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The Margin of Safety Quarterly
Southeast Asset Advisors, LLC
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Investment Management & Consulting
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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 3rd Quarter 2020 Commentary
DATE: October 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.

Third Quarter 2020 Key Takeaways

Despite some volatility in September, the S&P 500 Index rose 8.9% in the quarter. Without the ~42% year-to-date gain in FANMAG stocks (Facebook, Amazon, Netflix, Microsoft, Apple, and Google/Alphabet), the S&P would still be down for the year. This concentration in mega caps (and FANMAG, etc.) and in their performance can be seen by the comparison of the S&P return to the equally weighted Value Line Index, which is up only 3.46% for the quarter, but still down -17.08% year-to-date.

The mega cap growth names continue to lead the U.S. market and dominate the S&P Index with only the 10 top stocks accounting for ~28% of the index. However, over the

long term, owning the largest stocks has badly lagged vs. owning the diversified index. More on this topic later in this letter.

Bond markets were relatively calm over the last quarter as the Federal Reserve's extremely accommodative monetary policy continued. With Treasury yields basically unchanged, core investment grade bonds gained 0.6% in the third quarter. We continue to keep our portfolios' bond duration/maturity short as bond yields cannot go much lower. We believe long maturity bonds may be even more risky than equities.

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Where do we go from here…………………… Our guess…….

Going into the final quarter of 2020, multiple concerns and uncertainties present risks and can cause increased volatility. There are certainly reasons for caution including election uncertainty, the politics of additional stimulus, high valuations of market leaders relative to history, and a concentration of the market in mega cap companies (many tech). Our guess is an additional stimulus will pass; it's just the timing thereof, i.e. before or after the election. The pandemic continues, but a vaccine is promised, and upon approval, much of the economic pandemic damage will hopefully be repaired, though some industries may not recover. Monetary policy is extremely supportive, and many stocks are cheap relative to bonds. However, the high valuations of many of the current market leaders are priced based on their high growth lasting many years; using current low interest rates in the discounted cash flows (DCF) models. These high growth stock valuations are thus vulnerable to changes in their growth rates and present low interest rates. We think an ongoing, sustainable "competitive moat" assessment is so important in valuation. We worry many current "disrupters" high valuations do not allow an adequate margin of safety for investors.

Technology and anything connected with the home (work-from-home-solutions, or home improvement), cloud, network, or clean energy is continuing to lead the current investment "must haves." Low interest rates have raised prices of most all assets other than the "least popular" bucket. Homes have sold like "hot cakes," even as home building costs are up ~35%. A shortage of homes, appliances, and related home items prevails. It follows that furniture sales are also in bubble territory as are most things related to the "home." The key question is, "How long will this continue?"

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In the short term, the Fed may be more important than the November election, as low interest rates are the “rocket fuel” driving the “V” recovery and “Mr. Market.” The huge deficits, which have only grown under the required pandemic stimulus relief, will need to be addressed at some point despite many who think “deficits don’t matter,” including some economists believing in MMT (Modern Monetary Theory). We continue to think deficit spending does matter in the long run. The key questions are, “Whether and, if so, when, will interest rates rise?” and “Will inflation, stagnation or deflation be the outcome of running huge deficits? Not only in the U.S., but all over the world?” We are thinking and rethinking about the answers, timing, etc. to these questions!

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Conclusion

Our recommended path for clients is “prudent portfolio diversification” in one’s equity allocation. We also believe investors should maintain enough short-term liquidity to handle possible increased volatility both from a “spending needs” as well as “temperament” standpoint. We generally recommend 2-5 years of estimated spending in cash or short-term bonds. Of course, everyone and every situation is somewhat different.

We have an unusually wide range of plausible short-term macro outcomes. Thus, it is important to maintain discipline, patience, and a willingness “to not follow the herd.” Don’t let the many “Macro Pundits” use “fear” psychology to alter your temperament, especially in the final days of this election campaign. We must keep our emotions in check and continue to be long-term investors, ideally using “Mr. Market’s” volatility as an opportunity to rebalance within one’s asset allocation profile. (See #5 at the beginning of this letter).

This election, current rhetoric, and headlines will eventually pass. The “American Tailwind” is the surest bet no matter who is elected. God Bless America!

Enjoy life and your family. We will write again after the election.

Your SAA Team

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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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"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.'"
This MOS is important in asset allocation as well as in the valuation of individual securities.

SAA Team

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" The object of life is not to be on the side of the majority but to escape finding oneself in the ranks of the insane."

M. Aurelius