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The Margin of Safety Quarterly
Southeast Asset Advisors, Inc.
Lanigan Wealth Management

Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile – Charleston

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 1st Quarter 2018 Commentary
DATE: April 2018

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 (i.e., temperament.)
(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 holdings/managers when appropriate to take advantage of underpriced and avoid overpriced assets.

Q1 2018 - Welcome Back Volatility

The first quarter of 2018 began where 2017 left off, with continued upward momentum through January. Many investors had grown accustomed to positive returns and a smooth ride, but February was a wakeup call with the first monthly loss after 15 consecutive months of gains, followed by another monthly loss in March. In our last letter we said, "We expect more volatility." This proved accurate as there were more triple digit moves (in both directions) in Q1 2018 than in any quarter since the depths of the financial crisis in 2008. Also, as we go to press, 23 out of 27 days have had triple digit losses in the Dow.

We ended Q1 2018 recording the first quarterly loss in the US stock market index in about three years (~1%). Developed international markets also declined during the quarter, with a loss of ~1.5%. Emerging markets were the sole bright spot, with a gain of ~2.5%.

Core bonds did not play their typical "safe haven" role. They also posted losses during the sharp stock market correction in February and ended the quarter with ~1.5% loss, as Treasury yields rose across the maturity curve.

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What's Causing the Volatility? (Some Thoughts from Us and Our Managers)

Tech Stocks: Some of the largest tech companies (members of the FANG fraternity—Facebook, Amazon, Netflix, and Google) have come under particularly strong pressure. The Cambridge Analytics misuse of Facebook data brought Facebook's basic business model under scrutiny. Various public outcries accusing Amazon of hurting small retailers, not paying enough sales tax, taking advantage of the US Postal Service, etc., caused some wild fluctuations in its stock. Alphabet (Google) also dropped almost 15% in the first week of February as questions arose about threats to its advertising business. Facebook, Amazon, and Google are surely great businesses and models (margin, etc.). We, and some of our managers, own Alphabet in some portfolios, but they all are surely not automatic winners regardless of price level—valuation does matter, even with FANGs! Key is to forecast what the business may look like in 5 – 7 years, growth and sustainable competitive advantage. This is difficult in a world where all businesses must constantly change and adapt to disruption.

Index Funds and ETFs: Most index funds and ETFs are capitalization weighted. That is, the assets within the fund are allocated among the component stocks in proportion to the companies' overall stock market values. Subsequent flows of capital into and out of a fund maintain these proportions. Thus, the stock price movements of the very largest companies (which includes the FANGs) have a disproportionate impact on the volatility of the fund or ETF. For example, the tech sector represents ~25% of S&P (or did), but that does not include Amazon or Netflix which are actually in S&P consumer discretionary sector. With these included, tech sector allocation increases to ~28% of the S&P. As money flows into these passive instruments, new units are created by buying each of the component stocks. Large inflows mean large, non-price-sensitive buy orders which can exacerbate volatility of the underlying stocks. The reverse is true when investors sell the funds and the component stocks must be sold on short notice. The short-term fluctuations caused by these trades do not affect the underlying business value of the component companies. This is merely noise in the markets; however, the noise in both exuberance/momentum and the opposite, (i.e., fear) can get loud at times and investors can find it unsettling. This is a time to know what you own, the value thereof, and have confidence in the operators/capital allocators of the company you invest. We continue to favor bottom up research managers over passive index strategies in this momentum market environment. We continue to hold Berkshire Hathaway as our anchor in lieu of an index in many of our client portfolios.

Interest Rates and Inflation: Interest rates have been unusually low because of (1) Fed policy (manipulated) and (2) inflation has been low by historical standards for many years. Now the Fed is raising short-term rates and letting its bond portfolio self-

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liquidate as bonds mature. The withdrawal of the Fed's capital from the bond market puts upward pressure on interest rates. Inflation is beginning to tick up because of economic growth and very low unemployment, which also pushes interest rates higher. Rising interest rates act as a headwind for stock and bond prices. The impact is direct for bonds. For example, a 10-year, 2% bond issued at a price of $100.00 falls to $83.65 in value if comparable bonds soon become available with 4% coupons. With stocks, aside from higher borrowing costs, the impact is less direct. Higher bond yields present stiffer competition for investors' capital. In a higher-yield environment, stock investors require a higher prospective return from future cash flows, thus a lower starting stock price. As a result, higher interest rates generally lead to lower P/E ratios for stocks.

Of course, on the fixed income side, one benefit to higher interest rates is that we can design a laddered bond portfolio with view to hold to maturity as a fixed income strategy vs. staying in very short-turn maturities or cash.

Political climate: The polarization of Congress and the determination of our President to bring change to Washington have injected a large dose of uncertainty into the stock and bond markets. We have certainly experienced some positives from the new administration in tax reform and reduction of regulations, etc.; however, concerns exist around the current political climate (not only Presidential but Congress, etc.). America has withstood an amazing variety of leadership styles, and we are confident this trend will continue. Thank goodness we live and work in the United States of America!

