Member of
The Lanigan Group of Companies

The Margin of Safety Quarterly

Southeast Asset Advisors, LLC

Lanigan Wealth Management

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

www.assetadvisor.com

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 1st Quarter 2021 Commentary
DATE: April 2021

WE STRIVE TO PROTECT AND GROW
OUR CLIENTS' CAPITAL OVER THE LONG TERM BY:

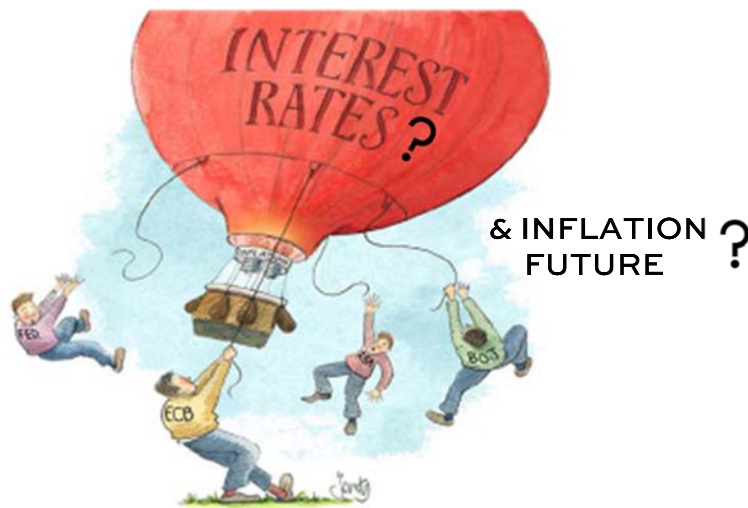
(1) Focusing on individual client goals and objectives.

(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 based on the client's profile of asset allocation ranges.



1st Quarter Comments

Value outperformed growth for the second consecutive quarter with the S&P 500 Index returning 6.2%. S&P Value Index returned 10.8%, while S&P Growth lagged, returning 2.1% for the 1st quarter. Many of our deep value managers outperformed their value benchmarks for the quarter.

In prior SAA letters, we have written about the importance of diversification in one's equity allocation, i.e., a blend of growth (GARP) and value. Furthermore, the stock market appeared to be bifurcated into three markets: 1) high forecast growth businesses, 2) theme or story stocks with little or no earnings, and 3) more traditional businesses that do not appear overvalued, especially considering very low interest rates. Of course, as discussed in the past and herein, most assets are somewhat inflated due to low interest rates. It is just a matter of to what degree assets are inflated and what happens if interest rates rise and inflation is not "transitory," as the Fed tells us. We worry at the "top down" macro level, but invest as our chosen managers do, in companies who meet qualifiers of business, people, and price.

However, from these current inflated asset valuations, we believe investors should prepare for lower future returns in all asset classes, including equities. However, we still think equities, in general, are a better bet than returns from bonds of most maturities; if one can handle the volatility, both in temperament and liquidity needs.

* * * * * * * * * * *

We see increased risk and risk taking in many areas, i.e., SPACS (a quick IPO alternative), high level of stock margin debt, continued disruptive technology risk, some of which will surely not develop, theme investing and high growth "story" stocks, crypto rage, climate change, driverless cars, etc. Indeed, some of this speculation may be profitable, but most of the companies are impossible to value and determine sustainability. The point is the risk appetite and fear of missing out (FOMO) are at a heightened level. However, the risk level does not yet appear to be as high as in the 2000 tech bubble. For example, many of the tech companies now have high cash levels, are highly profitable, are truly good/great asset-light businesses, and appear more sustainable. Also, interest rates are so much lower, and fixed income offers little alternative return compared to equities. We believe the key questions on the general market are: 1) Will healthy growth of the GDP offset the inevitable increase in interest

rates, which are artificially controlled by T-Fed? 2) Will inflation be "transitory" like the Fed believes and tells us? Our internal SAA motto is "Do not Fight the Fed in the short run" but also, "Do not believe the Feds talk (totally) either." More on the Fed later in this letter.

* * * * * * * * * *

Pundits Are Everywhere – Moving on from Predicting Pandemic…………

The pundits are out in full force, and their predictions of the stock market, economy, "new normal," infrastructure bill, and the amount of the increase in corporate tax rates, etc., are all over the spectrum – from gloom and doom to Goldilocks. The potential individual income tax and estate/gift tax changes are most important to many of our clients. We are busy with tax planning for certain clients who want to take advantage of a window before these major tax changes are enacted. Please call us if we can help you with this planning, etc., as we have some great strategies; but we think one must move quickly to implement before any anticipated changes are enacted. We, of course, cannot predict exactly, but we can certainly prepare!

