Member of
The Lanigan Group of Companies

The Margin of Safety Quarterly
Southeast Asset Advisors, Inc.
Lanigan Wealth Management
Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile – Charleston
www.assetadvisor.com

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 2nd Quarter 2019 Commentary
DATE: July 2019

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.

2nd Quarter and First Half Market Recap: Most Everything Went Up

"It's a wonderful world."

After a tough end to 2018, the first half of 2019 saw gains across most asset classes, but it certainly was not a smooth ride. Global stock markets got a jump start on the year thanks to progress in U.S. - China trade negotiations and a newly patient Fed "talk," but, an abrupt breakdown in the trade talks spurred a sharp market sell-off in May. Stock markets subsequently shook off their swoon in June, rebounding on expectations of Fed rate cuts later in the year and (tentative) signs of re-engagement on the U.S. - China trade front.

The S&P 500 hit a new high near the end of June. Large-cap U.S. stocks (LC) shot up 7.0% for the month—the best June since 1955. LC was up 4.3% for the second quarter as a whole, and a remarkable 18.5% for the first six months of the year—the best first half since 1997.

Developed International stocks gained 3.2% for the second quarter and 14.2% year to date. Emerging-market (EM) stocks were only up 0.8% for the second quarter and first-half gains stand at 12.6%.

Moving on to the Fixed-Income markets, the 10-year Treasury yield continued to plunge from its multi-year high of 3.2% last October, dipping below 2% following the Federal Reserve's June meeting. This was a near three-year low and among its lowest levels ever. The 10-year yield ended the month at 2.0%. Bond prices rose as yields fell, driving the core bond index to a 3.0% gain for the quarter and an impressive 6.1% return so far this year.

* * * * * * * * * *

The Fed "Talk" & Importance of Interest Rates to all Asset Prices & Valuation

The Fed policy has had an enormous impact on financial markets since the 2008 financial crisis and is one of the many key metrics and indices that we monitor closely. We have seen that impact continue in 2019, marked by two major shifts in the Federal Reserve's stance. First, the Fed shifted from tightening monetary policy "talk" in 2018 to "talk" of a "patient" stance (i.e., rate hikes on hold) in the first quarter of 2019. Then, at its recent June Federal "talk," the Fed signaled it was inclined towards loosening policy once again, setting the stage for rate cuts later this year. Fed Chair Powell cited heightened uncertainty around the outlook for global growth, trade policy, below-target inflation, and falling inflation expectations. Many other global central banks continue to lower rates and pivot towards "looser" policies. Some $14 trillion dollars of debt around the world is yielding less than 0% (negative rates). This is an amazing time for sure!

To state the obvious, "looser" monetary policy (or even "talk" of this) is generally a stimulant for financial markets and asset prices. A lower interest rate environment (like we are presently experiencing) increases the value of all assets. In addition to multiple (P/E) expansion, the alternative (to equities) of fixed income is even less attractive as interest rates decline. Remember "TINA" (There Is No Alternative to Equities).

Many wonder what the Fed sees that we do not? We are enjoying a very healthy domestic economy compared to a slowing of the global economy. The tariffs are certainly an overhang and tough trade talks spook us all. The low inflation, low unemployment, high deficits and low interest rates in combination seem to go against gravity and what has been taught in economics for many decades.

Suffice it to say, the Fed, as well as global central bank policies, trade issues, slowing global growth, and the political climate remain a significant uncertainty and potential market catalyst over the short to medium term.

* * * * * * * * * *

Is it Different this Time?

The Fed is targeting 2% as a "goldilocks" inflation rate; not too hot/inflation or too cold/deflation. We wonder if the "4 D's" (Détente, Demographics, Disruption, and Debt) make "this time truly different" or alternatively, are central bankers in a "great delusion."

- Can monetary policy fix these problems with contrived low rates or will the outcome continue to be asset price inflation in the global equity markets (i.e., continued market expansion)?

- What if the Fed takes the "punch bowl" away and "spikes the punch" with a move to higher rates? This is the same institution that missed the "mortgage lending bubble of 2007."

Arguably, this economy does not yet exhibit the widespread financial market excesses (asset price bubbles) or economic overheating (inflation) typically seen late in the cycle. Such excesses or imbalances are what typically lead the Fed to tighten monetary policy and ultimately—inevitably—kill the expansion and tip the economy into a recession. However, we do see some asset classes that are certainly overvalued. The "caution light" is on in Private Equity, many IPOs and Commercial Real Estate, which is trading at very low cap rates, i.e., high valuations. Overall, if interest rates stay this low and corporate tax rates stay at 21% (both big "ifs" in our opinion) public equities are not generally overvalued.

