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

Member of
The Lanigan Group of Companies

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 2nd Quarter 2020 Commentary
DATE: July 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.

Second Quarter 2020 Takeaways

For most of the second quarter, the market seemed to defy grim economic news and the resurgence of COVID-19. Although many stocks rebounded in the second quarter, with the exception of FAANGM (Facebook, Amazon, Apple, Google & Microsoft) and other popular "perpetual growth" names, stocks generally did not rebound enough to offset the prior quarters huge "meltdown."

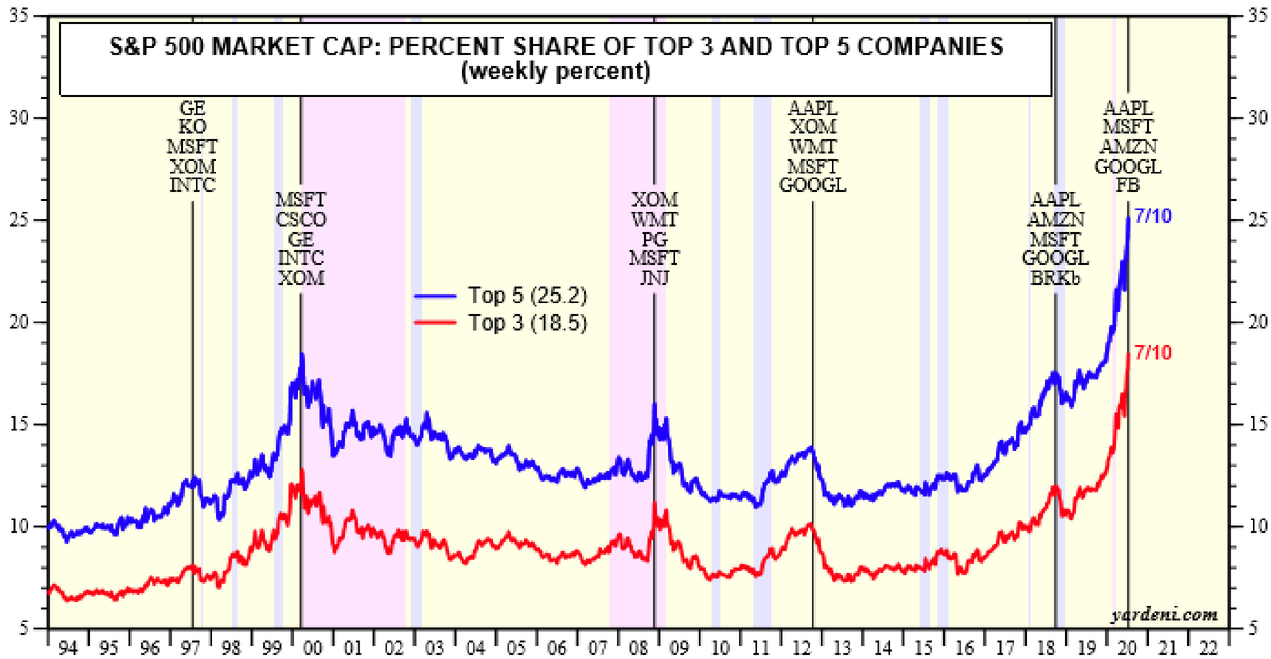
The FAANGM stocks now make up over 25% of the S&P 500 (see Charts). Their performance led the S&P index to a gain of ~18% for the quarter. The S&P is now down ~3% year-to-date through June 30th despite the huge drawdown in March. These year-to-date numbers; however, do not portray the complete picture, as the Value Line composite (an equal weighted index) is still down ~20% for the year. This is more representative of the average stock on a year-to-date basis and illustrates how narrow this market rebound has been.

The graph below shows the performance difference in the S&P with and without the "FAANGM" since 2013. Note the recent "steepness" of the red line.

FAANGMs

* FAANGM stocks include Facebook, Amazon, Apple, Netflix, Google (Alphabet), and Microsoft. Both classes of Alphabet are included.
Source: Standard & Poor's and Yardeni Research Inc.

The following graph shows the percent share of the S&P market cap comprised by the top 3 (18.5%) and the top 5 (25.2%) stocks over time. Note the previous high in 2000 at around 14% and 20%, respectively. After each peak, there was a subsequent decline in the weight of these few stocks in the index. High concentration appears to possibly be a sign of a melt up in stocks.



Note: Shaded red areas denote S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%. Yellow areas show bull markets.
Source: Yardeni Research using Standard & Poors and I/B/E/S data by Refinitiv.