* * * * * * * * * *

We are frequently asked, "What is the stock market going to do in the next month or year?"

> When asked this question over the years, we have always quickly answered, "In the short term, Mr. Market is a voting machine (reflecting psychology and emotions), so your guess is as good as ours; but in the long term, Mr. Market is a weighing machine (i.e., returns will follow the FCF sustainably in individual companies). So, we do not know, but we guess, "Mr. Market" will be volatile in the short term."

WHAT WE THINK WE KNOW, OR OUR BEST GUESS……

We cannot resist being a forecaster either, so our view at the present moment is……

- The economy appears to be emerging from the recession created by the pandemic in a continued "V" shape recovery, with a flood of stimulus by central

banks and huge deficit spending continuing. Chairman Powell has clearly stated that the economy is at an inflection point, with output and job growth poised to accelerate in the months ahead, so long as the Covid-19 pandemic continues to retreat. Chairman Powell reiterated, "The Fed plans to wait until the economy's recovery is complete before it raises interest rates." He said large rate increases are "highly unlikely this year," and he has also indicated in recent weeks that they expect to hold U.S. short-term interest rates near zero until 2023. They also plan to continue the Fed's massive monthly bond purchases until the economy makes "substantial further progress" toward its dual goal of maximum employment and sustained 2% inflation. The Fed and Treasury (T-Fed) seem to be coordinating the massive stimulus.

- If handled in a responsible manner, the potential "infrastructure bill" could indeed provide additional economic opportunity, but that is a big **IF**. Actually, in the present form, the bill does not appear correctly titled, as there are few "shovel ready" projects. Rather, there is significant other proposed spending in drafts now in discussion. Time will tell what, if any, legislation passes and the method of paying for the spending therein.
- Deficits are indeed high, but with low interest rates, we may be able to handle them in the long term, as long as we have healthy growth in the economy and stop the increase of deficit spending.
- Future T-Fed and government missteps are of great concern; thus, inflation and higher interest rates rank as our worry #1 and #2. We see the "helicopter/B-52 stimulus" consequences as a high risk of being inflationary. We think interest rates and inflation will increase, but the timing and degree are anyone's guess and largely depend on the T-Fed action and timing.
- Bonds are not a good alternative for capital at today's rates. Investing in high yield bonds with credit risk or long maturity duration to reach for yield (where one is not appropriately compensated for the risk) is not smart to us.
- We do not believe that we (or anyone) can correctly predict macro. However, we worry the Fed is not correct in its view that inflation will be "transitory."
- We guess that a continued market "melt up" is in order, at least in short term (absent a "black swan" event), and thus, we at SAA are letting our equity allocations (for most profiles) increase as equities grow, rather than our normal rebalancing.
- We are in an unusual time where no asset appears cheap as low interest rates have inflated almost everything. We carefully watch for signs of increased inflation, interest rates, and tax changes that can offset and slow the growth of

GDP. Alternatives to equities do not appear great to us, but many portfolios must have fixed income allocations.

- We believe that from today's prices the returns on most assets will be lower than in the past for reasons outlined, herein. *The question is, "How to prepare and invest for higher inflation, higher interest rates, and great uncertainty?" Our Co-CIOs and Chairman answers this in the attached Exhibit A. It is a good read and reread, even if we do say so ourselves.*

* * * * * * * * * *

Two of our favorite year end letters are out and are required reading and studying by our SAA team. They are the Berkshire chairman's annual letter (https://www.berkshirehathaway.com/letters/2020ltr.pdf) and J.P. Morgan Chase Chairman and CEO Jamie Dimon's annual letter (https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/investor-relations/documents/ceo-letter-to-shareholders-2020.pdf). We encourage our inclined clients to read both as they are informative, even if one does not agree with some of their political views.

* * * * * * * * * *

One of our primary research advantages is that we see great "in depth" views of many different industries and business models among our clients, our companies, and our investment partners. Of course, we are skeptical of the reliability of most of what we hear and read these days. We also realize that everyone is generally biased in their thinking, for one reason or another, even if they do not readily admit it. However, we find primary research extremely valuable. We constantly try to disprove what we think we know, and our team debates each other as a way of getting to the best or better answer. We think that the T-Fed should talk more to Main Street, in addition to using their "economic models".

* * * * * * * * * *

As always, thank you for your confidence and trust. Have a great Spring! Let us all thank God that we are blessed to live in America despite some shortcomings of our democracy.

