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

Investment Management & Consulting
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Member of
The Lanigan Group of Companies

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 4th Quarter 2021 Commentary
DATE: January 2022

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

2021 was a turbulent year as a myriad of headline news drove the short-term "animal spirits" of fear and greed. The majority of the risks we listed last quarter all appeared in the headlines at one time or another. Mr. Market, however, climbed the short-term wall of worry to post a ~28% S&P gain led by a narrow group of 8 stocks (Mag 8 – See Exhibit A). The "Mag 8" stocks were a big part of index returns and now represent ~26% of the market cap of the S&P 500. The narrowing of the market performance does give us some concerns as discussed later in this letter.

The 10-year treasury rate has increased to ~1.8% (as we go to press.) The general consensus is the Fed will raise rates 4 or more times in 2022 to slow inflation. "TINA" (There Is No Alternative) to equities as intermediate or long-term bonds are awful alternatives in a rising interest rate environment. This could change by the end of 2022, although the real interest rate may still be negative even after anticipated rate increases, if inflation does not subside.

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Risk Off - On as Fed Talks Rate Increases

In late 2021 and early 2022, we see a change in risk pricing as many speculative companies with no or little earnings get hammered. For example, ~40% of the Nasdaq index was down ~50% or more from their 52-week high. The rotation to fundamental value may be real and continue especially if interest rates increase as is generally expected. However, the recent Fed appointments may overpower Fed Chair Powell's intent to use rate increases to slow inflation. Just as low interest rates have increased most asset prices, even the talk of increased interest rates should decrease most prices and reduce speculative behavior. If history rhymes, generally the riskiest end of the market deflates first – as it has been doing recently. Actually, this may be a positive event as this perhaps tames the market euphoria without a lot of pain. Investing is hard and not supposed to be easy!

Predictably Unknowable

"Even the most serious efforts to make predictions can end up so far from the mark as to be more dangerous than useless." - P. Bernstein

This time of year, many media poll financial "experts" as to where they believe the market will be one year hence. People like these predictions, although according to one survey, the median forecast has missed their prediction by 13% each year for the past 20 years. The curious part is that given their dreadful track record, their opinions are still sought!

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Our favorite source of company information and generally most reliable is a company's 10Q and 10K (SEC filings). When considering an investment in an individual company or reengineering a manager's valuation of a particular company (part of our continuous due diligence on a manager and its competitors), these documents are required reading for our team as a start in our valuation process. We know from our public company board experience they are the most reliable source of information. However, GAAP (Generally Accepted Accounting Principles) prepared financials usually require adjustments to get the correct owner earnings, FCF, etc., and be useful in valuations. Sometimes these adjustments to GAAP financials are positive, and many times they are negative, to get to true owner earnings.

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We believe reading, along with being curious, skeptical, thinking for yourself, and of course, not following the crowd, are all critical for investment success. Also, we must keep in mind that much about the future is unknowable, especially short-term "macro" factors.

Of course, all investments deal with future expectations. We try to judge the probability of outcomes and seek business models that are reasonably predictable, run by capable capital allocators, and at a price that has a margin of safety (MOS) between price and a rough estimate of value. We have little interest in companies that have no free cash flow (FCF) or near-term prospects, as they are generally too hard for us to value.

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Accordingly, when valuing individual companies, we ask ourselves and our managers key questions such as:

- How much margin of safety is in our estimate of value to price, and how is the intrinsic value growing?
- What is growth rate in owner earnings, FCF, etc. necessary to justify current price and provide a proper margin of safety (using DCF valuations)?

- Many companies fall in the *too hard* file as it is impossible for us to value for one reason or another.
- To be a good investment – must meet quality of Business, People, and Price criteria. This is a very high qualifying criteria!

To predict long-term FCF, owner earnings, return on capital, etc. with any confidence, a sustainable competitive advantage assessment (i.e., moat) is key. For example, in the current environment, a company must be able to pass on their inevitable inflation in their cost or have top line growth necessary to compensate therefor.

