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

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

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Member of The Lanigan Group of Companies

TO: Clients and Friends

FROM: SAA Managing Directors

RE: 2nd Quarter 2021 Commentary

DATE: July 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.

Market Recap

Equities around the globe continued to move up in the second quarter. The U.S. and developed international markets led the way, with the S&P 500 Index gaining 8.5% and developed international stocks rising 5.7%. Emerging-market stocks trailed in terms of progress on the COVID-19 front and in turn rose by a more modest 4.9%.

Within the U.S. stock market, the rotation from growth to value stocks took a pause, with the Russell 1000 Growth Index gaining 11.9% versus a 5.1% rise for the Value Index. The S&P 500 Growth Index's forward P/E is currently 11.7 points higher than that of the S&P Value Index, nearly 3x greater than the average differential over the past decade. This further illustrates that diversification by styles is important. Smaller-cap value stocks slightly outperformed their growth counterparts and have been the top-performing segment of the U.S. market this year.

Many have been puzzled by the bond market conundrum. Despite higher inflation readings during the quarter, the 10-year Treasury rose as yields dipped below 1.50% in June, ending the quarter at 1.45%, down from 1.75% at the end of March. "Don't fight the Fed Chair" might indeed be good advice in the bond market. Chairman Powell continues to say inflation is temporary and bond holders seem to follow his lead.

Investment Outlook

As COVID-19 vaccinations and immunity spread across the globe, we expect global economic recovery to contribute to healthy corporate earnings growth, but as we go to press, Mr. Market seems spooked by the recent Delta variant surge. We believe that increased earnings growth should bode well for equities over the near term (next 12 months) at least. While the Federal Reserve is now signaling it is moving closer to beginning to taper its quantitative easing asset purchases, monetary policy and interest rates should remain accommodative for a while.

Everyone's #1 Question – Is inflation transitory, as the Fed believes, or is it sustaining?

On the major question that everyone is asking, whether recent signals of price increases are harbingers of a sustained period of meaningfully higher inflation, we believe it is too early to tell. But what we see and hear from our clients is that inflation is certainly occurring within tight supply chain areas.

Consumer price index (CPI) inflation numbers have been surprisingly high, and longer-term CPI inflation expectations have increased substantially from their pandemic lows. Currently, inflation appears inconsistent with the Fed's long-term 2% to 2.5% core inflation objective. However, digging more deeply into the numbers reveals the answer to the "transitory" question is – "it depends!" The bigger drivers of increased inflation are clearly pandemic disruptions (i.e., supply chains issues, transportation, and labor shortage). In all, we think it is more likely that many of the recent sharp price increases will prove "transitory," as current supply shortages catch up to demand as the pandemic recedes. However, we believe some inflation will indeed not be "transitory." The stimulus has been unprecedented as was the pandemic shutdown. This caused many demand factors to be pushed forward. It is too early to tell and remains unclear that the current landscape is our "new normal". For reference, we have again attached our white paper on investing in an inflationary environment (Exhibit A) which was included in our last quarter letter.

Peak earnings growth will probably be in the 3rd quarter as the economy moves from "stay at home" to "go out and spend." Even if the new Delta variant spread is significant, we think the possibility of new lockdown mandates is remote as we have learned this response is a "no go".

With the likelihood of a U.S. recession very low—absent a severe external shock—we see low risk of a near-term bear market. Of course, 10%-plus stock market corrections can always occur, which will present an opportunity for the long-term investor. As we move further into the U.S. earnings cycle, and questions remain on inflation longevity and Fed policy, the odds of a typical mid-cycle market correction increase. But despite elevated S&P 500 valuations and a likely deceleration in S&P 500 earnings growth, we believe global equities have additional return potential in this cycle. As always, though, investors (both equity and bond) should be prepared for increasing volatility.

We continue to see increasing signs of "speculation" (i.e., in IPO, SPAC's, meme stocks, story stocks, fads, etc.) many of which are impossible to value. We are reminded of difference in speculation and investing - speculation is based on the greater fool theory, while investing is based on an asset's intrinsic value calculated on future cash flows and then bought with a margin of safety.

