The Margin of Safety[1] Quarterly
Southeast Asset Advisors, Inc.
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Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile – Charleston
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January 2019

In lieu of our normal quarterly letter we decided to send this PowerPoint for your update of our thinking as the "Mr. Market" investment environment is changing quickly, but good fundamentals of companies change at a much different pace (thankfully).

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.*

Index for the Margin of Safety

2018 Recap → Sentiment vs. Fundamentals → Nowhere to Hide → Volatility → Our View & Positioning → Our Long-Term Concerns → YTD 2019

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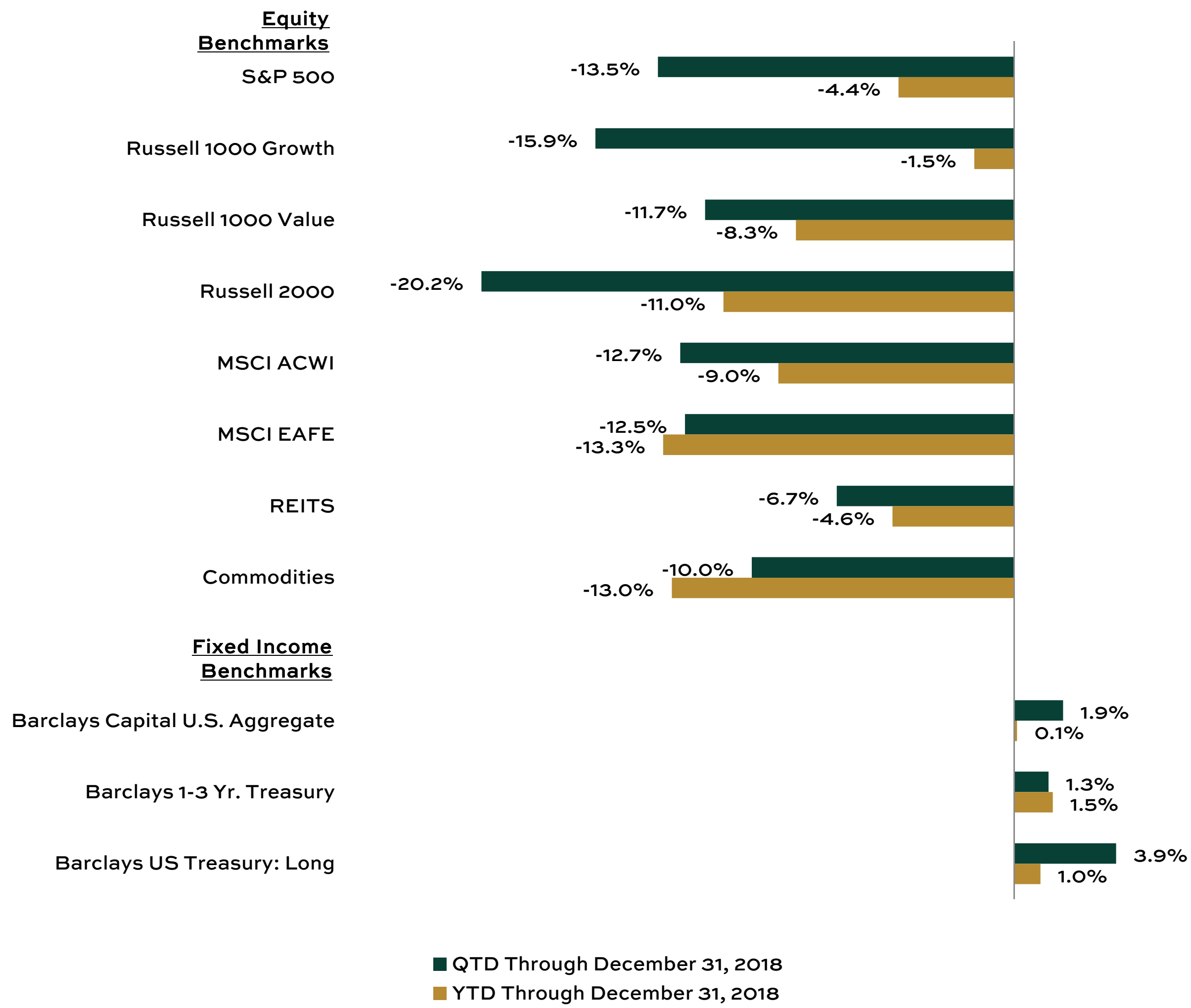
Market Recap – 4Q 18
NOWHERE TO HIDE IN FOURTH QUARTER

- **Equities –** the fourth quarter saw a major turning point, with global stocks falling -13%, led by US stock losses as they "caught down" to their international peers. Losses were particularly large for parts of the market that had outperformed earlier in the year, such as US large cap growth and US small caps.

  There were a number of concerns that helped to fuel the selloff, from uncertainty over trade tensions to weakening Chinese growth, and these fears were exacerbated by a fear that monetary policy was becoming too restrictive at a time when fiscal policy was waning.

- **Fixed Income –** Interest rates started the quarter by reaching a fresh post-crisis high. The 10-year Treasury yield touched 3.25% in October—and again in November—but then reversed sharply lower due to a flight to quality. As a result, yields retraced most of their 83 basis point (bp) rise and ended up closing the year at 2.68%, just 28bps above the end of 2017.