Just as we want qualifying individual companies to have an adequate margin of safety in value to the price paid, we also want to have a margin of safety in one's asset allocation. This MOS helps clients handle equity volatility with the proper temperament and to remain patient to experience long-term compounding.

"Margin of safety are the three most important words in investing." - Ben Graham

We have called this quarterly letter *Margin of Safety Quarterly* to constantly remind our SAA team of these all-important criteria in even conservative projections.

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We constantly remind our clients (and ourselves) that in the short term, Mr. Market is a voting machine (think – psychology, behavior finance, and popularity), but in the long term, a weighing machine (of free cash flow or owner earnings.) Temperament is so important in the short term to handle volatility. We and our managers can only hope to be able to predict a range of long-term FCF of some companies and have no confidence in our ability (or anyone else's) to predict the psychology of market participants in the short term.

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One of our guru managers began his recent letter saying, "Valued by quoted market prices, our returns were [X]%." We think this manager's statement is emphasizing that the market often overstates, or sometimes understates, the intrinsic value per share in daily pricing. However, quoted market prices are what are required to compute returns. Valuation fundamentals and the right temperament are required to be a value investor. Many investors only buy what is popular at the moment and thus are usually at a high price.

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In Closing

As always, we thank you for your continued support and for entrusting us with your investment assets. **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. We have no marketing, so we depend on referrals.

We wish you a healthy, happy, and prosperous 2022!

Your SAA Team

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"Attempting to guess short-term swings in individual stocks, the stock market or the economy is not likely to produce consistently good results. Short-term developments are too unpredictable." - Lou Simpson (1936-2022)

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"Keep it simple – focus on quality businesses with top notch management who understand capital allocation (per share value – a CEO either gets is or doesn't). Pick ideas as if you have to own them for the next 5-10 years. Activity and group decision making have a negative correlation to results." - Lou Simpson (1936-2022)

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"Prediction is very difficult, especially if it's about the future!" - N. Bohr

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"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." – Sir John Templeton

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"One of the tests of leadership is the ability to recognize a problem before it becomes an emergency." - A.H. Glasow

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"You are not here merely to make a living. You are here in order to enable the world to live more amply, with greater vision, with a finer spirit of hope and achievement. You are here to enrich the world, and you impoverish yourself if you forget the errand."
– Woodrow Wilson

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"Self-improvement comes mainly from trying to help others." – Sir John Templeton

Enclosure: Exhibit A – "Mag 8" Facts

EXHIBIT A

"Mag 8" Facts

A few facts about Mag 8 need to be considered as a big part of the S&P index today:

- The Mag 8 are 8 stocks in the S&P 500 with highest market capitalization and include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla.
- The Mag 8 market capitalization rose to ~$12 trillion at the end of the year, up from ~$1.2 trillion at the start of 2013.
- They now account for ~25.7% of the market cap of the S&P 500, up from 7.3% at the start of 2013.
- These eight stocks have accounted for 29% of the market capital gain in the S&P 500 since the start of 2013.
- They are projected to increase revenue and earnings 14.8% and 9.7% over the next 12 months.
- Some of these Mag 8 are truly great companies with sustainable competitive advantages run by capable operators, but at some point, the law of large numbers are truly headwinds for their growth in price, etc. Perceived quality and growth are usually priced high, accordingly.
- The forward profit margin of Mag 8 was ~20.4% with Amazon and ~27.8% without Amazon. The profit margin of the entire S&P was only 12.5% without the Mag 8. Their collective P/E is ~33.8x compared to 21.3x and 18.6x for the S&P with and without them. Needless to say, the Mag 8 stocks are not cheap!

For the most part, the Mag 8 stocks are great businesses; although, most are priced for growth in earnings far into the future, leaving little margin of safety in many of their price to value. Even great companies bought at a high price have proven to not be great investments. Time will tell! In full disclosure, we own Alphabet and Apple in most portfolios and think they are great businesses; the best of the Mag 8.