americans were certain that our country's greatness was lost and the next depression had begun, Warren Buffett took the other side of that bet. He took advantage of the prevailing pessimism and the value that resulted as stock prices plummeted by purchasing the railroad company Burlington Northern Santa Fe. Railroad companies are one of the most domestically focused and economically sensitive industries that exist, therefore representing a pure-play bet on the future of the U.S. economy. Looking back to 2009, the naysayers were 100% wrong and Warren Buffett was proven once again to be 100% correct. Prior to announcing his purchase of Burlington Northern Santa Fe, Buffett made the following remarks:

"Amid this bad news, however, never forget that our country has faced far worse travails in the past. In the 20th Century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21% prime rate in 1980; and the Great Depression of the 1930s, when unemployment ranged between 15% and 25% for many years. America has had no shortage of challenges. Without fail, however, we've overcome them."

Many individual investors would be wise to read these words of Warren Buffett and remember them the next time they are tempted to sell their equity investments when pessimism engulfs the markets. Those selling during such times are usually the fools that people like Buffett are able to buy and profit from.

When you have over half a century of experience in business and investing to draw from, and arguably the best temperament and instinct for creating long-term value, Warren Buffett can get away with telling the hard truth. His 2015 annual letter (published 2/27/16) exemplifies his ability to speak honestly about contentious issues. He took on several subjects that currently divide Americans, such as climate change. Climate change and any resulting action can and will have significant investment related implications. Buffett's conclusion to his climate change comments are below:

"If there is only a 1% chance the planet is heading toward a truly major disaster and delay means passing a point of no return, inaction now is foolhardy. Call this Noah's Law: If an ark may be essential for survival, begin building it today, no matter how cloudless the skies appear."

Buffett also took on the major narrative of several of our current Presidential candidates from both sides of the isle. He discussed slow economic growth and the problems we are facing as a nation with inequality and the mismatch of worker skills and the modern workforce. He discusses these macro-economic and social issues by reminding his readers of similar periods and problems from America's history. He compares the technological changes that have reshaped our economy over the last several decades to the impact that mechanical innovations had on the American economy during the first decades of the 1900s. See Buffett's observations and comments below pertaining to the impact of innovation on our country's economy 115 years ago:

"In 1900, America's civilian work force numbered 28 million. Of these, 11 million, a staggering 40% of the total, worked in farming. The leading crop then, as now, was corn. About 90 million acres were devoted to its production and the yield per acre was 30 bushels, for a total output of 2.7 billion bushels annually. Then came the tractor and one innovation after another that revolutionized such keys to farm productivity as planting, harvesting, irrigation, fertilization and seed quality. Today, we devote about 85 million acres to corn. Productivity, however, has improved yields to more than 150 bushels per acre, for an annual output of 13-14 billion bushels. Farmers have made similar gains with other products."

Mr. Buffett points out that only 2% of today's workforce is attributed to agriculture. From a long-term perspective, he explains how this major shift in our country's workforce was beneficial:

"It's easy to look back over the 115-year span and realize how extraordinarily beneficial agricultural innovations have been – not just for farmers but, more broadly, for our entire society. We would not have anything close to the America we now had we stifled those improvements in productivity. (It was fortunate that horses couldn't vote.) On a day-to-day basis, however, talk of the "greater good" must have rung hollow to farm hands who lost their jobs to machines that performed routine tasks far more efficiently than humans ever could."

As a boy growing up in the 1960s and 1970s with a grandfather who had been a small dairy farmer and an employee of the Pennsylvania Department of Agriculture, I overheard many conversations regarding how large "professional" farmers killed the family farm in America. Although, as Warren Buffet pointed out, the death of the small family farm began three generations before I was born, it was still a contentious subject around my Grandparents' dinner table three generations later. Today, the innovation that is transforming the U.S. economy is occurring in the areas of communications, information processing, sensors, and robotics. Luckily, these transformational innovations are not going to displace 40% of all American workers as agricultural innovations did in the last century. However, unlike mechanized farm equipment, today's innovations have vastly changed the American economy and the requisite skills that are necessary for workers to hold a secure and well-paying job within just one generation (measured as twenty-five years).

