Southeast Asset Advisors, Inc.
Lanigan Wealth Management
Registered Investment Advisors

The Margin of Safety Quarterly

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member of
the LANIGAN GROUP of companies

Southeast Asset Advisors, Inc.
Lanigan Wealth Management
Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile

TO:	Clients and Friends
FROM:	SEA/Managing Directors
RE:	Newsletter – 3rd Quarter Commentary
DATE:	October 2015

Our Long-Term Goal at SEA:
We strive to protect and grow our clients' capital over the long term by: (1) focusing on individual client goals and objectives, (2) having the proper asset allocation to reflect each client's tolerance for volatility (risk tolerance), (3) stress testing short-term liquidity needs, and (4) investing with a value orientation, utilizing managers who understand the intrinsic value of a business and margin of safety.

Third Quarter Sell Off/Correction Comments

The third quarter has ended, and no one is sorry to see it go! In fact, it was the worst quarter for stocks since 2011, with most indexes down 10% or more at some point. The S&P 500 finished down 6.4% for the quarter and 5.3% year-to-date. Value generally performed worse than growth, and small cap did worse than large cap.

Anything related to energy (down 21% year-to-date) got hammered, as did anything related to China, or any commodity for that matter. Taken in historical perspective, the current decline should not be a surprise as markets regularly decline 10–15% in the course of a steady move upwards, like we have had since 2009. However, this correction feels different because it has been awhile since we had a correction.

What was Different in this Correction?

Volatility reached extremes on some days. On Monday, August 24, we saw flash trading cause chaos in the markets – with many stocks down more than 20% during the day and some exchanged traded funds (ETFs) down over 38% as they deviated from the net asset value of the volatile underlying stocks. In the end, the S&P 500 was down 4% for the day. We suspect high frequency computer trades (HFTs) triggered "algorithms" which aggravated the selloff.

The broader volatility throughout the quarter was caused by "general fear" as well as uncertainty surrounding the Fed's decision on rate changes, signs that China's growth is slowing, and China's devaluation of their currency in an effort to spur export demand.

Bottom line momentum investors and computer "flash trades" ruled the day, and relatively good fundamentals were overshadowed by macro pressures and fears.

What Drives Mr. Market in the Short Run vs. the Long Term

Whether it is momentum investors, computer flash trading, or fear and greed (psychology), it is the same script in the short term. In the long term, bottom up fundamentals determine a stock's value as Mr. Market ultimately prices companies correctly. Whether privately held or publicly traded, in the long term a business is ultimately worth the present value of the cash earnings it generates. So, buying great businesses at reasonable/good prices, run by capable managers who deploy capital to accelerate "value growth," will be successful in the long term.

Subsequent to the post global financial crisis, massive asset flows into index funds have fueled passive investing success, causing some to question whether individual stock picking is worthwhile. We view the issue as not whether one or the other is correct, but believe that a combination of active and passive is normally in order. However, in this environment (market not cheap but not way overvalued) we strongly favor bottom up fundamental stock pickers/active management. It may not show up as beneficial in the short term, but it gives us confidence to stay invested during volatile times and to avoid trying to time the market. Further, with proper asset allocation reflecting a client's individual volatility tolerance, we can use volatility to a client's long-term advantage.

Value Investing – Concentrated Value Managers Comments

Wally Weitz, a great value investor, wrote the following in a recent letter discussing value investing: "We believe that the value of a business to its owners is the price today that an informed buyer would pay for the right to receive the cash that business will earn in future years. That price is an estimate based on (presumably) informed predictions. The estimate is subject to change as the business landscape changes, but ***generally, the value of a business changes much more gradually than the company's stock price.*** So, as emotions drive investors to overreact to imperfect information, a stock's price can move far below (or above) that company's business value. Business value is (roughly) measurable and it acts as a powerful "gravitational force" on a company's stock price. Investors usually (eventually) recognize business value, and if not, a buyer of the whole company may take advantage of the bargain. Unfortunately, the ***timing*** of the reconciliation of price and value is always a mystery."

Some of our Concentrated / Active Value managers are underperforming vs. the index this year – some by significant amounts. This short-term deviation can be troubling for investors, but we remain confident in our managers because of the constant due diligence we perform on them and their holdings. Some of the factors that give us confidence to hold through this period of underperformance include:

- This type of performance is not unusual in the short term for these managers.
  - Value managers may have a higher current exposure to Energy and Materials than growth managers as they end up contrarian.
  - Concentrated portfolios are always more volatile than the broad index.
- The time tested value investment approach of our key managers has been successful long term and remains intact.
- The skill, experience, discipline, and common alignment of interest of the managers we use is comforting. Typically, our managers have little turnover in their staff and significant amounts (or all) of their personal capital invested alongside us and our clients.

