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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 4th Quarter 2019 Commentary
DATE: February 2020

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.

The above points are on top of our mind and should be on top of our clients mind also, especially at this point in the cycle and elevated P/E multiples ("x").

Fourth Quarter 2019 Key Takeaways

The S&P 500 Index posted gains in every quarter of 2019 and surged 9% in the fourth quarter to end the year at an all-time high. It's 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose ~25% for the year. Foreign equity markets were also strong. European stocks gained 9.9% in the fourth quarter and ~24% for the year. After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 18.7% for the year. The core bond index was flat in the fourth quarter but gained 8.6% for the year. This was its best core bond return since 2002 and the asset class return that surprised us the most, as the Fed continued easing.

A few observations about the 2019 market returns.

Growth continued to outperform value. This was driven by FANG+AMs (Facebook, Amazon, Netflix, Google plus Apple & Microsoft).

- The Russell 1000 Pure Growth index returned 40.1% while the Russell 1000 Pure Value index retuned only 25.3%. A difference of 14.8%.

The returns of the market were primarily in the larger cap stocks. The average stock did much worse than the index.

- The Russell 1000 index (market weighted) returned 31.4% while an equal weighted Russell 1000 returned 24.7%

Why did both stocks (high P/E "x") and bonds (defensive, not long maturity) appreciate sharply in 2019? The key driver was the Federal Reserve's sharp U-turn toward accommodative monetary policy. This was followed by other central banks across the globe. Coming into 2019, the Fed was indicating it expected to continue to raise interest rates. This led investors to fear that higher rates could tip the U.S. and global economies into recession, bringing an equity bear market at the end of 2018. The ongoing U.S.-China trade conflict didn't help matters.

However, in 2019 the Fed ended up *cutting* rates three times in the second half of the year, and it also started expanding its balance sheet again via purchases of Treasury Bills in order to boost banking system reserves and inject liquidity into the short-term lending markets. Other major central banks also cut rates and/or provided additional stimulus to the markets during the year. This lessened recession fears. So, we were "off to the races" in 2019 as equities and bond prices increased.

Meanwhile, inflation (and inflation expectations) remained at or below central bank targets. This lifted concerns that interest rates would be hiked anytime soon, and the bond market rallied.

U.S. equity investors responded to the Fed policy reversal and stimulus much as they have during the past 10 years by bidding up stock prices and valuations. A détente in the U.S.-China trade war late in the year (the "phase one" deal) was an added boost to market sentiment. Importantly, earnings growth did not drive U.S. stocks higher; the majority of the S&P 500's return came from expanding valuations with alternative low yields in fixed income or still negative or low yields throughout the world.

Bottom line for 2019 – Great year for equities and almost everything but the energy sector!

What's Next for 2020?

After a year like 2019, the obvious question looking ahead is how much higher can equities go? **As Seth Klarman, one of the true great long-term investors, recently asked, "When will the rocket fuel run out?" The rocket fuel in question is the current low interest rates and quantitative easing policies of central banks all over the world.** For many years, assets have been flowing into U.S. stocks on the back of a strong U.S. dollar, the United States' perceived safe-haven status relative to other global economies and avoiding the low to negative interest rates of many fixed income securities outside the U.S. In this respect, 2019 was largely an exclamation point on the decade's investment pattern.

As we look ahead to financial markets in 2020, there are reasons to be cautiously optimistic. Accommodative central bank monetary policy and easier financial conditions should continue to support at least a modest rebound in global economic growth. Along with reduced U.S.-China trade risk, the global economy appears on the rebound. The U.S. consumer also remains in good shape as ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

The U.S. economy continues to grow at neither a boom nor bust pace. That is an ideal environment for prolonging the current expansion. It is an ideal scenario for the stock market. The S&P 500 may stall around last year's close of ~3,230 and give time for earnings to catch up with stretched P/E multiples. Amazingly, we still see many companies that are reasonably priced while the S&P index is at an overall stretched valuation multiple.

Our modestly positive outlook (at least short term) is consistent with the consensus view, suggesting that financial markets may have already responded positively to most of these developments. The risk of the election results, global unrest, or decline of confidence in world central banks to keep ultra-easing of interest rates should not be ignored.

As we go to press, China's coronavirus outbreak is a worry, but it is still too early to know how big of an effect it will have on the world economy. At this point we are hoping it may lessen the "melt up" in the market on a short-term basis.

