The Margin of Safety[1] Quarterly
Southeast Asset Advisors, Inc.
Lanigan Wealth Management

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

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Member of
The Lanigan Group of Companies

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 3rd Quarter 2018 Commentary
DATE: October 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 for 3rd Quarter

We will quickly recap the quarter ending 9/30/18 and then discuss the brutal October selloff happening as we go to press. First, market trends in the 3rd quarter were largely an extension of what we have seen through the year, with a stark divergence in return between US stocks and foreign stocks. Larger-cap US stocks hit new highs in late September and gained 7.7% for the quarter, while smaller-cap US stocks gained 3.6%. Developed international stocks gained 1.4% in the quarter, while emerging-market stocks (EM) fell 1.0%.

Growth stocks, led by tech, continued to outperform value in the 3rd quarter. Last year, the growth portion of the S&P 500 outperformed the value portion by 12%. This year, the trend has continued, and through September 30, 2018, growth outperformed value by ~13.7%. Year to date, the median stock in the S&P 500 trails the index's overall return by almost 7%. This illustrates that the market performance continues to be concentrated in a few mega tech information companies. The current multiples of these

1. Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY. Ben Graham, *The Intelligent Investor, Chapter 20. We still think it best to keep on the top of our mind in all we do at SAA.*

companies imply a long-term growth rate that for the most part is very unlikely. The stocks are priced for perfection and thus, do not have an adequate "margin of safety" (MOS), in most cases.

In fixed-income markets, the 10-year Treasury yield rose to over 3% at the end of September, flirting with a seven-year high. Consequently, the core investment-grade bond index had a negative return in September and was flat for the quarter. With strong economic activity and the prospect of increased inflation, the Fed has raised rates, causing bond prices to fall. We continue to believe there is a "bond bubble," thus we keep any fixed income allocations in very short duration, high quality bonds and accept a lower yield for now.

Market Update – October 2018

The month of October (through 10/24/18) has brought an abrupt end to a steady upward market as gains for the YTD were erased. The market has declined ~9.2% since the high on September 21, putting the S&P to a loss. Current concerns are many and include: increased interest rates, potential inflation increases, global trade wars, and mid-term election anxiety. It is amazing how in 30 days the sentiment of Mr. Market can swing!

The reported sharp drop in housing starts is also concerning. The reasons behind this are speculated to include material cost inflation, price increases and affordability, interest rate increases, construction labor shortage, etc. We saw lumber prices drop substantially in September and think all the above reasons play a part, but we do not see housing starts dropping significantly more, because of remodeling, storm repairs, etc. Auto sales have also declined for similar reasons.

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Even with the October market selloff, we do not believe this is the beginning of a bear market, and absent a major geopolitical event (or error), do not foresee a recession on the horizon. The U.S. economy is strong and growing with low unemployment. Valuations in all but a group of mega tech stocks do not appear overvalued, especially considering present interest rates. The corporate tax cuts have provided a real boost to earnings, and consumer confidence appears solid. Perhaps the market is spooked by the mix of U.S. fiscal, monetary, and trade policies. A recent commentator described them as akin to, "Driving a car with one foot pushing hard on the accelerator while tapping on the brakes!"

There are many headwinds for equities; foremost to us is increasing interest rates, as the Fed moves to normalization after a 10-year period of manipulation. The key question is, at what rate will fixed income provide a real alternative to equities. We believe that if rates move to the 4-5% range on the 10-year, a major rebalancing of investment portfolios will occur as investors increase bond allocations at the expense of equities. We look forward to having the option of increased returns on fixed income and a move away from "TINA" (There Is No Alternative but equities.)

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Our long-term worries are deficits. Will the grand experiment of lower corporate tax rates stimulate growth in GNP and more than offset growth in our projected $1 trillion deficit in 2019? Will (or how will) our large off-balance sheet, unfunded social security liability be addressed before a crisis develops? What are the consequences of substantial inflation (i.e., higher interest rates) that will surely result? Can current supply side policies boost growth while keeping inflation down and narrow our huge deficits? The questions are clear while the answers are not!

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We know the conditions that have created an almost perfect economic environment will not last forever. Going forward, low interest rates and PE expansion will not continue to be a market "tailwind." Company fundamentals and earnings growth will be key going forward as will be management that can skillfully allocate capital to enhance value on a per share basis. We think active management with "bottom up" fundamentals will beat index funds, dominated by a few mega tech stocks, with much less risk of permanent loss of capital.

We are constantly reminded of the saying, "You cannot predict (with accuracy), but you can prepare!" Thus, we are thinking and constantly evaluating asset allocation in all our client profiles. We will write more on this in future letters. Please read our long-term goal for each client at the beginning of this letter: "We strive to protect and grow our client's capital over the long term by………"

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Musing on Market Cycles…

We are enjoying reading several new books – one by famed investor Howard Marks, "*Mastering the Market Cycle: Getting the Odds on Your Side*." The book provides examples of how markets and economies move in cycles over time and gives some insight to clues that might help investors understand where we might be in the cycle. It should not be confused with market timing, something we do not believe anyone can do reliably.

We believe that valuation (our North Star) and trying to gauge sentiment are key areas on which to focus when evaluating the cycle. At SAA, we have been good at identifying cycle extremes (high and lows in both valuation and sentiment), but in the absence of extremes, we have not added much value in our tactical allocations. We also look for other clues to the cycle trends and extremes usually caused by increased risk taking. As Buffett said, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs". After a 10-year bull market, we are seeing early signs of less prudence and many investors ignoring MOS.

While we cannot predict with certainty what might happen, we can prepare for various scenarios. For now, we are "proceeding but with increased caution," as one of our managers says. This means that we, and the managers we choose, will demand an increased MOS in valuation compared to Mr. Market's price, and we will continue to be cautious of lengthening our clients' fixed income duration. We are constantly reminded of the most important words in investing and aptly call this letter "Margin of Safety". We demand even more MOS as we move to a more mature part of the economic cycle.

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Besides truly caring about our clients, we think one of our competitive advantages is the tremendous exposure we have to so many different industries and businesses, through our clients, board participation, and constant conversations with top business leaders everywhere. We have a curiosity and relentless interest in business models, and real time feedback on the economic and investment cycle, sentiment, etc. When we consider the many conversations our partners have and the prime intelligence they gather, it gives us clues about business activity on Main Street and the attention to risk, etc. Our information is constantly flowing, helping us understand how the business environment is changing and evolving. Of course, we must interpret this information correctly!

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Our hearts and prayers go out to the many people in the Florida panhandle, SW Georgia, and beyond who lost their homes, businesses, and farms, as well as those who had significant timber damage. It reminds us how fleeting material things are and how important family, beloved friends, and clients are, as well as our faith.

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Lastly, the best compliment we can receive is a referral from a satisfied client. We appreciate your referrals, and we handle them with utmost care. With virtually no marketing effort, we have grown our business to over $2 billion of assets under advisement.

In addition to our Thomasville location, we now have managing directors located in Mobile and Charleston to serve a few new likeminded clients.

Thank you, and have a great Fall!

Your Investment Team

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"In your own life what you want to maximize is a seamless web of deserved trust."

- C. Munger

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"Education is not the learning of facts, but the training of the mind to think."

- A. Einstein

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"Experience is a hard teacher. She gives the test and the lessons afterwards."

- Anonymous