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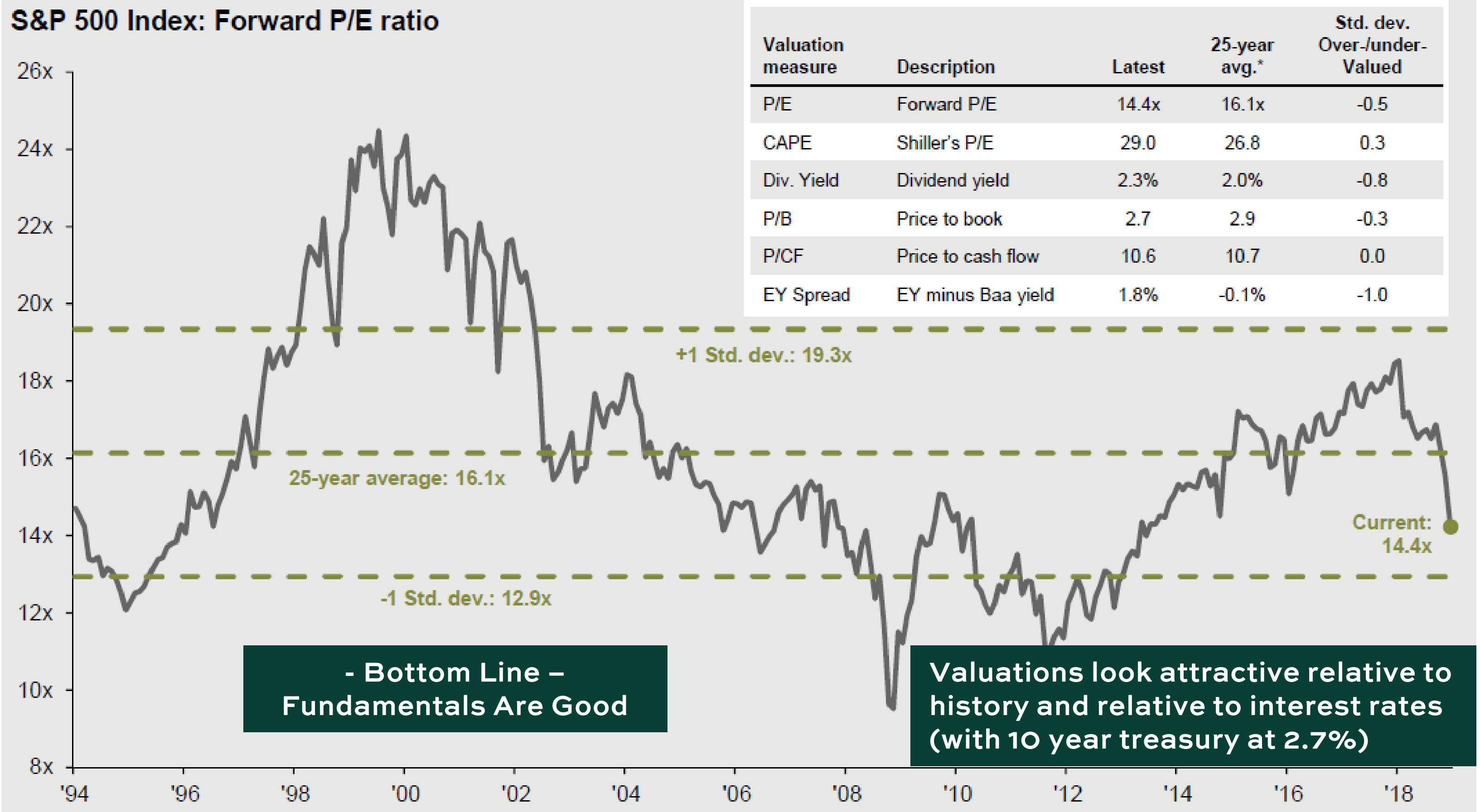
Mr. Market's Sentiment Turned Extremely Bearish in Fourth Quarter

- The S&P 500 was down 4.4% in 2018, however many investors experienced more significant losses in their portfolios.
  - Top ten performing stocks contributed +2.3% to returns (MSFT, AMZN, MRK, PFE, MC, LLY, NFLX, ABT, CSCO, UNH) – 4 pharma stocks + UnitedHealth
- The average US stock (as measured by Value Line Geometric Composite Index of ~1,700 companies) was down ~16%!
- ~90% of all asset classes (of which there are ~70) had negative returns.
- Most asset classes underperformed the S&P 500.
  - The Value line Index (equal weighted index of ~1,700 stocks) was down ~16%
  - Value stocks declined 8.3%
  - Small Cap Stocks were down 11.0%
  - International Stocks were down 13.3%
  - Emerging Markets were down 14.2%
- Most blended equity portfolios underperformed the S&P 500 due to the inclusion of some asset classes that underperformed the US Large Cap Index.

