The Margin of Safety Quarterly

May 2017

member of
the LANIGAN GROUP of companies

Southeast Asset Advisors, Inc.
Lanigan Wealth Management

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

TO: Clients and Friends
FROM: SEA Managing Directors
RE: 1st Quarter 2017 Commentary
DATE: May 2017

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.

Q1 2017 Market Commentary

The first quarter saw continued positive market moves that started the second week of November 2016, following the election. For the quarter, the S&P 500 returned 6.1%, a strong result in any quarter. It has returned ~11% since the election on the back of expectations of tax and health care reform and reduced regulations that should jump start the GDP growth, if enacted.

The quarter also saw the resumption of growth outperforming value (8.9% vs. 3.3%) and large cap outperforming small cap (6.1% vs 2.5%). As investors have continued to move capital to index and passive options, it has been a self-fulfilling prophecy that the largest stocks continue to perform best. The performance of the indexes is, however, again concentrated in a few names. Apple, Facebook, Amazon, Microsoft, and Google (Alphabet) have accounted for ~45% of the S&P's return last quarter.

International equity markets returned 7.4% this quarter. Broadly, international equities appear less expensive than the U.S. market. Our global managers (those that can invest anywhere) appear to have more opportunities than domestic managers, if measured by cash levels. Accordingly, we have started adding to international and global managers, but we are moving slowly. We will continue to closely monitor the international area and global managers in which we have confidence.

Finally, fixed income and bonds returned a scant 0.8% for the quarter, as the 10 year treasury yield is at ~2.3%. After inflation, we believe the real return is actually negative for many bonds. Rates have moved up since the election, but after an initial surge, long rates have leveled off and only short rates are moving up due to the Fed actions. As we have said in the past: We continue to believe that fixed income / bond yields are too low and do not compensate investors for the risk of rising inflation and rates. Long bonds continue to look like a "bubble" to us and clearly an area to avoid! Thus, we are keeping all fixed income durations very short, giving up some yield in the process.

Where do we now stand?

In general, current equity valuations are at the high end of fair value. However, the alternative for equities (i.e., fixed income/bonds) remain unattractive as current rates remain extremely low. Thus, equities look fairly priced, or cheap on a relative basis. Investors and forecasters appear to conclude that Trump's promises of lower taxes, less regulation, and higher growth will come to pass. For example, if Congress passes a bill that lowers corporate taxes to ~15-20%, we could actually see S&P earnings increasing by 10-15% from tax reductions alone which would make the overall equity valuation metrics more attractive.

The current S&P earnings yield (after corporate tax) is ~5.6% (PE ~17.8x), which is substantially more than the yield on the 10 year U.S. T-Bill rate of 2.3%. We expect that returns from equities in general from today's prices will be less than the long-term equity historical average and less than we normally want for taking equity risk. However, for long-term investors who can handle the possible increased volatility, there appears to be few good options to equities (as we have said in past letters). We currently believe that active managers with valuation discipline should be able to outperform the general market index (risk adjusted). Many of our value managers currently have more cash than normal and are having difficulties finding qualifying investments. Thus, our equity allocation is lower than it first appears as these managers are listed as 100% equities on your report. As noted earlier, our global managers do seem to see more qualifiers outside the U.S. We believe that our active managers should be able to protect capital by avoiding overpriced businesses and bad business models. The passive S&P index, however, owns and buys the highest market cap companies and is blind to valuation. As one active manager put it, "In a market decline, the index does not have any brakes."

Conclusion

We find the world in a very uncertain state with a lot of geopolitical risk. However, we are bullish on America and thankful that we live and work in the U.S.A.

Each of our clients is unique, having different goals and objectives, tolerance for volatility, and different cash flow needs, and thus, requiring different appropriate asset allocation. We certainly do not think equities in general are cheap, but if interest rates stay in the present range, equities are not in bubble territory. It is certainly a time to be long term and to only invest with managers who practice "bottoms up" valuation analysis to determine a company's intrinsic value and are managed by properly incentivized, capable operators.

Thus, we continue to maintain equity exposure with portfolio allocations near the midpoint of a client's target range. We have raised some cash in many portfolios as we have trimmed some individual stocks that have approached our valuation targets. We also recently added (in most accounts) to an individual stock idea that should participate significantly if the repatriation of overseas cash is allowed in a tax favored holiday as well as be a big beneficiary of secular shift to more online spending. As discussed herein, the cash levels of some of our guru active value managers are elevated, but we are confident that this capital will be redeployed if and when they find a qualifying investment opportunity.

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

Thank you for your confidence and trust.

Your SEA Investment Team