Please call, come in, or let us have a Zoom or Team call if we need to discuss any changes to your asset allocation, etc., or if you need our help planning for Individual tax and Estate/Gift tax changes that appear to be on the near-term horizon.

Your SAA Team

Enclosure: *"How to Prepare and Invest for Higher Inflation, Higher Interest Rates, and Great Uncertainty"* – Exhibit A

"The key to investing and many things is to be rational, maintain your composure, and use common sense. Always be prepared, anticipate "fear and greed" swings, going to extreme and creating opportunities for the rational and prepared."

- A Secret Hero of SAA

"Human behavior flows from three main sources: desire, emotion, & knowledge."

- Plato

"Value investing is simple to understand but difficult to implement. The hard part is discipline, patience, and judgment. Investors need discipline to avoid the many unattractive pitches that are thrown, patience to wait for the right pitch, and judgment to know when it is time to swing."

- Seth Klarman, Margin of Safety

"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

- Warren Buffett

HOW TO PREPARE AND INVEST FOR HIGHER INFLATION, HIGHER INTEREST RATES, AND GREAT UNCERTAINTY

B. Lanigan, Co-CIO
B. Jackson, Co-CIO

We have been thinking a lot about prospects for inflation pressures and higher interest rates and the general effect (what if) on valuations of all assets, including both high growth (i.e., tech, etc.), cyclical, value, as well as steady growing business models, income real estate, etc. We think, usually, all assets are affected by increased interest rates and inflation, both actual and anticipation of increase, therein.

Key question: If we do have inflation and higher interest rates in the future, then how best to invest? Of course, some asset valuations are hurt by inflation and higher interest rates more than others.

We have considered many alternatives (as a hedge) such as TIPS, gold, gold mines, copper, timber, agriculture land, income yielding real estate, etc., as well as other hard asset plays. Some of these do offer some inflation hedge and diversification; however, most of these are not as liquid as our conclusion of the best hedge.

Our conclusion on how to prepare if we have increased inflation and interest rates, and the T-Fed is wrong that increases will not be "transitory" but lasting, etc. The T-Fed has seldom been right as, in my opinion, they spend too much time with models and not enough talking with people (i.e., primary research). Of course, I am reminded, "Don't fight the Fed, at least in the short run."

Our game plan is as follows:

- First, of course, be a "long-term investor" – buy great businesses at a fair to good / great price that is run by capable and honest operators and good capital allocators! This is the ultimate hedge against inflation, increased rates, mania, and irrational behavior, etc.
- Any debt needs to be at a fixed interest rate and hopefully mid to long term and covenant lite, etc. (conservative).
- Be prepared for equity volatility, and use it as opportunity to be ready with a plan, etc.
- Be an "investor" not a "speculator," and know the difference. For sure, limit speculative investments (if at all) to a small (i.e., 1-3%) of total portfolio (more on this later). Guard against "FOMO" (fear of missing out). For some, FOMO is very tempting and can lure one into gambling or speculation especially in mania times when many are being irrational.

- Think a lot about the amount of "MOS" (margin of safety) required in both individual stock holdings (P to V) and overall allocation to equities. A company's sustainable competitive advantage is "key" and not "speculation" in something that can "change the world."
- Think about companies that have a "sustainable competitive advantages" or "moats"; what can even disrupt the "new disruptors" business models.
- Own businesses that have "5Ps" attributes as follows:
    1) Market where industry **"pie"** is growing.
    2) Run by **"people"** able to gain profitable share, increase intrinsic value (IV) per share, and do great capital allocation to increase per share IV.
    3) Execute strategy to grow their company **"piece of the pie."**
    4) A company that 0perates **"predictively."**
    5) Company that has **"pricing power"** to offset cost inflation. Usually these have a large "sustainable competitive advantage" or "moat."
- Patience to wait for the right pitch is key, and judgement to know when to swing. Must have discipline of **"patience"** and judgment to say "no" to "non-qualifiers."
- "Temperament" is most important. It is so hard to not follow the crowd in "greed or fear" mode. "Be fearful when irrational greed behavior is everywhere and greedy when all are fearful."
- Make sure you have a "MOS" with special attention to near-term client cash needs; that you keep client long-term focus with "right temperament" to handle the volatility of "Mr. Market," and use as an opportunity, etc. Avoid being a forced seller.
- Realize one cannot predict "macro" or "Mr. Market" successfully in the short run, but one "can prepare" and be somewhat diversified without of course, "diworsification".

So, the game plan is the same as always; it is just more important than ever.