"Fear is the foe of the faddist and the friend of the fundamentalist" – WEB (1994 Chairman's Letter)

FUNDAMENTALS DEPART FROM BEARISH SENTIMENT



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

- Bottom Line – Fundamentals Are Good

Valuations look attractive relative to history and relative to interest rates (with 10 year treasury at 2.7%)

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1993, and FactSet for December 31, 2018. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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S&P Fundamentals & Valuations by Sector w/ Historical 20 Year Average

	Financials	Materials	Industrials	Real Estate	Cons. Discr.	Energy	Technology	Comm. Services*	Health Care	Cons. Staples	Utilities	S&P 500 Index	
NTM Earnings Growth	9.3%	5.9%	10.7%	3.6%	9.7%	7.2%	7.0%	6.0%*	7.3%	4.9%	5.2%	7.6%	EPS
20-yr avg.	22.6%	20.4%	11.0%	7.6%**	15.8%	13.4%	15.4%	10.7%*	9.9%	8.8%	5.0%	12.0%	
Forward P/E ratio	10.4x	13.5x	13.6x	16.5x	18.3x	13.7x	15.1x	15.7x	14.9x	16.8x	16.2x	14.4x	P/E
20-yr avg.	12.7x	14.0x	16.2x	15.3x	18.0x	17.5x	20.6x	18.2x*	16.9x	16.9x	14.2x	15.8x	
Trailing P/E ratio	11.4x	14.3x	15.0x	17.1x	20.1x	14.7x	16.1x	16.6x	16.0x	17.6x	17.1x	15.5x	
20-yr avg.	15.4x	16.7x	17.9x	16.3x	20.5x	21.6x	24.0x	20.2x*	18.5x	18.2x	14.8x	17.6x	
Dividend yield	2.6%	2.5%	2.3%	3.8%	1.5%	3.9%	1.9%	1.7%	1.9%	3.4%	3.7%	2.3%	Div
20-yr avg.	2.3%	2.6%	2.1%	4.4%	1.4%	2.3%	1.0%	1.7%*	1.8%	2.7%	4.0%	2.0%	

Fundamentals and valuations look attractive assuming interest rates stay in the present range.

The Fed (interest rates) & Geopolitical Risks are a key concern of the market.

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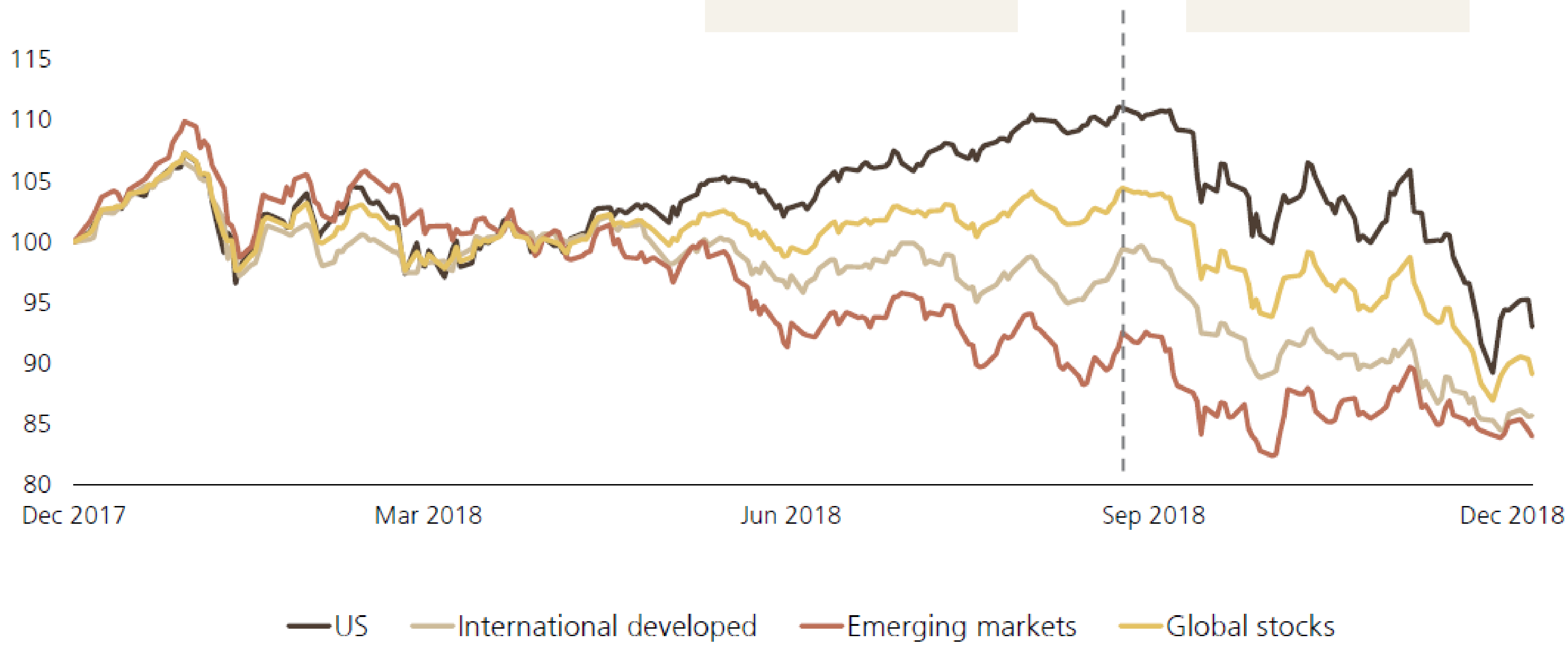
Global Contagion & Fed Fears pulled US Stocks sharply lower in Q4