Growth stocks (FAANGM and other high-growth stories) have continued to outperform value stocks, as they did before the pandemic. Many growth stocks are perceived to be “perpetual growth machines” and currently trade at high multiples.

The first half of 2020 has seen the U.S. and other governments spending enormous amounts of money and the Fed providing unprecedented liquidity support to markets and economies. On the fiscal side in the U.S., trillions in direct payments and loans have been delivered quickly to citizens and businesses. Most “PPP loans” will be forgiven based on a revised formula. The current level of stimulus already dwarfs both the amount and speed of what was done in the 2008 financial crisis. Our yearly deficit appears to now be over $4 trillion and still climbing (it was originally forecasted to be “only” $1 trillion). More stimulus is surely on the way, as the original unemployment supplement of $600 comes to an end at the end of this month. In addition to unprecedented fiscal stimulus, the Fed has cut interest rates to near zero and has stepped in to provide trillions of liquidity to debt markets (even "junk" bonds were on the table) to keep from freezing up the economy.

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As a result of the recent fiscal and monetary stimulus, the "melt up" in the market continues as it did before the pandemic for many growth stocks (some are, indeed, great companies). This rally appears to be based on assumed high perpetual growth rates and very low discount rates. An abrupt "perceived" change in the growth rate of these companies or an increase in interest rates can deflate prices quickly, as has happened in past bubble/melt ups. In other words, the output (valuation) from a discounted cash flow (DCF) valuation model is extremely sensitive to the inputs of both growth rates and interest rates. Having a margin of safety (MOS) in this computation is critical. Today's prices appear to have little MOS because of the aggressive inputs by Mr. Market (low discount rates and high growth rates), and many companies appear priced for perfection.

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For example, compare these two companies. In the Appendix, we share our current thoughts on Berkshire Hathaway (BRK), a substantial long-time holding in many client portfolios. BRK is down ~21% year-to-date (S&P is down ~3%) and ~2.5% for the second quarter. We think this is an example of Mr. Market's irrational pricing of a low risk company. Conversely, Tesla (electric car co.) is up ~60% the past month, ~288% year-to-date, and ~530% over the past year despite having little or no profits. Tesla's market value is now more than American Express and Bank of America combined (if it gets into the S&P, it will be around the #19th most valuable company). In our humble opinion, even if Tesla is more than just an electric car company, it is currently priced as if it will change the world (which it may do). Investors are paying a high price for an unknowable future. As Professor Elroy Dimson of the London Business School said, "Much more can happen than will happen."

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The Tax Man Cometh…

Eventually, all the fiscal and monetary stimulus will have to be repaid. Possible political changes in November will likely result in substantial changes in both the income and estate taxes. These changes could take away many of the 2017 tax reductions (TCJA) for both companies and individuals.

The future is indeed unpredictable; however, we recommend preparing a plan for potential tax changes. We have outlined possible changes in an internal memo to identify various potential actions to lock in some benefits. We are working on several unique strategies that may fit your needs. We stand ready to assist our clients in thinking about these issues. (For example, which assets to use to implement any lifetime planning is critical in light of possible changes to at death step up basis, etc.)

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Where do we go from here?

In the last few years, continued low interest rates and tax rate reductions have been the rocket fuel to inflate most assets. Both are controlled/manipulated either by the Fed or Congress. We have little confidence or trust in either.

We continue to monitor the ever-increasing federal deficits and the inevitable increase in taxes in most scenarios. The Fed has indicated that interest rates will remain very low for at least the next several years. Nevertheless, we know that not only taxes, but interest rates, inflation, and even possible deflation can appear very quickly, and perception of the change can quickly affect investment market prices of all assets and liabilities. We continue to watch for signs of these changes in this very uncertain world and internally debate future inflation or even possible deflation.

For now, however, we believe that equities will generally outperform bonds over time. In the current interest rate environment, bonds are priced for very low future returns, unless deflation turns out to be the reality. Equity performance is contingent on taxes and interest rates remaining the same as they are now. Maybe a big "if".

Regardless, given today's starting point, we believe returns from all asset classes will be below their historical averages.

Thus, we continue to proceed with caution, staying diversified with our Value/GARP (growth at a reasonable price) bias, and avoiding what we consider "fads" or assets valued on perpetual growth. As always, we emphasize the importance of stress testing a client's allocation for any near-term cash needs, and thus, making sure one can handle the increased market volatility, which may accelerate given the continued COVID-19 concerns and the November elections.

<u>In Closing</u>

The COVID-19 pandemic is having a massive impact on all of our personal and professional lives and continues to take a terrible toll on the global economy. While we anxiously await a vaccine, we must remember that "this too shall pass" (we hope and pray).