Warren Buffett reminded his readers that America's short-term pain associated with the inevitable march of innovation always has led to long-term gain. Buffett does not take on these subjects because of a political agenda. He does so because he believes that most investors are far too short-term oriented in their thinking and should learn from the past.

Warren Buffett has always recognized that many investors are short-sighted. He once was quoted as saying, "what we learn from history is that people do not learn from history". As investors, we cannot fall prey to the rhetoric that judges today's U.S. economy as sub-optimal according to preconceived norms that emanate from a time when our demographics were substantially different and the global economy was less competitive. Today's economy has very little in common with the economy that those over 30 years old were born into. Comparing today's economy with the economy of the 1960's, 70's and 80's would be like comparing the industrial economy of the 1950s with that of the agriculturally dominated economy at the turn of the century.

At Seven Summits Capital, we view investment opportunities by first being honest with ourselves on important contextual subjects such as the global economic backdrop, durable demographic and social trends, the irrational and unpredictable aspects of public markets, and the very real danger posed by the financial media's fixation on short-termism. Far too many investors today have a very hard time distinguishing between the endless chatter that emanates from today's 24-hour news cycle and a well thought out thesis about long-term fundamentals. Benjamin Graham, Warren Buffett's mentor, famously said, "to be an investor you must be a believer in a better tomorrow." We consistently ascribe to that prerequisite for investing.

PASSIVE INVESTING – WHAT BUFFETT HAS TO SAY AND WHERE WE COME DOWN

In Warren Buffett's 2013 shareholder letter he made a statement that after he is gone, the trustees of his wife's estate should simply put the trust's investable assets in a low-cost index fund. He went on say that "I believe the trust's long-term results from this policy will be superior to those attained by most investors — whether pension funds, institutions or individuals — who employ high-fee managers." What is the Oracle of Omaha referring to when he references "high-fee managers"? Large institutional money, like the sums of money that someone like Warren Buffett is referring to when it comes to what his wife will inherent, are typically overseen by a money manager/trustee who gets paid to allocate the money among investment managers. That money manager/trustee fee could range anywhere from 0.50% to 0.75%. The money would then be allocated to fee-based asset managers who would get paid another 0.40% to 0.75% for a traditional stock and bond portfolio, whereas alternative investment strategies, such as hedge fund and private equity managers would be paid 1% to 2%, plus a 10% to 20% cut of any appreciation over a certain agreed upon threshold.

It is also likely that Warren's wife's estate would include a significant amount of Berkshire Hathaway stock, which would constitute a concentration within her estate. I see Warren Buffett's pronouncement that his wife's estate should invest the non-Berkshire Hathaway portion in a low-cost index fund as prudent in the context of her situation. She will have more money than she will likely ever need, she will still own significant shares of Berkshire Hathaway, and the costs of allocating this sum of money on top of paying active managers and hedge funds would be significant. Buffett has also stated in the past that the average investor would be well served by low-cost indexing. The average retirement age person in the U.S. has less than $75,000 saved and invested for retirement. I would concur with Buffett that the low-cost passive investing makes a lot of sense for the "average" investor. That brings us to the non-average investors who make up Seven Summits Capital's client base. Buffett has provided a lot of very sound advice for the non-average investor who has sufficient wealth to build an individual stock portfolio or have a good money manager do it for them.