Growth of USD 100 invested in December 2017 (Russell 1000, MSCI EAFE, and MSCI EM)

Dec 2017—21 Sept 2018:
US 11%
Int'l DM –0.6%
EM –7.4%
Global 4.5%

21 Sept—24 Dec 2018:
US –19.6%
Int'l DM –14.2%
EM –9.1%
Global –16.8%



Source: Bloomberg, UBS, as of 31 December 2018

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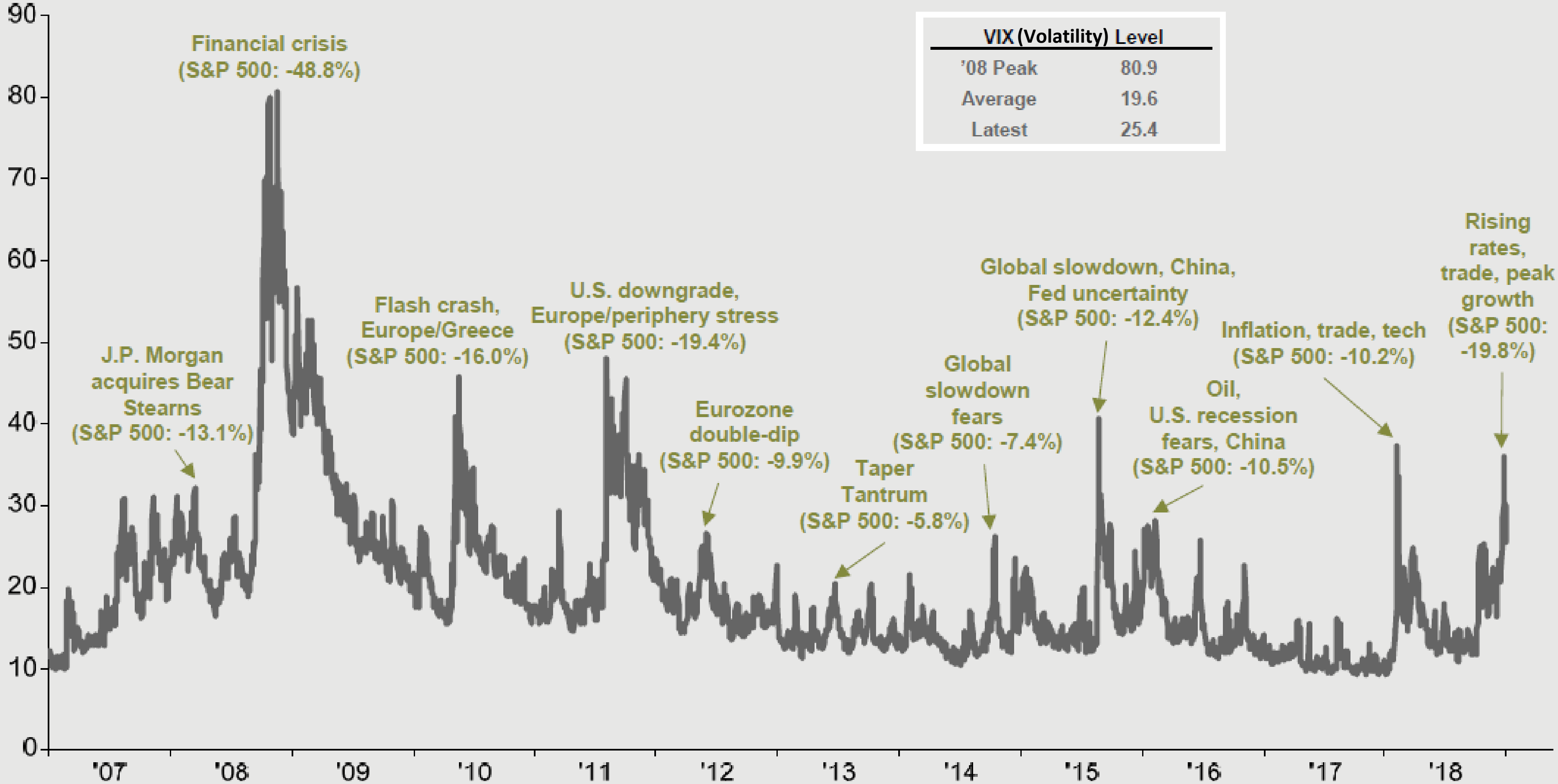
Volatility: 2018 had Tremendous Volatility

CBOE Market Volatility Index (VIX)

