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

The Margin of Safety Quarterly

July 2016

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: 2nd Quarter 2016 Letter
DATE: July 2016

Our Long-term Goal:

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.
(3) Stress testing short-term liquidity needs.
(4) Investing with a value orientation and utilizing managers who understand the intrinsic value of a business and margin of safety along with passive strategies as appropriate.

Q2 2016 Comments…

During the second quarter, the U.S. stock market continued its sideways movement, interrupted occasionally by sharp, temporary dips like the one after the Brexit vote.

We have been rather negative about the outlook for bonds in these quarterly letters, and we continue to feel that way even though long bonds have performed surprisingly well. Example of "smart early dumb late" (i.e., late in our opinion) and like picking up dimes in front of a steam roller.

The clear winners among S&P stock sectors during the first half were utilities. The companies in this group, in our opinion, are not great businesses, but their stocks exhibit low volatility and have high dividend yields. These attributes make them close analogs to treasury bonds, which were the star performers during this period. The runner up group was energy. After the price of oil fell from over $100 to around $25, a rally to $50 gave new life to oil and gas stocks. Please see our prior quarter letter on energy. Another category of first half winners includes a handful of companies with highly predictable near-term earnings growth. Predictable growth has been so rare that these stocks developed a bandwagon effect ("momentum stocks.")

These momentum plays, though, hold little attraction for us. In an environment in which investors are frustrated and impatient for income and profits, there is a temptation to buy "what's working" in order to avoid being left behind. This is temporarily self-fulfilling for indexes as they are pushed higher by the momentum crowds. We try to remain both flexible and realistic, but we believe that sticking to our, (and our managers') valuation discipline, is key to our long-term success and past track record. We can also sleep well knowing that we and our managers are disciplined and fundamentals are part of our valuation culture.

BREXIT……………

The U.K. voted on June 23rd to leave the European Union, surprising investors and triggering a 2 day sell off of equity securities in all major markets. A flight to safety further lowered yields on the 10 year U.S. Treasury bond to ∼1.4%. The stock market recovered over the following several days and is actually hitting new highs as we write this letter.

All this uncertainty seemed to increase the certainty that Global Central Banks and our own Fed will keep rates low and provide additional monetary stimulus as needed to support the economy (and the equity markets by proxy).

Quantitative Easing (QE) - Negative Interest Rates

The concept of negative interest rates certainly seems like an oxymoron, yet sovereign debt issues throughout the developed market totaling over $10 trillion are trading at negative interest rates. Under these conditions, banks are unable to earn adequate spreads on their loans, insurance companies cannot earn adequate income to pay future claims, and savers are penalized. With "free money" available to borrowers, it seems inevitable that some uneconomic projects/acquisitions will be funded. This is wasteful at best but foreshadows future credit losses, in our opinion.

The current chapter of monetary policy represents a huge experiment. There will be unintended consequences. Many companies are taking advantage of this situation by extending maturities of their debt and lowering cost. However, others are tempted to over-borrow to fund transactions / expansions that do not make sense in a "normal" environment or to buy back stock at inflated prices (destroying value.)

Finally, these low rates cause investors to lower their discount rate (used in FCF valuation) increasing the price one is willing to pay for equity securities and thus, driving up the stock market. Also, investors chasing "yield" have driven up the prices for stable but low growth business that pay dividends beyond reasonable valuations. See our comments, attached to this letter, on acronyms as the latest we know here – **TINA – There is no Alternative**.

Outlook – Valuation Matters!

Finally, the most frequently asked questions are, "What happens next?" "How will the 'standoff' between positive and negative forces be resolved?" and "Will the next move be up?" **The short-term answers depend on market sentiment. The long-term answers always depend on valuation.**

Our impression is that while investors and most nonvalue advisors (which is almost all advisors) thereto, are neither confident nor enthusiastic about their holdings, they believe the Fed's QE safety net allows them to stay fully invested and avoid the risk of "missing out" as they crowd into indexes, yield payers, etc.

The more important factor is valuation. Although economic growth has been subpar, and many of our (and our managers) companies' growth rates have moderated, their business values continue to grow, albeit at a slower rate than expected. Our core belief is that stock prices eventually reflect the value of a business to a private owner. Alternatively, if a stock languishes below its business value long enough, there is a good chance that a buyer of the whole company will reward us for our patience by buying the company.

