Southeast Asset Advisors, Inc.
Lanigan Wealth Management

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile

TO: Clients and Friends
FROM: SEA Managing Directors
RE: 3rd Quarter 2016 Letter
DATE: October 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.
(5) Rebalancing portfolio holding/managers when appropriate to take advantage of underpriced and avoid overpriced assets.

Q3 2016 Market Commentary

The S&P index rose nearly 3.8% for the quarter and was up some 7.8% year to date.

However, during the quarter, investors registered high anxiety with stocks rising and falling in response to oil related headlines and any suggestions of interest rate changes by central banks. The media is generally focused on the presidential election as the candidates compete for "soap box time" rather than discussing their plan for addressing jobs, growth, entitlement, healthcare costs, and our growing deficit. GDP growth continues to be very slow even with central bankers keeping interest rates low. This continued low growth is a real conundrum and may be attributed to technology, education levels and demographic dynamics of increasing income inequality.

The "passive index momentum" continued during the quarter. Yield hungry investors pushed some sectors, and stocks therein into bubble territory (more on this later) because they believe TINA (There is no Alternative). On the positive side, one of our great value managers that had been hurt by its commodity company holdings over the last few years experienced strong quarter and year to date performance, vastly outperforming the indexes year-to-date. Deserved confidence in a manager experiencing a rough patch is a complicated and critical decision. It is gratifying when your confidence in people and their process is reinforced and validated.

On the fixed income side, yields on U.S. 10-year Treasury bonds ended the quarter at 1.64%, up from 1.51% as of July 1, as investors braced for an interest rate hike by the Federal Reserve that did not come (bond prices fall as rates rise). The core bond index gained just 0.4% for the quarter and is up 5.7% year to date.

Those looking only at starting and ending yield levels would have missed the big mid-September move. Yields briefly backed up to 1.75% on worries over central bank policies. The Fed's decision not to raise interest rates in September smoothed markets, but a December rise is potentially still on the table. Financial markets remain keenly attuned to this possibility. For now, flows into core bonds are strong, the buyer base is broad, and central banks across the developed world remain hesitant to hinder a still fragile economic recovery by doing more than just paying lip service to a move away from their easy monetary policies.

Where do we go from here?

Our answer is, "In the short term, the market is a voting machine but in the long term, it is a weighing machine" (Benjamin Graham). Thus, as always, we make it clear that we have no reliable predictions about the short-term movement of the market (nor does anyone). However, currently we see few stocks that are cheap and many that are overvalued if indeed rates do increase.

In order to help us allocate capital and properly value assets, the key questions that we are trying to answer (at least within a range) are: What will be the ultimate consequences of huge increases in money supply by the Fed and virtually all central bankers around the world? Will it end in stimulation of economic growth (finally) or inflation? Our training, economic theory, and historical experience strongly suggests that both the inflation rate and interest rate will eventually move to higher levels.

With this as our current base case, we are keeping the duration of our fixed income exposure very short (giving up some yield) and credit quality high. We use a high 9 to 10% discount rate (when compared to 10-year T-bill) when valuing a company's conservatively estimated free cash flow to provide a large margin of safety. We avoid equities whose prices have been inflated by "yield chasers" such as high dividend paying stocks that have questionable balance sheets. We continue to prefer equities and managers who have an "intrinsic value" fundamental methodology and a "go anywhere" mandate to find qualifying investments. It is more important than ever to get the people (capital allocation) and business (moat, ROIC, etc.) right, and to buy at a price to value spread that has a margin of safety. Intrinsic value growth is key to avoiding a value trap.

Presently, we are cautious about investing in passive index funds or ETFs. Recent headlines saying "Active Investing is Dead" or "Dying Business of Picking Stocks" remind us of the 70's headline "The Death of Equities," which proved to be a major turning point of the opposite happening. We will write more on the ETF/Index investing vs. active managers in future letters.

Momentum Speculation and Yield Chasing Examples

In fixed income investments, the consequences of being caught long as rates rise can be devastating and wipe out years of interest income. For example, if the yield on a 10 year bond moves from 2% to 4% market yield, the price of the bond falls 16.4%. Looking at the inverse, if a stock has a dividend yield of say 3%, the price must fall 25% in order to increase the yield to 4% all other things equal. Small moves from low levels have big implications on value.

Consider the following chart showing the current 10 Year Treasury, and the Utility and Consumer Staples sectors.

These sectors look pricey!	Dividend Yield (LTM)	Volatility (1 Year Beta)	P/E Ratio or Equivalent		% Over/ (Under)
			Current	10-Year Average	
S&P 500 **Utilities** Sector [1]	3.6%	0.3	18.1x	15.0x	20.8%
S&P **Consumer Staples** Sector [1]	2.7%	0.7	22.2x	17.5x	26.8%
Ten Year Treasury [2]	1.6%	N/A	64.1x	34.6x	85.3%

(1) Source the Bloomberg as of 9/30/2016
(2) P/E Ratio for Ten Year Treasury estimated using the inverse of the current yield. 10-Year average yield for the Ten Year Treasury is 2.89%.

What stands out in the above chart is the current P/E ratio of the above sectors are over 20% above the 10 year average. Paying these high multiples for companies that are growing at less than 4% will not end well. It may be acceptable when the alternative is 10-year treasury at 1.6%, but when rates begin to rise, we think that these values will revert to their historic average valuations. Further, we believe the decline will be accelerated as many of the index investors run for the door simultaneously.

If the above chart is not enough of a bubble for you, look at these bonds, published in the Wall Street Journal on October 26, 2016:

Going Long With a 70-Year Bond

In the latest example of the impact of central banks' easy-money policies, Austria on Tuesday issued a 70-year bond—the longest-dated publicly issued government bond in the eurozone. C1

	Long-term sovereign bond yields	Years to maturity
Austria	1.53%	70 years
France	1.43	50
Italy	2.85	50
U.S. Treasury	2.50	30

Note: Austria's bond was sold with a 1.53% yield Tuesday. Italy's was sold with a yield of 2.85% on Oct. 4. The other bond yields reflect prices in the secondary market Tuesday Source: Thomson Reuters

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Who would buy these bonds?

Summary

We remain disciplined and patient. Many of our clients' portfolios and many of our managers' portfolios are currently holding more cash (and short-term, high quality bonds) than normal. As stated, we believe the stocks we (and our managers) own are well positioned to grow their intrinsic values, even while the market does not fully appreciate them. They/we are not holding cash in order to try to time the market, but rather, because it is difficult to find qualifying investments. As one manager put it, "Quality is expensive, but we will not reduce our standards just to put money to work. Patience can be difficult, but we are confident (and history has shown) that something will happen and valuations will become attractive again."

We do not know when rates will rise, or when investors will begin to question current valuations of certain overvalued sectors. We do not know when the passive/index investing momentum will end. Price discovery is vital to efficient markets, but it is not present in index/passive investments. Index investing has a role but, as with most of life, anything to an extreme usually ends badly. We remain disciplined and patient with client capital. Opportunities will appear, and we will invest cash reserves when risk/return make sense on a valuation basis.

Thank you for your continued confidence and trust. We are working hard on your behalf to control the risk and produce satisfactory risk adjusted returns within your individual goals and objectives in a very fragile and uncertain environment.

Please contact us if you want to discuss any changes to your goals or objectives and/or your specific financial or tax situations.

Your SEA Investment Team