Index level



VIX (Volatility)	Level
'08 Peak	80.9
Average	19.6
Latest	25.4

Sources: CBOE, FactSet, J.P. Morgan Asset Management.
Stock market returns are based on calendar year peak to trough declines experienced during VIX spike, except for J.P. Morgan acquires Bear Stearns, which is based on the calendar year peak to the acquisition date. Average is based on the period shown from 12/31/2006 to 12/31/2018.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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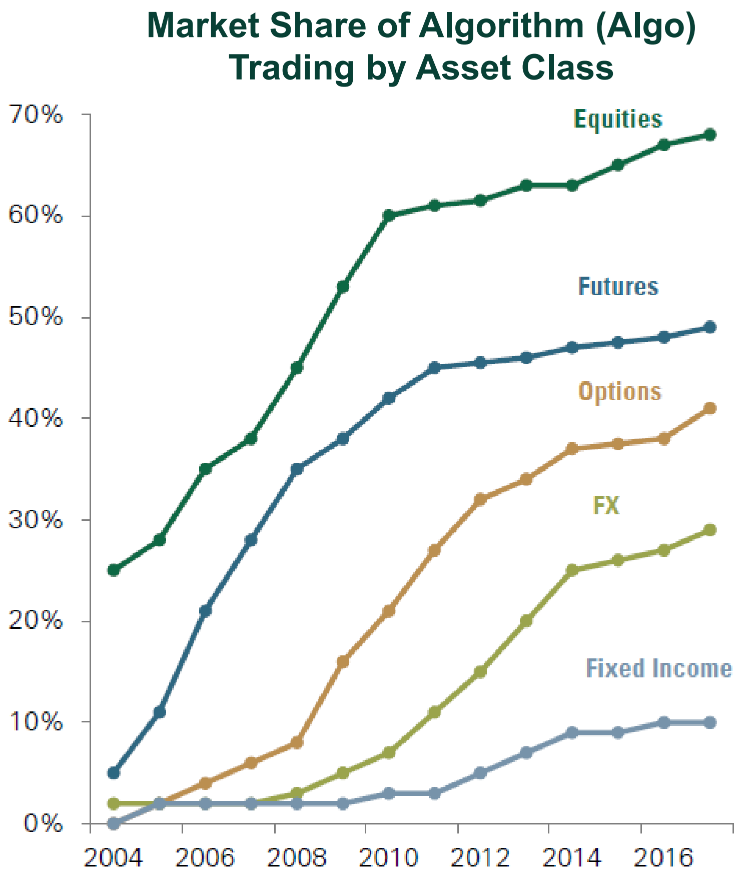
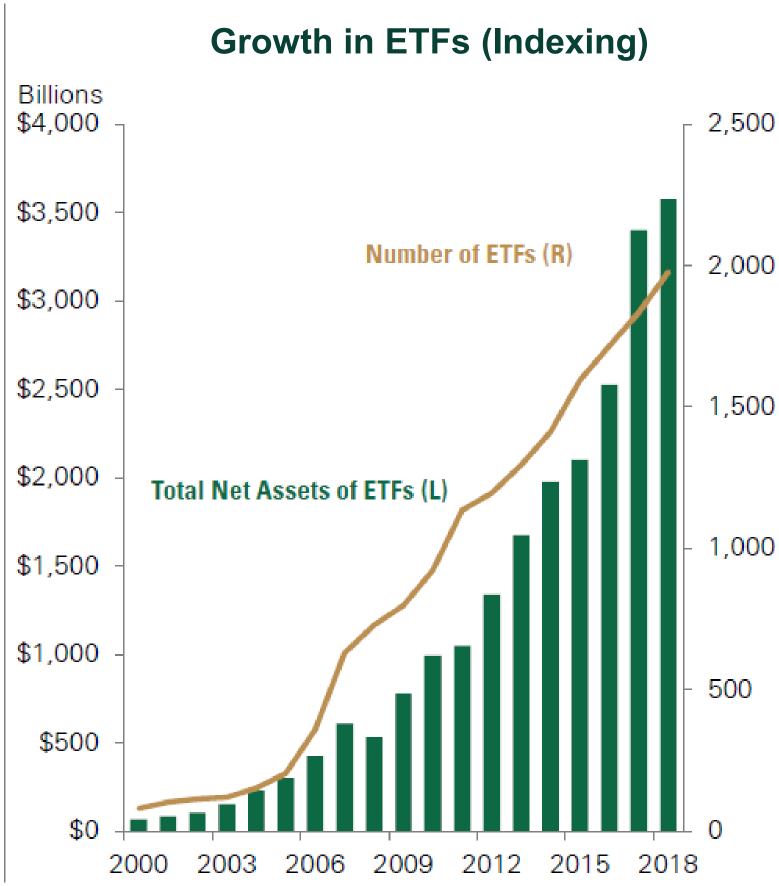
Two contributors to increased volatility – 4th Qtr & Future





"Algos" trading and growth in ETFs added to the spike in volatility during the fourth quarter, creating opportunity for the long-term investor.

Left as of 2017. Right as of November 30, 2018.
Source: Bloomberg, ICI, Goldman Sachs, Aite Group

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Summary Views and Positioning

- We remain cautiously positive on equities for the intermediate term. Investors should at least have their long-term neutral allocation to equities.
  - We expect increased volatility as rates rise and the market adjusts.
  - Volatility will be exacerbated by Algo Trading and ETFs.
  - Value has underperformed growth for over 10 years, but this dynamic may be changing.
  - We do believe we are probably late in the cycle.
- Valuations are good / Value should outperform
- Continue to stay away from long bonds – the real bubble in our opinion; what is the risk?
  - $8T of bonds real yield less than -0-
  - Little or no real yield available after taxes & inflation.
- Hold cash (getting better yield now) and/or short term, high quality bonds.
  - Important for diversification and to provide stability during periods of volatility.
- We are watching interest rates / Fed action, global trade, and inflation.
- Geopolitical risk is a key concern for "Mr. Market."
  - China trade agreement conclusion?