We do not see the Fed doing anything except possibly lowering interest rates in the near term. We think our political leaders and the Fed are the key to interest rates and thus the valuation of most asset classes. SAA's Game plan continues to be "Proceed with Caution," (know what you own),[1] and watch the Fed and Central Banks in Europe, etc., and hope they are prudent. We believe that we are possibly in a "melt up" state due to low interest rates that could continue with the Fed's current easing stance and an election year. Future tax rate changes are a wild card, and so are the increasingly large deficits, which do not seem to

[1] Know what you own means knowing the companies, and valuations of the stocks in the portfolio. Also, knowing the stocks that managers in our portfolios own and valuations thereof on a look through basis.

concern anyone. These deficits may not be a problem until we have a currency credibility crisis, at which time it will be too late to address.

* * * * * * * * * *

Outlook for Trade and Handling Uncertainty

One of our managers (a China expert) summarized the China Trade negotiations best when he recently wrote: "Still I (we) believe the odds are in favor of an eventual trade settlement and the two countries will find a way to manage their differences and keep the relationship mostly constructive because doing so would best serve both countries' long-term interest." We agree and are hopeful we can have an enforceable agreement. This would remove one major uncertainty and possibly restore global growth.

* * * * * * * * * *

Uncertainty is a constant presence, and volatility can return to markets at the drop of a "tweet". In fact, when asked about what we think about the "market forecast," we quickly answer, "our guess is it will be volatile." Of course, volatility is the ticket to higher returns for those with proper asset allocation and the "temperament" of a long-term investor coupled with valuation and a margin of safety in all.

* * * * * * * * * *

Valuations and FANGS (++)

Usually at this stage of the market expansion, most of our clients' comments pertain to high valuations. We are not hearing these valuations comments or questions but do hear some comments saying "it is different this time" as discussed herein.

A couple of comments about valuations:

1) The FANGS are now FAANGMs (which includes Microsoft and Apple.)

   a. FAANGMs account for 18.1% of the S&P 500 index market capitalization, which is up from ~9% at the start of 2013. They did get whacked at the end of 2018 to 15.8%, but have rebounded to the current level (18.1%) since then.

b. The aggregate forward earnings of FAANGMs is up 78% since the start of 2015 while the S&P 500 earnings are up 39% and 26% excluding FAANGMs.

2) The forward P/E of the FAANGMs is currently 30.8x versus 17.2x for the overall S&P 500 and 15.7x if you exclude them from the index. The 15.7x for the general market excluding the FAANGMs equates to a 6.4% earnings yield which does not look excessive in a 2% 10-year T-bill world. That is if interest rates stay in that range or go even lower, current growth continues, and corporate tax rates stay as is (a big if).

3) Growth has been mostly outperforming Value during the current bull market. Obviously, the outperformance of FAANGMs has been a major contributor to this divergence. Above average growth is scarce in our world of subpar growth. Companies that can deliver above-average growth get higher P/Es and their market capitalization increases, which make them even more influential in a market-cap-weighted index like the S&P 500. The corporate tax rate changes in 2018 were also a huge tailwind for corporate America.

It is also worth noting that market concentration has increased as competition has decreased across many industries. This is easily demonstrated in technology by the FAANGMs. The government may be the biggest risk for the FAANGMs. Time will tell.

* * * * * * * * * *

Our overall allocations for client portfolios (equity / fixed income) are basically in line with our long-term targets for equity exposure, while continuing to keep fixed income high quality and short to intermediate duration as noted above. Thus, we are watching and "proceeding with caution" (knowing what we own)[2]. The election year should be interesting. Watching the anti-capitalism talk is frightening. As discussed, we continue to watch the Fed, and the potential for the return of higher corporate tax rates (35%) from the present 21% (this will become even more worrisome if the Senate changes hands). We also worry about our massive deficits that continue to increase.

* * * * * * * * * *

[2] Know what you own means knowing the companies, and valuations of the stocks in the portfolio. Also, knowing the stocks that managers in our portfolios own and valuations thereof on a look through basis.

The highest compliment we can receive is a referral from a satisfied client. We appreciate your referrals, and we handle them with the utmost care. As you know, we do virtually no marketing and have grown our business to over $2 billion in assets under advisement primarily through referrals. We believe that our job is to provide value to our current clients, and if we do that well, the rest will take care of itself.

Thank you again for your continued confidence and trust. Please call us if you would like to discuss your asset allocation. We are working hard on your behalf. Investing and helping our clients is our passion. Deserved trust will always be the most important thing we will ever earn.

Your SAA Investment Team

* * * * * * * * * *

"Asset allocation and time horizons are the key to an investor's success. The biggest barrier is one's personal psychology or how they react to the daily noise and clutter. Valuation will always be our North Star."

- SAA Team

"Our message to all political parties: We need to stop the political division and get back to the business of America and enhancing the "American Tailwind""

-Unknown