- The quality of the businesses in the current portfolios. Based on our discussions with managers and our independent review of their holdings, we find portfolio holding of companies that have competitive strengths and strong management who are properly incentivized to allocate capital to grow per share value.
- The margin of safety in their portfolios, as a whole, are trading at low price to value (P to V) multiples, which imply superior returns from this point forward (in our opinion). For example, one manager's portfolio has a free cash flow yield of 8.9% vs. the S&P forecast cash flow yield of 4.9%.
- Many previous periods of value investing underperformance (where momentum investing was the rage) have been followed by periods of very strong absolute and relative performance as the market eventually correctly prices the undervalued companies in the portfolio. Value investing requires time for the markets to understand or correctly interpret a company's operating strengths. As noted earlier, "the timing of the reconciliation of price to value is a mystery." Time and patience are critical to the success of value investing.

- We believe that the market will move back to a phase where value should outperform growth. As one investor recently quoted, "Value stocks will lead the next leg of this bull market, not the momentum stocks that have been the best performers of the last six years."

Investing with concentrated value managers requires that investors have great confidence, patience, and discipline. This is why we use multiple concentrated managers. This can only be achieved by knowing the manager, what is in the portfolio, and why. We continually monitor our managers and work to maintain our conviction in these concentrated value managers as their performance will vary (sometimes significantly) in the short term from the benchmark index and test our patience and discipline, but we know that:

- In order to outperform the index, you must invest differently than the index.
- To be successful, investors must fight the urge to chase returns when their manager is underperforming on a temporary basis. Study after study shows that investors typically change funds at the wrong time. For two decades, Dalbar, a market research firm, measured the performance of US investors in mutual funds. The results show that in the 20 year annualized period ending 2014, while the S&P returned 9.85% annualized, the average fund investor earned just 5.19%, due to changing funds and chasing returns.

Where do We Stand

While this correction is uncomfortable, we do not believe this will lead to a long-term bear market. The economy is not booming, but it is set up for slow steady growth, and there are no signs that a recession is imminent in the US. Unemployment is improving, wages are improving, household formation is improving, gas/energy prices are low (good for the consumer), and inflation is low/non-existent. Additionally, interest rates are low, and they are expected to stay low. Indications seem to point to the Fed raising rates 0.25% and then "hold" for a while. This will leave rates at a very low level and should not hurt the economy. All this points to a growing economy.

Investing in the stock market is a long-term rational exercise. The market over the long term is relatively efficient, but can occasionally get very expensive or very cheap. Currently, we believe the market is not cheap, but not expensive either, certainly based on other investment alternatives (i.e., fixed income). The prudent course of action for investors and our clients is to follow a reasonable asset allocation plan that accounts for cash requirements – and to expect volatility, which we view as an opportunity. Attempting to time the market or panic and sell stocks is not a winner's game.

Summary

The reality of owning stocks is that occasionally, inevitably, we will experience volatile market declines. A key ingredient in managing through corrections is helping our clients accurately assess their risk tolerances and investment objectives. If you are in an appropriately structured portfolio and have cash and other resources to provide liquidity through temporary market volatility, there is no benefit to selling in a market downturn. In fact, by doing so you risk selling nearer to the bottom and then missing the subsequent recovery. Our bias is to view such downturns as potential buying opportunities.

It is worth repeating again in this letter – we believe it is important for investors and their advisors to reassess goals, cash needs, and temperament, all of which impact asset allocation decisions on a regular basis. If we (and our clients) have the proper temperament, adequate cash reserves for spending, long-term discipline, and valuation as our "North Star," we should prevent long-term permanent loss of capital. We are ultimately only as good as our clients – staying focused in the long term.

Welcome New Managing Director, Staff, Mobile Office

This quarter we want to welcome Mikell Leland to our team. Mikell has been a friend of our firm for many years, and he shares our core values. He has worked over 23 years in the investment business, and we are excited to add Mikell's great experience and talent to our team. Mikell will be a Managing Director and work out of our new office in Mobile, Alabama. Additionally, we have added Dianne Ewing, who will be an executive assistant to Mikell in Mobile. Dianne also comes with over 19 years of experience in the investment business working with advisors and clients.

Also, in Thomasville we are pleased to welcome Alexis Cooksey and Anda Spencer to our team. Alexis will be working in our client service/compliance area, while Anda will be in portfolio accounting and administration. They both add depth to our existing wonderful and dedicated team.

In Closing

At Bernie's daughter's wedding last month, he ended his toast saying, "The most important things in life, other than one's faith, are family and friends." We are so lucky that our clients are also our friends – on whose behalf we work hard not to disappoint. It makes our jobs much more enjoyable to know that we are helping those who we truly care about.

As always, thank you for your confidence and trust. We are working hard on your behalf. Please contact any of us at any time if you desire to schedule a personal conference to discuss your individual allocations and any changes in your goals, cash flow needs, or other personal aspects that impact your investment plan.

Have a great balance of the Fall and a happy upcoming holiday season.