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The Margin of Safety Quarterly

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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 2nd Quarter 2018 Commentary
DATE: July 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 to avoid overpriced assets.

Market Recap

Year-to-date larger-cap US stocks (Vanguard 500 Index) gained 2.6%, but they were outdone by smaller-cap stocks (iShares Russell 2000 ETF), which jumped 7.7%. The smaller-cap outperformance was driven by the market narrative *du jour* that smaller companies are more domestically focused and, therefore, not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

The dollar's appreciation during the year translated into a meaningful headwind to returns for dollar-based investors in foreign securities. Tariff concerns hurt international stocks. Developed international stocks (Vanguard FTSE Developed Markets ETF) fell 2.8%. Tariff concerns were most dramatic for emerging-market (EM) stocks causing a 7.3% drop in dollar terms (Vanguard FTSE Emerging Markets ETF).

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high. Yields then fell back, ending the quarter at 2.86%, a 12-basis-point increase from the prior quarter-end. As such, the core bond index (Vanguard Total Bond Market Index) had a negative return of 1.8% year-to-date (bond yields and bond prices move inversely to each other).

Outlook

We generally agree with a recent analyst who said, "This current cycle still has legs." With strong job growth in the US, inflation only beginning to creep higher, a favorable tax environment for corporations, and yields remaining relatively low (but rising slowly); we believe that earnings and cash flows will grow, keeping this market moving forward. Since the beginning of the year, we've seen earnings multiples pull back to ~16-17x from roughly 18.5x, but earnings (due largely to tax breaks) have improved significantly, which has kept the S&P moving in a positive direction. We believe the second half of the year may show continued improvement as the benefits of tax reform continually filter through corporate earnings in a more meaningful way. It is hard for the economy and employment to get much better than we are presently enjoying.

The following is a summary of our thoughts:

- Tariff and trade concerns (primarily with China) will continue to cause volatility, but in the end, it will be worked out. Tariffs hurt everyone.
- Capital expenditures and a strong US consumer are the engines of growth for the US economy.
- This market cycle will continue to run, but earnings (not PE expansion) will be the primary driver of equity returns. However, we believe that after the initial boost from tax cuts, the earnings growth may be slower.
- Interest rates will continue to increase slowly. Lower rates around the world will work to keep long rates in check. For our fixed income allocations, we are staying in very short duration bonds.
- Maintain a positive view of equities and a negative view on bonds and fixed income, other than short duration bonds.
- Maintain a bias towards high quality companies with a sustainable competitive advantage, bought with a margin of safety (MOS).

- A mix of active and passive is important. We believe that in the current market environment, investors should overweight active managers who invest in high quality companies purchased at prices that provide a margin of safety based on a conservative estimate of intrinsic value. (See attached exhibit "Value Investing MOS" for further discussion).
- While we favor US over international, we like managers who can "go anywhere" and have a global approach in the large cap space as we see some favorable valuation opportunities outside the US.
- Finally, we see some return on short term money markets with rates ~1.5%-2% in some cases. This means that holding some "opportunistic cash" is not as expensive as it once was.

We always have an eye toward what can go wrong or what might cause more volatility in the short run. Our current list includes:

- Geopolitical turbulence, especially trade tensions and trade wars.
- Profit Margins: Will increasing labor costs impact margins and bring them back towards the long-term average?
- Inflation: An inflation surprise could force the Fed to "catch up" with a more aggressive rate cycle than is currently anticipated.
- Mid-Term elections.
- Will tax cuts achieve the desired results, and will the time be given to see if they work as intended?
- Prolonged and uncontrolled slowdown in China (potentially from trade wars).
- Our increasing deficits and pressure of financing the deficit.

There is always something to worry about, and our list is not exhaustive. There are also "known unknowns" that could occur and increase volatility. Macro concerns are always with us, and we must be aware of them. However, predicting the future exactly is impossible over the long term. We believe that investors must have a long-term horizon for their equity allocation, focus on business fundamentals, valuation, and of course be willing to accept short-term volatility to be successful. If investors maintain adequate liquidity in their asset allocation and purchase securities (or invest with managers who do) with a MOS (read 1 – 5 at top of this letter), then they maintain a long-term perspective and even consider volatility as an opportunity.