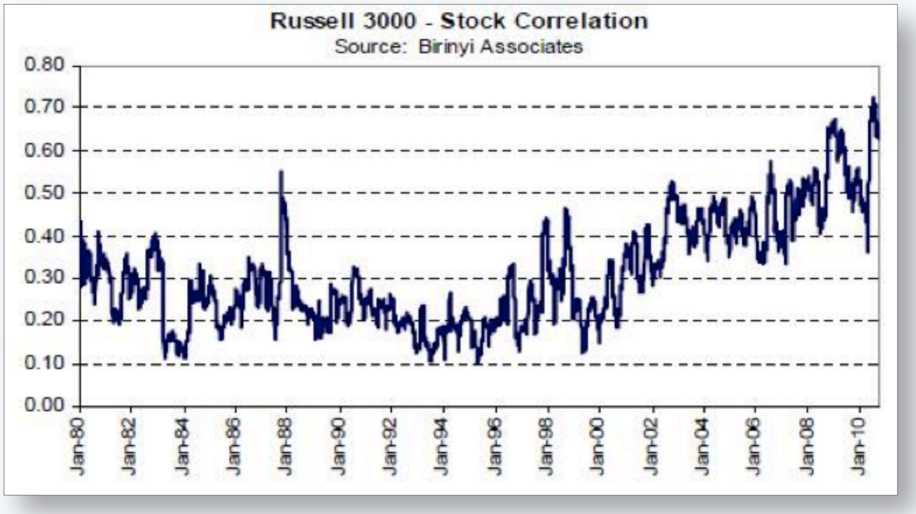
The following comments pertains to those investors who can prudently get access to active investment management at a reasonable price. Buffett once stated that, "nothing sedates rationality like large doses of effortless money". I cannot think of anything more effortless than passive index investing. Several decades ago when index mutual funds gained prominence, the intent of offering these funds was to allow small investors, who did not have sufficient assets or skills to assemble a portfolio of individual stocks, the opportunity to access to the average returns of all active investors. Today, I estimate that over 50% of the equity securities in the public markets are owned within overtly passive index mutual funds, ETF's, and what are called "closet index" funds. These closet index funds are large "actively" managed funds that are statistically indistinguishable from the index to which they are benchmarked.

The proliferation, over the last twenty plus years, of passive investment strategies has caused investors to place far too much emphasis on day-to-day, quarter-to-quarter, year-to-year market performance. I embrace investing based upon Warren Buffett's philosophy that, "I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years". For Seven Summits Capital clients, who have added non-traded investment strategies to their portfolios over the last couple of years, these private investments inherently fall within Mr. Buffett's philosophy that urges investors to invest on a long-term premise instead of worrying about what the market does within the span five years increments.

As mentioned previously, index funds were originally designed for small investors so that they could easily capture the average returns of all active investors within one or two funds. I contend that passive investing no longer succeeds at providing an investor with the average returns of the active market participants. From an article published by WSJ Interactive, titled "Index-Fund Movement Recalls Physic's Uncertainty Principle," Burton Malkiel, an academic who advocated passive investing from the time that Vanguard first introduced the index fund, reflects that "for a couple of years, I think Jack Bogle [Vanguard's chairman] and I were the only shareholders. The idea was to let investors duplicate, a broad market average -- not to influence it." I have been very concerned for a long-time that the blind faith in indexing, and the allure of these products' low expenses, have ballooned index strategies' share of all equity invested capital to a level where the index return, once just a measure, has become a strategy to chase.

Patrick O'Shaughnessy, of the O'Shaughnessy Funds, recently published an article titled "When Measures Become Targets: How Index Investing Changes Indexes." Mr. O'Shaughnessy reminds readers that the very definition of an index is "an indicator, sign, or measure of something". The article states that when "measures then became the targets of enterprising citizens, in the process they ceased to be good measures. In America, home ownership was a measure of quality of life and happiness, so it became a target, and we know how that ended. This is becoming a bigger and bigger problem in the stock market." I have been speaking about the possibility that the same markets, that individual investors are generally frustrated with in recent years, are being distorted by market chasing investment strategies. I have argued that the popularity of passive investing itself is contributing to the market behavior that investors, who are choosing passive strategies out of frustration, are attempting to avoid with the use of these products. In other words, index investors are seeking a more certain outcome in the broad markets, while those same markets are being made more uncertain by the popularity of index-oriented investment strategies. This paradox is only evident when one steps back and looks at the impact that passive investing has had on markets over a multi-decade period of time.

