

Market Commentary Second Quarter 2018

If there's an earthquake, do you have disaster preparedness kits in your car and house? And what's this question got to do with investing, anyway?

Most of us aren't prepared for a disaster. That's because we suffer from a condition psychologists call "normalcy bias". That means we underestimate the possibility of a disaster from actually happening. And even if were to happen, normalcy bias leads us to make five wrong assumptions: that the disaster won't affect us directly, that we can pull together a kit from items already in the house, that the disaster won't be that bad, and if it is bad we can always get emergency supplies at the store, and finally, the government will rescue us.

Take a moment and think how much better you would feel if you assembled a disaster preparedness kit this weekend. Google <https://www.redcross.org/store/preparedness> for the Red Cross' sensible and easy-to-follow kit guide. If you live in Los Angeles County, you can go to www.lacounty.gov/emergency/alert-la and sign up to get up-to-the-minute notifications of an emergency in your neighborhood.

Now, take another moment and think how much better you would feel if you had a financial disaster preparedness kit. But again, the normalcy bias thwarts us. It's as easy to make delusional assumptions about financial disasters as earthquakes or tsunamis or wild fires. We fool ourselves into complacency, thinking the "big" one already hit us in 2008, or that it won't be as bad this time because better regulations are in place.

What does a financial disaster preparedness kit look like? It's the equivalent of having a two-month supply of water and food in the house. It's a diversified portfolio of stocks, bonds, commodities and other non-correlated assets such as real estate or art. But at 7Summit Advisors, it's not just any stocks or bonds.

As a value investor, I look for companies whose shares are selling at a discount and where I believe the market has mispriced the company's assets or cash flow. Typically, the premium has already been taken out of value stocks, so they should hold up relatively better in the downturn.

Some investors like Warren Buffett, his partner Charlie Munger and Seth Klarman at Baupost Group, the hugely successful hedge fund in Boston, take value investing a step further and search for "margin-of-safety" stocks. Investors borrowed the term from the engineering profession; it refers to requiring a higher level of reassurance in case something goes wrong.

To give a simplistic example, there would be a big margin of safety if IBM stock fell from its current to \$146 a share to \$20—assuming normal operations—because IBM's net assets are worth much, much more than \$20 a share. We bought two stocks during the fall of 2016 that offered a margin of safety, Twitter (NYSE:TWTR) and Shake Shack (NYSE:SHAK)

Twitter stock has rocketed up more than 80 percent through the first half of 2018 to around \$44 a share, reflecting investors' approval of changes to its platform, a clearer strategy and its first quarterly profit for the 4th Quarter 2017.

Shake Shack is Daniel Meyer's brainchild, a restaurant chain that started as a hot dog stand in the Big Apple in 2001. Shake Shack's first quarter revenues hit \$99.1 million, up 29.1% compared to the same period a year ago--better than analysts had predicted--and earnings per share jumped to \$0.15, up from \$0.10 during the same quarter last year. The stock trades for about \$63 a share, up from around \$30 a share last August.

The problem with value plays is that they can take years to work out. (Our timing with Twitter and Shake Shack was fortunate.) So, some people get impatient, sort of like eating the energy bars in a preparedness kit because, well, no disaster happened.

A bull market will do that. Why watch a margin-of-safety stock tread water when so many easy picks abound? This bull market, now in its 9th year and ranked the second-longest in history, encourages the normalcy bias even though the lessons of history should still be fresh. A widening trade war with China, rising interest rates and simmering geopolitical issues could corral the bull tomorrow. Having a "backpack" of defensive investments helps all of us at 7Summit Advisors sleep better at night.

As always, thank you for the trust you have placed in me and in 7Summit Advisors. We work hard to earn that trust each day.

Sincerely yours,

Li Chang