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The Margin of Safety Quarterly
Southeast Asset Advisors, LLC
Lanigan Wealth Management

Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile – Charleston
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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 1st Quarter 2020 Commentary
DATE: April 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.

First and foremost, our hearts go out to all those affected by COVID-19, and especially the front-line healthcare providers. The pandemic spread is frightening and puts everything in perspective.

The first quarter of 2020 has been an unprecedented period in U.S. financial market history across numerous dimensions. In 23 days, the equity market dropped ~34% as the COVID-19 virus and fear both spread.

As one pundit stated, "I have never used the words "panic" and "FOMO" (fear of missing out) in the same week before." It is indeed hard to believe that ~6 weeks ago we were enjoying one of our best economies (and market) ever, and now we are facing a "global economic shutdown" of which we have no historical comparison.

Year-to-date, large cap U.S. stocks have fallen ~20%, having rebounded slightly from the initial historic drop of ~34%. Smaller cap U.S. stocks have done even worse, falling ~30%.

Fixed income yields have been extremely volatile – shooting up on some days when stocks were selling off. The 10-year yield is currently at 0.67%, down from 1.92% at year-end, 2019. High yield bonds have dropped ~14%, and even floating rate loans and investment grade corporate bonds have fallen.

The depth and duration of the shutdown of the U.S. economy and resulting (inevitable) recession will of course depend on testing and our adhering to social distancing as well as the success of the government stimulus programs. The "CARES Act" and "FFCRA" will help many small businesses and employees survive as they are critical lifelines, and our guess is more stimulus will be passed soon. Hopefully, these actions will "flatten the curve" and give us time to develop an effective treatment and vaccine.

Valuation Comments vs. Mr. Market Markdown

The duration of the recession and resulting earnings drop will determine the decrease in the intrinsic value of most businesses – public and private. We must remember that only ~5% of intrinsic value of an asset is the first year of its FCF. Due to COVID-19, Mr. Market has been marked down much more than 5%! The key now is the duration, and how long this crisis will last. What is the effect on a business and its competitive position in the "new" normal? We surely need to avoid sectors that may never recover to the "old" normal (i.e., over built retail real estate.)

Which Way Now? - Timing Thoughts

Please pardon us if we sound trite in this letter as we have never read or listened to more pundits than we have in the last two weeks. We quote what we have heard or read from professionals that we believe have some special expertise in this pandemic crisis.

Currently, we are working from a combination of our offices and homes. We are thinking about issues that we have never had to consider. We are experiencing and testing the quote, "All of humanity's problems stem from man's inability to sit quietly in a room alone." This is indeed a lesson learned real time for us all.

"Thinking is very hard work." We try to stay rational while thinking in probabilities. We do not believe that we (or anyone) can accurately predict or forecast the pandemic duration, so we view outcomes in a "base case" and "worst case" scenario and adjust those as new reliable data becomes available.

As for the market, with all but our most aggressive portfolios we will think defensively for the time being.

The questions for us as investors and advisors are most important even though the answers, with certainty, are "unknowable." Some of these questions are:

1. How long will it take to get the markets, businesses, and economy back to "normal," and what will the "new normal" look like? We need to realize a huge unwinding of leverage is taking place as near zero interest rates created speculative buildup by Wall Street of "yield products" for yield hungry investors that have, for now, turned into forced sellers with little regard to price.

2. In the past periods of crisis, Mr. Market turned up before the economy rebounded as the fear subsided. We expect history to repeat this time also. We anticipate more bouts of fear ahead as the number of cases are sure to increase as more testing is done. Small businesses and their employees in certain industries are especially hard hit.

3. How much fear is left? The March 29th episode of *60 Minutes* was frightening on many levels (N.Y. hospital cases, etc.). We expect market volatility to be with us, as we guess the recovery will be more of a "W" than a "V". We all need to prepare for a shock of huge contractions in employment and corporate and personal income, hopefully only for the balance of 2020. However, some sectors may never recover to prior normal.

4. What will be a permanent or semi-permanent change in the mindset and behavior of investors? Behavioral finance is always more important in the short run and difficult to predict (that is why, as value investors, we first look at long-term valuation and downside risk.) We are confident that for patient long-term investors the market values will return, and great companies run by good and capable people will increase their competitive advantage. Their value and price should also increase accordingly.

We spend 24/7 thinking about the range of outcomes and answers to these and other questions. Some of us at SAA have been through 7 of these major drawdowns and have developed biases. It is great to have a team that has deep experience. None of us, individually, is as smart as all of us together.

As Warren Buffett recently said, "I had to wait 89 years to experience this firsthand." Warren further commented in his 02/20 chairman's letter in Berkshire Hathaway's annual report, "What we can say is that if something close to current rates should prevail over the coming decades and if corporate tax rates also remain near the low level businesses now enjoy, it is almost certain that equities will over time perform far better than long-term, fixed-rate debt instruments." He goes on to say, "That rosy prediction comes with a warning: Anything can happen to stock prices tomorrow. Occasionally, there will be major drops in the market, perhaps of 50% magnitude or even greater. **But the combination of The American Tailwind…and the compounding wonders [of retained earnings of companies]…will make equities the much better long-term choice for the individual who does not use borrowed money and who can control his or her emotions. Others? Beware!"**

This pandemic is testing all our short-term emotions, just as we were tested in the last 6 major drawdowns. We are confident that, "This too shall pass" (although it may take longer than most think). We must remain patient and stay the course if indeed our allocation to equities for your profile are reasonably correct for the long term. The stimulus packages and government asset purchases, along with virus containment and businesses reopening, will eventually restart our economy. The timing of the restart is a guess, as we have never had an economy put in a "coma" before.

Americans are truly resilient, and together, we will get through this crisis and learn from it.

As one of our favorite pundits recently wrote, "The most important thing is to be ready to respond to and take advantage of the declines. The world will be back to normal someday, although today it seems unlikely to end up unchanged. What matters most – in terms of both health and finances is how we do in the interim."

Please call any of us on our cell phones or office lines (or e-mail us) if we need to discuss your specific allocation. Our points 1-5 outlined at the beginning of every MOS letter have never been more important.

We know our clients are counting on us, and we feel this responsibility deeply.

Stay safe and follow the local health guidelines. God bless all.

Your SAA Investment Team.

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"The massive fiscal and monetary stimulus will make a huge difference."

- Steve Mnuchin, Secretary of the Treasury

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"The unemployment number is not the important number now. What matters is who is not getting paid or barely paid. Many are getting paid more now – i.e., extra $600 per week plus $1,200 per person, etc."

- Unknown