- **US Economy is still performing well**
  - Low unemployment
  - We see no recession in sight despite slowing growth of housing and auto sales.
  - Watching Margins and Cost pressures
- **Global slowing is a concern.**
- **Trade wars, interest rate normalization, and political developments in Europe (Italy and UK Brexit) have contributed to recent volatility.**
  - Volatility increased due to algo and programed trading.
  - Growth of ETFs has also contributed to increased volatility as people can trade an entire market with one click.
- **US Stocks – moderate positive growth in US should continue – but benefits of "tax cuts comps" no longer.**
- **Europe and Emerging Markets have weakened; hurt more by trade wars and strengthening dollar.**
  - Agreement on Trade will be beneficial to these markets.
- **<u>RISK to continuing BULL Market:</u>**
  - Fed makes a mistake and does not pause in 2019.
  - Trade wars continue / No agreements are reached
  - LONG TERM: Growing US Debt
- **Valuations are generally reasonable**
  - Many of our mgrs are excited about valuations after 4Q selloff.

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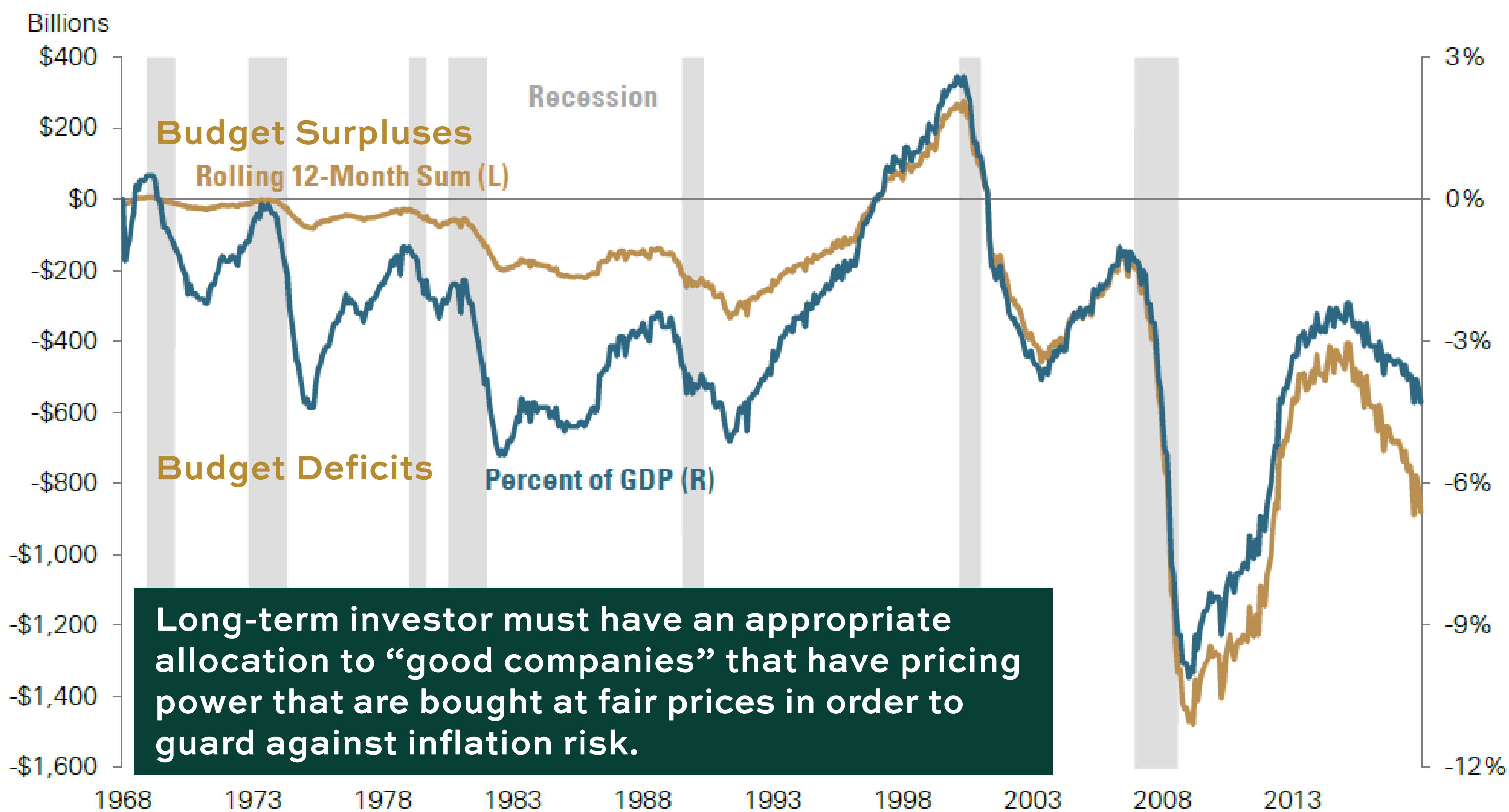
Our Biggest Long-Term Concern: Growing Federal Deficits (and Off-Balance Sheet Liabilities) in addition to global social tensions. However, we are reminded that economic and political forecasts matter little in the long term and actually provides opportunities if separate long-term fundamentals from short-term "noise."