The future is truly unpredictable, but we believe that the "American tailwind" will prevail. In these uncertain times, we must all work together and be grateful for all our many blessings.

We wish you and your family a safe balance of the summer. Thank you for your confidence and trust.

Your SAA Team

Enclosure: Appendix

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"Well, again, kindness, kindness, kindness. Acts of kindness. Be kind. More than ever. Our country seems to need kindness more every week, and so, as I said last week, the more kindness you give the more you'll have."

Michael Osterholm, Director CDR at Univ. of Minn.

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"A great company is not a great investment if you pay too much for the stock."
Ben Graham, The Intelligent Investor

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"Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing. We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."
WEB, 1992 Letter to BRK Shareholders

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"Margin of Safety (MOS) are the 3 most important words in all investing according to many investing greats (Graham, Klarman) and that's why we named this quarterly SAA letter the 'Margin of Safety Quarterly.'"
SAA Team

Southeast Asset Advisors, LLC
Appendix to July 2020 Quarterly Letter

Comments on Berkshire Hathaway:

In recent years and especially this past quarter, Warren Buffett, CEO of Berkshire Hathaway, has been criticized for underperforming S&P 500. As the (FAANGMs concentrated) S&P 500 rallied over 20% in the second quarter, assisted by the Federal Reserve's $2.5 Trillion liquidity injection, BRK.B was down 2.36%. While, year to date through 6/30, Berkshire has declined ~21% as compared to the S&P's decline of ~3% year to date. This is not unusual for many managers that don't have a significant FAANGMs weighting, as is present in the S&P Index (top 5 stocks over 25% of index).

Pundits were quick to point out that Buffett did not make any meaningful purchases or investments in Q1 when the market was down over 30%; other than realizing a loss in his airline positions. As he explained, the velocity and magnitude of the market meltdown were so severe yet extremely short, and corporations were quick to tap the capital markets and refinance their already leveraged balance sheets. Instead of seeking out Buffett and Munger for a Convertible Preferred lifeline, the Federal Reserve came to the rescue. Buffett was quick to praise the Federal Reserve, stating, "The Federal Reserve did the right thing, and they did it very promptly, which they should have, and I salute them." Clearly Buffett and Munger were outbid by the Fed and the market and the calls they did receive were not of great interest.

Berkshire did, however, recently make a meaningful investment in the second quarter, purchasing natural gas pipeline and storage assets from Dominion Resources for $10 billion. This acquisition increases Berkshire's transport capacity to 18% of all natural gas in the U.S. We believe that this acquisition will yield the company a ~10 to ~12% return on investment and be very low risk.

More importantly, Buffett may have been active in buying back Berkshire's stock (which addresses a question we have been asking during all of 2020). A regulatory filing by the company disclosing Buffett's holdings as percentage of shares outstanding brought to light that the number of shares had been reduced over the period. Per our calculations, it appears that the company has repurchased ~$5 to $5.5 billion in stock between the annual meeting and July 8.

We won't know exactly how many shares were repurchased until the 10-Q is filed in early August.

Berkshire has experienced similar underperformance in a similar yet different technology market melt-up. In 1999, Berkshire was down ~20%, while the S&P 500 was up over 20%. Conversely in 2000, Berkshire was up over ~26%, whereas the S&P 500 was down ~9%. Berkshire outperformed in the market in the next two years and over the period of '99 to '02, Berkshire was up ~9%, while the S&P 500 was down over 20%. Is it different this time? Only time will tell but we have conviction with Berkshire. Trading at ~1.2x book value (bargain price) with over $140 billion in cash ready to deploy into the right opportunity, the stock, we believe, has been significantly discounted by Mr. Market. It is also pleasing to see Buffett executing on stock buy backs, as he said he would when the stock is trading substantially less than its intrinsic value (conservatively calculated).

Another point to consider is that Apple is Berkshire's largest public stock position, comprising ~44% of Berkshire's invested public holdings. Apple was up over 40% in the quarter leaving BRK with over $61 billion in unrealized gains, dwarfing the $4 billion pretax loss in his airline stocks (stocks bought then sold, as he felt the industry would get worse in the pandemic).

Buffett and Munger are arguably two of the best capital allocators in investing history. They purchase good businesses that they can understand which have long-term, competitive advantage and sound management at a fair to good price. Additionally, acknowledging mistakes quickly (i.e. airlines) has been a key to their success and strength of their culture.

We are very happy to own a significant amount of Berkshire stock for ourselves and our clients, especially in the continued "melt up" stock market.