Summary

The economy looks strong, and we see no recession in sight. We continue to favor equity exposure vs. fixed income in this interest rate environment. Current market valuations are not excessive, particularly if interest rates remain low (even rising at a measured pace). We do see some issues that might cause short-term volatility, but investors should consider volatility as an opportunity to add to equities when possible. Relative to your risk profile, investors should keep equity allocations neutral to above target and hold some cash to be opportunistic when volatility offers more attractive valuations. With cash now generating some yield, we are actively managing cash positions in order to make a fair return while we wait for volatility to give us a better entry point in equities.

As always, we thank you for entrusting us with your investment assets and your continued support. We work hard to make sure this is “deserved trust.”

Lastly, the best compliment we can receive is a referral from a satisfied client. We appreciate your referrals and handle them with upmost of care. With virtually no marketing effort, we have grown our business to over $2 billion of assets under advisement through these referrals. In addition to our Thomasville location, we now have managing directors logistically located in Mobile and Charleston to be able to serve a few new likeminded clients.

Your Investment Team

Attachment: Value Investing MOS (Margin of Safety)

Exhibit A
Attachment to SAA Quarterly Letter

Value Investing MOS (Margin of Safety)

SAA has called this quarterly letter "margin of safety" (MOS) for many years as it is our "north star" of investing that we always have as "top of the mind." We also have our guiding principles (always listed at the beginning of each letter – items 1-5) incorporating margin of safety (MOS) into asset allocation and the valuation of individual securities.

As Benjamin Graham famously stated, the three most important words in investing are: "Margin of Safety" (MOS). The MOS principal of investing means that securities are purchased only when their market price is significantly below intrinsic value. For example, a security that is conservatively valued by an investor at $100, would only be purchased at a significant discount to that price, say $70. This $30 difference is the MOS or discount from the intrinsic value calculated with conservative estimates and checked against realistic sales metrics, etc.

Of course, determining exact intrinsic value of anything is impossible. Rigorous analysis on valuation (both quantitative & qualitative) is imperative to decipher the approximate intrinsic value of a business, but you'll still only have an estimate or range as much of the value in a DCF (discounted cash flow) is in the long term (i.e., after 7 plus years). Predicting the future 7 years out in a world where disruption of many business models is front and center is certainly difficult with any degree of accuracy. Many moats or competitive advantages are being destroyed or wounded in ways we couldn't comprehend a few years ago. Having a margin of safety (and constantly testing our thesis) is necessary to account for the inaccuracy of our forecast.

The challenge with "MOS investing" is the discipline and fortitude to remain patient and to only swing at pitches that are in our strike zone. Over the past several years, rising earnings multiples (from low levels) lifted most stock prices (as did the passive investing move) regardless of the quality of the business (or its earnings or management). This meant that valuation errors were "hidden." Accordingly, many think investing is easy and value (MOS plus) does not matter. We think different and believe this has very low odds of being right in the long term as they will not be bailed in the future by low rates and multiple expansion.

The present situation seems as a modern replay of Ben Graham's quote, "Today's investor is so concerned with anticipating the future that he is already paying handsomely for it in advance. Thus, what he has projected with so much study and care may actually happen and still not bring him any profit. If it should fail to materialize to the degree expected he may in fact be faced with a serious temporary and perhaps even permanent loss", (i.e., have a MOS in your intrinsic value determination). In other words, when forecasting, be careful not to project today's "rosy" economic environment out to infinity – it won't always be this good.

Of course, insisting on a MOS does not remotely dismiss the importance of demanding a quality business (i.e., a good business run by competent owners/operators who properly allocate capital and have an adequate reinvestment rate). Business quality must be incorporated into valuation – sustainable competitive advantage, business model and quality management. The MOS protects us from unexpected or unknowable negative events that may occur in the future as well as company specific errors such as overestimating the strength of a moat, future cash flows, or management.

As one of our great managers recently said, "Finding all the criteria for a qualifying investment – strong business, great people, purchased at MOS price – is extremely hard which is why we have concentrated portfolios."

The concept is simple, yet the discipline is the most difficult. Second level thinking and the ability to remove our biases are also critical with our investment process. Capital preservation is the foundation with all investments. Ideally, we like to find investments where there is a large upside and minimal downside (gain/loss ratio). We strive to remove emotions from our investment process. Greed and fear are the two most costly emotions for investors. If we can remain calm during turbulent times, we have an advantage over the "herd."

Let us close this discussion of MOS with two quotes by great value investors that sum up this discussion:

"For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price." (Howard Marks)

*"A **margin of safety** is necessary because valuation is an imprecise art. The future is unpredictable, and investors are human and do make mistakes. It is adherence to the **concept of margin of safety** that best distinguished value investors from all other investors." (Seth Klarman)*