Federal Government Budget Deficit/Surplus



Long-term investor must have an appropriate allocation to "good companies" that have pricing power that are bought at fair prices in order to guard against inflation risk.

As of November 30, 2018.
Source: Bloomberg, U.S. Treasury

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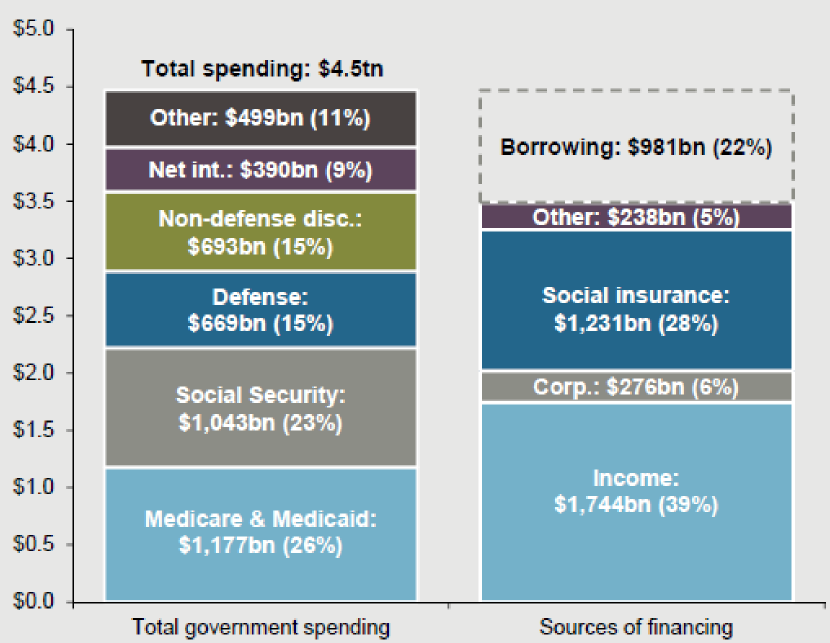
More Long-Term Deficits Concerns (Details)
"Our #1 Key Long-Term Worry"

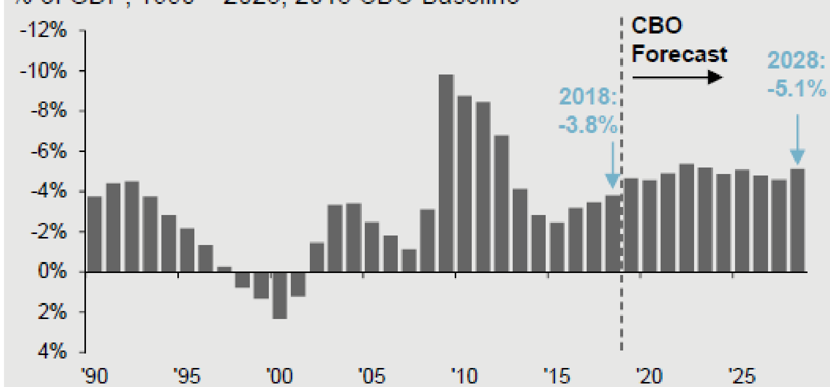
The 2019 federal budget
CBO Baseline forecast, USD trillions



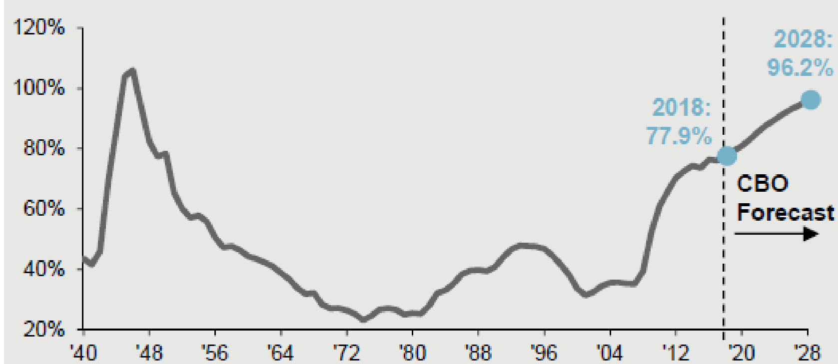
CBO's Baseline assumptions

	2019	2020	'21-'22	'23-'28
Real GDP growth	3.0%	2.1%	1.6%	1.7%
10-year Treasury	3.5%	3.8%	4.0%	3.7%
Headline inflation (CPI)	2.3%	2.4%	2.5%	2.4%
Unemployment	3.4%	3.5%	4.3%	4.8%

Federal budget surplus/deficit
% of GDP, 1990 – 2028, 2018 CBO Baseline



Federal net debt (accumulated deficits)
% of GDP, 1940 – 2028, 2018 CBO Baseline, end of fiscal year



Source: CBO, J.P. Morgan Asset Management; (Top and bottom right) BEA, Treasury Department.
2019 Federal Budget is based on the Congressional Budget Office (CBO) April 2018 Baseline Budget Forecast. CBO Baseline is based on the Congressional Budget Office (CBO) August 2018 Update to Economic Outlook. Other spending includes, but is not limited to, health insurance subsidies, income security and federal civilian and military retirement. Note: Years shown are fiscal years (Oct. 1 through Sep. 30).
Guide to the Markets – U.S. Data are as of December 31, 2018.