Also, we are looking at the possible opportunity that fear of a world outbreak might present. Of course, we continue to have long-term real issues to consider such as: huge deficits that exceeded 100% of U.S. GNP and are growing at over $1 trillion annually, income inequality, growing medical costs with an aging population, and unfunded growing entitlements. We worry that these will be a long-term economic headwind at some point. **Charlie Munger calls it the "great conundrum." As Munger says, "These factors together (low inflation, low interest rates, low unemployment, rising wages, etc.,) defy gravity. We do not know when or which one of these will change but I suspect they will…"**

The Trump administration's positive influence (short-term at least) on the market is undeniable, no matter which side of the aisle one is on. The election year will be interesting as our problems and solutions are debated by the different parties. Neither party discusses our deficit, and each add to this serious growing problem. Both parties need to wake up and address the issue of ever-growing deficits.

Valuation Comments

As discussed herein, multiple expansion fueled by low interest rates was the key driver of Mr. Market in 2019 as P/E expanded from 15.4x at end of 2018 to ~18.8x at year end 2019.

Reported earnings for the S&P 500 were actually flat over the first three quarters, and mid-single-digit percentage growth is projected for the fourth quarter. These stretched valuations leave many U.S. stocks particularly vulnerable to disappointment, and the possibility of negative surprises. China's coronavirus outbreak is causing worry. Any signs of economic bumps can cause considerable volatility, especially at these elevated P/E levels. We are hopeful that the scare is short lived, is helpful to prevent a further "melt up," and gives earning increases to reduce P/E "x", etc.

Private equity, income real estate, and long bonds appear to be the most overvalued asset classes as speculators reach for higher yields in a sub ~1.6% 10-year T-bill world. Of course, this is a generalization, and some areas to be especially careful of at this point in the cycle. We are finding a few qualifying investments in these and other areas despite a high overall P/E "x" and extremely low interest rates. Remember, to be a good investment, it must qualify as a good business, run by capable and good people, and purchased at a good or at least fair price. We have different opinions within our SAA team of what discount rate to use in our DCF valuation in this low rate environment, but we all know that using the current rates would not provide a proper margin of safety in price to value. We feel interest rates can rise swiftly at some point reducing all asset prices. The key is when and if this happens.

Portfolio Positioning and Outlook

What does all this mean for portfolios? We believe that investors should be at their long-term equity target allocations and make sure they know what they own, i.e., do not have a portfolio of all FANGs and high P/E stocks, etc., even if they are high quality businesses. As noted, we believe that equities will generally outperform fixed income over the next ~5-year cycle; however, that comes with a warning:

- Prepare for increased volatility and lower equity returns given the current P/E ~18x earnings. Volatility is generally higher when negative surprises happen in elevated valuations.
- As discussed, recent returns have benefited from the increasing multiples while earnings have remained flat or grown slightly (overall). Looking ahead, we expect earnings to grow in the 5-6% range, and with no multiple expansion, we would expect equity returns to be in this neighborhood.
- However, this lower equity return compares favorably with what we would expect from a very low return fixed income. Hopefully our managers, individual equity ideas, and rebalancing can add to these expected returns, or at least reduce the risk of permanent loss of capital.

We believe fixed income, especially on the long end, is probably one of the most overpriced asset classes. However, there is always a place for some fixed income in portfolios, whether it's holding for spending or opportunities to rebalance at dips. We continue to keep fixed income short in duration and high in quality and are very careful about reaching for yield. The spread between high yield and investment grade is currently at historic lows as is the yield on long duration bonds.

We are hopeful for opportunities to earn better returns than the market by taking advantage of volatility (using valuation to provide a long-term margin of safety to prevent permanent loss) and using it as a buying opportunity or for rebalancing. Together, we should have a plan (IPS) for investing cash on dips, with target entry points, and a "buy" list of managers, index or individual stocks, and valuation of qualifiers. Valuation does matter, and volatility is our friend and our opportunity if properly prepared.

In Closing

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 little 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 focus on that, the rest will take care of itself.

We now have offices and investment professionals in Mobile and Charleston to complement our team in Tville / Tally and Atlanta to provide investment, wealth management, and multifamily office services to clients. We have a talented team with different skills, ages, and expertise that we can call on to help you.

Thank you again for your continued confidence and trust. Please call us if you would like to discuss any changes in your current asset allocation or any planning, tax, or wealth management, as each is interrelated with asset management.

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 and a big part of our culture.

Have a great balance of the Winter!

Your SAA Investment Team