Trade Issues: Trade issues are potentially very troublesome. We believe free trade is generally good for business in the long term. Tariffs and other impediments to free trade have not worked well in the past and seem particularly unwise given today's complex global supply chains. The outcomes of *Art of the Deal*-style bluster and backtrack negotiating tactics are hard to predict but seem certain to complicate life for many businesses, farmers, workers, consumers, and investors. Trade wars are surely a concern for Mr. Market; however, we are mindful that, "This too shall pass!"

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Tax Changes Comments

The changes to the tax code are significant. They continue to be a major positive impact on earnings and we think understated by many corporations in 2018 guidance. The key is what will companies do with the tax savings and will this indeed increase growth, intrinsic value per share, free cash flow (FCF), etc. And what FCF growth is priced in the stocks? The tax changes have made us much more positive on the valuation of this stock market and growth of earnings in general. It is not "tax reform," which is still badly needed. The new tax bill is a start in the right direction.

Deficit Musing…….

The potential downside of the tax cuts is the impact on the growing budget deficit which may well turn out to be inflationary. Last week, the Congressional Budget Office (CBO) released *The Budget and Economic Outlook: 2018 to 2028*. The CBO projects the federal government debt-to-GDP ratio will rise from 77% last year to 96% during 2028. Hopefully, the GDP growth and productivity will exceed what is used in these projections.

Interest rates will surely increase and will only make our annual deficits higher. Additionally, at some point, we must address the increasing entitlements spending part of our deficit.

Hopefully, over the long term, productivity and growth will help reduce our deficits. The CBO is acknowledging that the recently legislated cuts in tax rates and increases in spending will provide some fiscal stimulus to economic growth that will lift real GDP growth above its potential, which is determined by the growth in the labor force and in productivity.

We don't know "how this movie ends" as we continue to pass this deficit to the next generation.

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Increase in Earnings Expected

We generally expect major increases in earnings for many companies in 2018 from tax rates alone. However, over the past nine years company earnings have grown and the valuation of those earnings (P/E) has also grown substantially. Falling / low interest rates have also had a factor in the P/E expansion and now will be a headwind as rates increase. Eventually, rates will be at such a level as to make bonds and cash competitive with equities for investor dollars and change the words TINA (there is no alternative) to TIAA (there is an alternative) to equities.

It would be perfectly normal to see a number of years in which earnings continue to grow but P/E ratios shrink. The result could be a near-term market that generally moves sideways but with plenty of short-term volatility.

We expect value stocks and managers will play catch up to the "momentum crowd" in the near future.

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Our Game Plan
Temperament, Valuation, and Time are Key – "Proceed but with Caution"

Volatility creates opportunity for us (and our managers) to add value (long term), if indeed we adhere to requirements of investment qualifiers: (1) a good business with sustainable identifiable competitive advantages that are (2) fairly valued and (3) run by capable operators and capital allocators who understand how to grow the intrinsic value per share. The "people" part is the hardest and perhaps the most important to get right. Also, the business and value matter a lot, and we are confident they will matter more in the next five years than they have in the last five years. Thus, we are grateful to our managers who understand and evaluate all three components that are required for a great investment - Good Business/Good People (cap. allocators)/Good Price and wait patiently for a "fat pitch."

We will continue to invest in and with managers who use "bottom up work" to determine price to value; and who refrain from momentum speculation based on predictions regarding economics, markets, politics, or investor psychology. We do not think anyone can predict the macro successfully. The current environment is still mixed: a fundamentally better economy but with high valuations relative to history (some would argue they are more reasonable relative to current interest rates). There are many arguments for a continuation of the bull market, but equally compelling cases can be made for more caution. As always, it is very uncertain in the short term. We predict volatility in the short run.

We are positioning portfolios, relative to a client's goals, objectives, cash needs, and tolerance for increased volatility, to maintaining more or less a neutral equity weighting as well as holding some short-term bonds or cash depending on the clients' profile. We do not feel there is significant opportunity cost to holding extra cash at this time, but it is still something we generally do not like to do. However, the prospect of intermediate and long bond losses in a rising rate environment seem to us to be the greatest risk for long-term investors.

Patience is always important, particularly when many valuations are high – investors need to fight FOMO (fear of missing out). As indicated for long-term investors, we have a significant weighting to our value managers and to global managers as well as Berkshire Hathaway and a few individual stocks in many client portfolios.

Thus, for now, "we are proceeding, but with caution."

Conclusion

Trust is essential in all our relationships. At a time when confidence in institutions is in short supply, we are deeply grateful for the trust our clients have put in us over many years. We strive to make it always "deserved trust."

For our new clients as well as a refresher to all clients, please find attached our "1997 – Pledge/Commitment to our clients" by which we strive to live. Also, our required ADV offering and privacy policy.

Have a great spring, and call us if you want to meet individually.

The SAA Team

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"Wisdom is in the anticipation of consequences. They are always there but you may not always be aware of them." -Cousins

"During my eighty-seven years, I have witnessed a whole succession of technological revolutions. But none of them has done away with the need for character in the individual or the ability to think." -B. Baruch

"The secret now is to be disciplined. It's so easy to get carried away with things valued on the hereafter." -A. Patricof

Attached: "Pledge/Commitment to our clients (1997)"
ADV Annual Offering
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