Key – what are long-term consequences of interest rates, inflation, etc? Is it knowable?

Interest Rates / Fed Talk Important for Short-Term Sentiment

The Trump "Put" and Fed "Put" cannot be counted on forever.

Former Fed Chair Yellen used the word "gradual" constantly to characterize the pace of monetary policy. The new word is "patient" that is used in the Fed minutes last month. Chairman Powell "walked back" his comments from using the word "gradual" to the now used word "patient" on assessing policy stance to describe this to sustain their "dual-mandate objectives" and be data-dependent going forward.

The Fed use of the word "patient" gives the markets hope that interest rates would not be increased on "auto pilot." The Fed action and talk going forward is key to short-term market movement.

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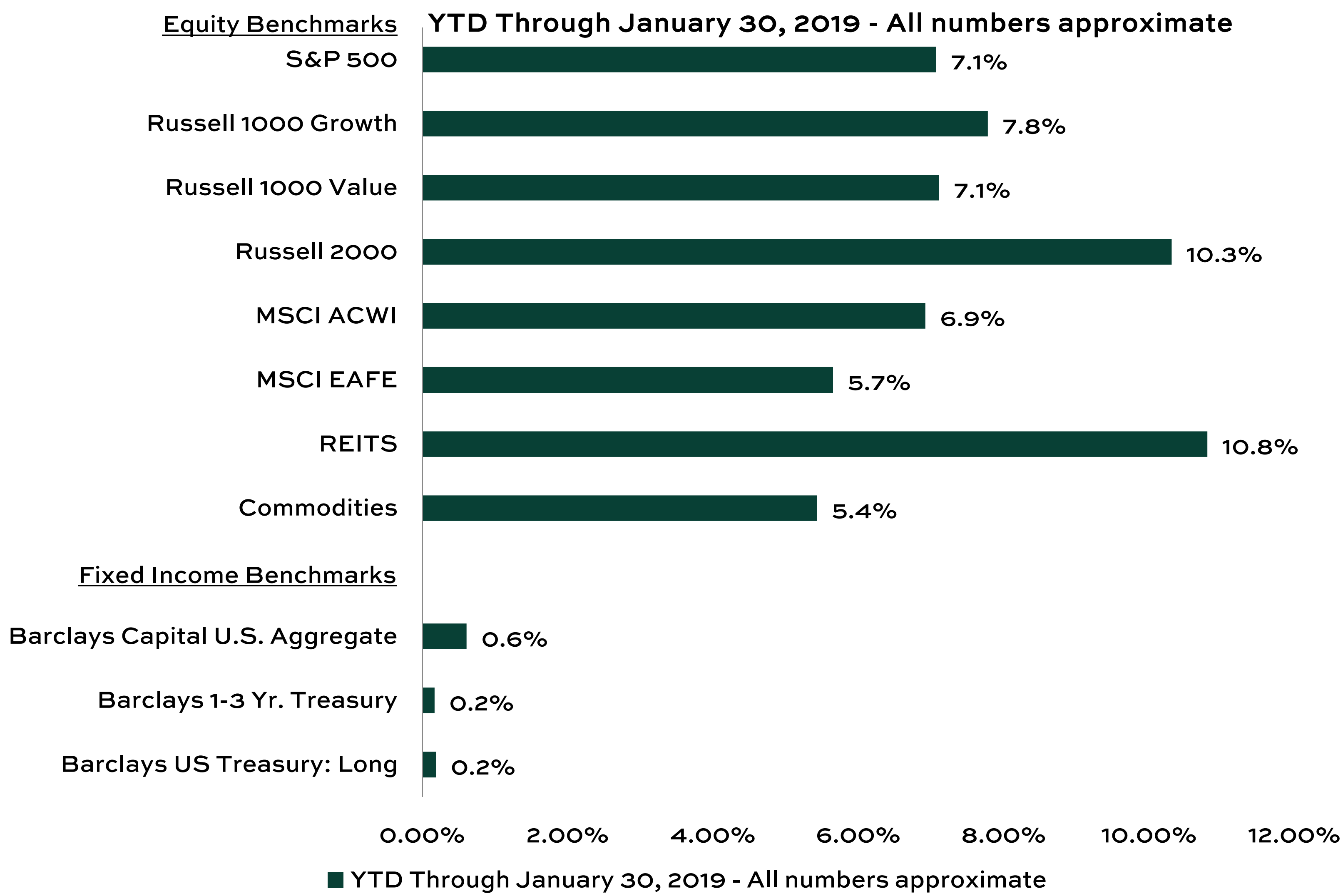
The Market Rebounds (1/30/19 YTD) on Positive Talk of Fed Not Raising Rates & Potential China Deal – Daily Volatility Continues



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Our Long-Term Goal at SAA:

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.

"Preparation, Patience, Discipline, Decisiveness – One without the other is useless."