The O'Shaughnessy article refers to the "Goodhart Law," which states that, "when a measure becomes a target, it ceases to be a good measure." In the article, value investing legend Seth Klarman is quoted from a 1991 Barron's article on the subject of the eventual effect of index investing on the markets. The early 1990's period represented a time when index investing was just beginning to become mainstream among both institutional and individual investors. Klarman stated, "a self-reinforcing feedback loop has been created, where the success of indexing has bolstered the performance of the index itself, which, in turn promotes more indexing. When the market trend reverses, matching the market will not seem so attractive, the selling will then adversely affect the performance of the indexers and further exacerbate the rush for the exits." One must ask whether Klarman's assessment is correct. I contend that his assessment is beginning to become evident. Below is one of the most widely published historical graphs of the correlations among all U.S. small, mid and large stocks:



This graph only runs through 2010; however, the power of this illustration is in its long-term trend, which shows that correlations among the majority of U.S. stocks remained in a fairly tight range for 20 years, hovering around a mid-point of 0.25 through the late 1990s. However, after the bursting of the dot.com stock bubble, correlations jumped up and never really reverted back to the long-term range that existed between 0.10 and 0.30. Instead, we see the range initially jumping into the 0.20 to 0.40 range for a couple years. The range then jumped again after 2003 to 0.35 to 0.50, and again following the 2008 financial crisis. The range remained above 0.40 for much of the 2000s and widened out later in the decade due to the extreme market volatility of that period.

As more and more dollars are committed to passive index strategies, it is intuitive, and is supported by the graph above, that a higher proportion of an individual stock's day-to-day price movement will be driven by non-fundamental dollars flowing in and out of passive index funds and ETF's.

From an individual investor standpoint, I believe that the growth of passive investing is dumbing down investors because of the myth that passive investing is a less risky, while providing higher returns. This dumbing down of the practice of investing, which I believe is a professional endeavor requiring hard work, process-driven execution, focus, and discipline, carries with it very misunderstood risks. In 2012, the Financial Analysts Journal published a report titled "How Index Trading Increases Market Vulnerability" authored by Rodney N. Sullivan, CFA and James X. Xiong, CFA. This report was a comprehensive study of the effects of indexing. The report concluded that, "the growth in trading of passively managed equity indices corresponds to a rise in systematic market risk. From this finding we can infer that the ability of investors to diversify risk by holding an otherwise well-diversified U.S. equity portfolio has markedly decreased in recent decades. As our research has demonstrated, U.S. equity portfolios have become less diversified in recent years; returns for all subsets have become more correlated, leaving no areas for investors to improve diversification and thus mitigate risk." Over my career, I have managed client money through many very scary periods in the markets. The one take-away that I have drawn from these experiences is that most individual investors' greatest fear comes from the unpredictability and irrationality of the markets themselves.

At Seven Summits Capital, we borrow one powerful attribute that a market index inherently possesses and that is remaining fully invested at all times as a strategy. We then substitute the mindless diversification and perverse market capitalization weighting that indices, such as the S&P 500 are characterized by, with a 25 to 30 stock portfolio assembled without giving consideration to broad market attributes, such as sector weightings. We select our securities carefully and opportunistically by screening for superior value attributes, under-appreciated growth potential, quality earnings, and proven management. I have found that this approach usually puts the individual investor more at ease, not less, during difficult times. This occurs because the investor is reminded by the individual securities that they own operating companies that have very real durable value, as opposed to owning "the market," which is enigmatic, misunderstood, and frightening at times. Warren Buffett has weighed in on the questionable value of broad expansive diversification. His comment is "diversification is a protection against ignorance. It makes very little sense for those who know what they are doing." Clients of Seven Summits Capital know that I rarely use the word diversification. Instead, I talk about achieving the risk management in a portfolio through careful consideration given to correlations between investments, which is truly the root objective of diversification.

I know that this was a longer than average commentary, however I believe the subject of passive investing is a very important topic and I feel passionately that the affects and risks associated with this common investment strategy are not well understood. My desire is for clients of Seven Summits Capital to be very well educated about the principles of investing, risks that are not well understood, and the merits of active management. After the last two months of extreme market and stock price volatility, the merits of active management come into sharp focus. Warren Buffett famously encourages investors to embrace volatility by stating that investors should "look at market fluctuations as your friend rather than your enemy, profit from folly rather than participate in it." A passive investor cannot "profit from folly" if they simply resign themselves to passively riding the market up and down. An active investor can "profit from folly" by seizing on the proverbial "babies thrown out with the bathwater" when the sentiment of the market swings negative, as it did in January and early February of this year.

I did receive a number of requests from clients regarding future topics to cover in our monthly commentaries. I will be touching on these topics over the coming months. If you did not contact me about a topic that you would like me to touch on, please do so at any time.

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