If interest rates stay below say 5% (now ∼1.4%,) then equities, valued using an 8% - 10% discount rate of conservatively estimated free cash flow and bought at 80% of their determined value, should be able to make ∼11% plus compounded. That is if the company is a good business, has good management, and capital allocation to go with a fair to discounted price to value. If interest rates change, the value of everything changes, but we (and our managers) have a built in margin of safety using an 8% - 10% discount rate.

The next six months should be interesting. Global stock and bond market volatility has been on the rise and may give us some opportunities in the second half. The political process at home promises to be colorful, but the American “system” ought to be able to withstand any potential outcome. However, we are certainly concerned about the Supreme Court nominations, as they are lifetime appointments.

Globally, we believe that the world is in an extended period of low returns across asset classes. Interest rates are the “price” of money, and money is cheap as measured by the low interest rate environment around the world. As discussed herein, many developed markets have negative rates, which we once viewed as highly improbable. The uncertainty introduced by the Brexit vote, our presidential elections, and slow growth among other things seem to insure that rates will stay lower longer. We believe these factors will mean investors must accept and prepare for lower returns across asset classes, generally.

Investors are faced with a choice. With inflation at close to 2% and US Treasury rates ranging from 0.5% for one year to 1.5% for 10 years, investing in treasury notes will deteriorate real purchasing power of your capital over time. The alternative is to overweight equities as most indexes (we think) are priced to return ~5% over the next ~5 years. While that is lower than equities have traditionally produced, it may protect and grow the purchasing power of your capital, but this introduces more volatility to portfolios as ones equity allocation is increased.

There are steps that we are recommending, and using in order to improve results beyond what we believe the broad market indexes may be offering at these levels. The first step is to utilize active management (value and **GARP - Growth at a Reasonable Price**[1]) as opposed to investing in an index. Indexing has outperformed most managers over the last 6 – 8 years, and investors have been moving money from active to indexing in greater numbers. Books are being written about the “death of active management.” However, we believe that the trend is about to change and as usual, investors switch to “what has been working” at just the wrong time. We believe successful active managers possessing a valuation based process, a concentrated portfolio (with good business, good management) that looks different than broad market index and have their own money invested alongside us, etc. can outperform. Often these managers will hold cash if they cannot find qualifying investments, which may hurt returns in the short term, but it provides ammunition when opportunities are present. While we believe in indexing in the efficient part of the market (and have some in most portfolios), we also believe now is the time to weight towards great active value managers or stock pickers, as they should be able to outperform over the next 5 years, and have a few great individual fat pitches (hint Berkshire Hathaway and Level 3.) Concentrated value managers will be volatile and not correlate with the broad indexes and will underperform during certain periods, so patience, as always, is required.

The second step is to hold some opportunity cash in the portfolio that is earmarked for investment when volatility presents an opportunity. In our opinion, the cost of holding cash is low as we do not see significant market increases and bond yields are low. However, it is important to have a plan for investment. Target levels for stocks or indexes where the cash will be invested. Without a plan, the cash may not be deployed and thus the opportunity lost. The Brexit decline is a recent example; with the market down 5% any cash deployed at those levels quickly returned 5% on the rebound. The market and stocks rebounded so quickly that we could not deploy much of our opportunity cash, but we feel other opportunities will come along if we are patient and remain disciplined.

We have attached to the newsletter an instructional observation entitled “What is smart early is dumb late and the use of acronyms” for your reading.

[1] The P/E or P/B ratio screens using conventional value metrics, for example, give no credit to non-earning assets or reinvestment, etc. or other nontraditional measures of ‘value’ as well as awesome management and capital allocation, etc. Intrinsic value determination and growth thereof takes judgement not just computers screens.

Our Final Thoughts

The world is full of risk and uncertainties and seems like a complete mess. Recent terrorist acts, the Brexit vote, our own presidential campaign (few are excited by either candidate,) low interest rates, low global growth and high (and growing) global debt, entitlements, and class “warfare” are just a few of the major issues that worry us. Low interest rates (to some extent) are likely going to be with us for some time resulting in lower returns for most asset classes and higher volatility. It is easy to become quickly overloaded with negativity at the current state of the world. While much seems out of our control, there are things we can control, and these are the things that give life true meaning and satisfaction during these turbulent times.