Accordingly, we believe the key dashboard factors are interest rates (i.e., the Fed's action and inflation), along with tax policy, fiscal stimulus, and consumer spending. Low interest rates increase the value of all assets and excite the animal spirits.

We are also closely watch homebuilding and lumber prices as they have always been a leading indicator of the economy. Lumber prices skyrocketed due to high pandemic driven demand coupled with supply disruptions, but prices have recently dropped significantly due to demand/supply changes (supply has opened up a little and demand seems to have fallen off some). Despite the significant drop, lumber prices remain above pre-pandemic levels. This illustrates that temporary demand supply issues are not necessarily indicative of the direction of near-term economic cycles. As for home builder reactions to these (and other) changes in their input costs, while they were quick to increase prices on the way up, many have not reduced home prices for the recent decline and thus should have higher margins in the near term. This similar dynamic may happen in other industries where there have been supply chain disruptions and cost increases.

Our game plan remains the same: "Remain overweighted in equities especially GARP (growth at a reasonable price) – with good businesses, good management, purchased at a fair price – purchased individually or through our stable of great managers who have an "edge." We strongly suggest limiting the speculation bucket (if at all) to a 1 to 3% allocation if one must, in order to contain one's "animal spirits."

Thought on Taxes: First Income Taxes

The daily back and forth debate on potential corporate tax increases - from 21% to 28% - is not that significant and may be appropriate (if cash is used properly). However, the more significant proposed capital gains tax rates, which includes tax on dividends, increase from 20% to 39% (plus 3.8% Medicare tax) is frightening. As we think about a potential capital gains tax increase, we are reminded of a key component of investing: a long-term holding period. Investing in a company with a strong competitive advantage and whose long term intrinsic value can grow, provides a long-term investor the opportunity to compound value no matter how Mr. Market prices it in the short term, while deferring capital gains tax. The long-term tax deferral can significantly increase after-tax return and the compounding thereof. Being a long-term holder, will be even more important if capital gains taxes are increased, as we expect will happen at some point in time.

Estate and Gift Tax Potential Increases

We continue to encourage our clients to review their estate and financial plans and let us help you think through planning in light of potential proposed law changes. Let's also keep in mind the alternative sunset of today's tax laws (i.e., the unified credit dropping back to pre-Trump levels after 2025,) which would be significant in itself. Many of our planning techniques could be eliminated (or limited) if indeed new estate and gift changes pass. However, we always caution clients in their planning to be sure they can afford to gift or use sales to trusts, (or other techniques) to the next generation. Proactive planning and stress testing using "what if scenarios" is strongly encouraged.

In Closing

As always, we thank you for entrusting us with your investment assets and your continued support. Deserved trust is very important to us. Lastly, the best compliment we can receive is a referral from a satisfied client. We appreciate your referrals and handle them with the utmost of care.

Enjoy the balance of your Summer!

Your SAA Team

Attachment: Exhibit A

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"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

- Warren Buffett

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"Knowing what you don't know is more useful than being brilliant."

- Charlie Munger

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"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

- Mark Twain

"If you are not a little confused by what's going on, you don't understand it. We're in sort of uncharted territory."

- Charlie Munger

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.

<u>Key question:</u> 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.

<u>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.</u> 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."

<u>Our game plan is as follows:</u>

- 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 "<u>5Ps</u>" attributes as follows:
    1) Market where industry **"<u>pie</u>"** is growing.
    2) Run by **"<u>people</u>"** 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 **"<u>piece of the pie.</u>"**
    4) A company that 0perates **"<u>predictively.</u>"**
    5) Company that has **"<u>pricing power</u>"** to offset cost inflation. Usually these have a large "sustainable competitive advantage" or "moat."
- <u>Patience</u> 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 "<u>can prepare"</u> and be somewhat <u>diversified without of course, "diworsification"</u>.

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