It is important to appreciate what we have, remember what is important to us in the long–term, and to remain optimistic. We are all fortunate to live in the U.S., which is and will continue to be the best (and safest) place in the world (regardless of how our elections turn out.) Remember that family, friends, and health are precious blessings and should be nurtured each and every day. Make sure that you spend some time with those you love doing something that you love. In choosing friends, employees, partners, clients, and customers, make sure you are surrounding yourself with people of high character, integrity, compassion, intelligence, perseverance, and loyalty. This is what ultimately will decide our success or failure / happiness or frustration within our lives.

Remain optimistic! Looking back, things are never as bad (or as good) as they initially seem. In the long term, most problems will be resolved and the long-term trends of increasing prosperity for the U.S. and the world at large will continue. Growth is not without bumps, and every generation seems to have its challenges. This generation, like those of the past, will solve problems in ways that we have not yet imagined. Technology is changing our lives in many ways and will help both us and future generations have healthier, longer, and better quality lives moving forward. Our capitalistic system is not perfect, but in the long run it is the best in the world.

We are thankful for our families, our clients, our partners, and our friends; all of whom give us great purpose, as they are the best... we value the trust that is placed in us, and welcome the challenge to build on that trust every day.

Contact us if you desire a personal conference or have any questions. Have a great balance of the summer and try to stay cool!

Your SEA Investment Team

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*“We believe the market impact of this uncertainty,
though severe, is more of a short-term
phenomenon which will provide opportunity for
long-term investors who understand valuation and
are disciplined and patient.”
- A great SEA manager*

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SEA EXHIBIT A TO 2ND QUARTER 2016

WHAT IS SMART EARLY (AND AT ONE PRICE) IS DUMB LATE (AT ANOTHER PRICE) AND THE USE OF ACRONYMS

We read an interesting article recently that gave some funny (but true) rules of thumb that illustrate the above title. In the following commentary, we have paraphrased and added to this article.

“Speculators,” (not investors), should be concerned when they are late in following a fad or momentum, as the “herd/crowd” always go into something when the party is almost over. A good rule of thumb to avoid this mistake is to watch for Wall Street to start using acronyms. For example, the use of the acronym **TMT – Telecoms, Media, and Technology,** and the subsequent pop of “tech bubble” in 2000. Just as **TMT** were taking it on the chin, **BRIC’s** acronym was born (circa 2001) denoting the four emerging market powerhouses that were going to grow to the sky – **Brazil, Russia, India, and China**. They have, of course, lagged significantly behind the developed markets in recent years.

The pools of mortgages, called **CDO - Collateralized Debt Obligation.** That acronym signaled the end of financing craziness; and the housing bubble that collapsed in 2008. Remember what the then head of Citigroup, Charles Price, said at the top of the **CDO** bubble, “When the music plays you must stand up and dance.” He was, of course, replaced in 2007 when CITI and all banks had huge lawsuits and losses on **CDOs**.

Then we watched the “herd” jump to a new acronym called the **FANG’s – Facebook, Amazon, Netflix, and Google**.

So for this year, the hot acronym is **STUB – Staples (necessities), Utilities, and Bond**. All very late cycle, (we think), as many go for at least some yield without regard to price and sustainability. For now, income–crazy investors are not concerned about their valuation or risk of permanent loss of capital, therein.

One of the other latest acronyms is **PIISTA – Passive Investing Is Superior To Active**. Prior newsletters have given our comments on our philosophy of passive versus active. “What is smart early is dumb late” sums it up on going into passive “large cap” at the present time unless you have an extremely long time horizon (see our valuation comments on large cap index).

Why? Another new acronym is the rage **TINA – There is no Alternative.** This implies that we must go into equities (passive not value managers) and high dividend payers, REITs, etc.

Lessons to Above Acronyms Musing

- **Be careful when anyone uses acronyms, as this is usually a sign that you are “late rather than early.”**
- **Thinking and fundamentals win in the end. Most value investors are “early in” and “early out,” which requires patience to let the herd quit buying at high prices.**
- **“A good company can only be a good investment if it has value growth that can be bought with a ‘margin of safety’ or below a conservative appropriate valuation.”**
- **Value is what you get, price is what you pay.**