The Margin of Safety Quarterly [1]
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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 1st Quarter 2022 Commentary
DATE: April 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.

1st Quarter Market Recap

The 1st quarter of 2022 saw extreme daily volatility in both equities and bonds. The S&P ended down ~4.6% after being down ~13% at its low on March 8. The NASDAQ ended down 8.9% for the quarter. Many stocks were down even more.

The MegaCap 8 stocks discussed in our past letters ended down ~6% and still represent ~27% of S&P market cap. The MegaCap 8 stocks are now selling for ~30x PE.

[1] Margin of Safety (MOS): Many investing greats have said these words are the most important three words in investing. We agree and call our quarterly letter accordingly.

The forward PE of the S&P, excluding the high PE MegaCap 8 stocks, was ~17x and ~19x including them at the end of the quarter.

Bond markets had the worst quarter in 40 years, as funds tied to intermediate maturity, investment grade fell ~5.9%.

Daily Volatility and Drawdowns Test Temperament

Daily volatility during the 1st quarter of 2022 tested most everyone's temperament as the tragic war in Ukraine exacerbated the anxiety generated by constant news of higher inflation, rising interest rates, and high oil prices.

However, we were disappointed that much of the speculator behavior witnessed in the past did not seem to be tempered, particularly in residential real estate, meme stocks, and day trader activity, etc.

A severe down market rebounded somewhat from quarter lows, and energy enjoyed a nice up market due to higher oil prices. The bond prices were also extremely volatile as Fed Chairman Powell finally turned more aggressive towards future rate hikes with the goal of slowing inflation without triggering a recession later this year or next.

As predicted in prior SAA letters, we see higher inflation and interest rates being a significant headwind to prices for most all assets other than perhaps ones used as an inflation hedge. This is the opposite of the significant tailwind of ultra-low interest rates that we have enjoyed for a number of years. The key question is, will increased Fed action cause a recession later in the year? We are encouraged by signs of US supply chain issues slowly diminishing, but there are still significant concerns about those in Europe and China.

We expect continued volatility in the markets. We also think some companies can be beneficiaries of inflation, such as ones with scale and/or other competitive advantages and can pass on their increased costs. We look forward to the time when increased real interest rates allow prudent buying of bonds laddered to different durations as part of one's asset allocation. For now, we believe all fixed income should be held in extremely short duration – think money markets!

On the equity side of asset allocation, we are staying the course and possibly doing some rebalancing on a dollar cost averaging basis, staying within one's Investment Policy allocation range. It has never been more important to have an appropriate investment policy and be a long-term investor. We remain cautious in this uncertain environment of rising inflation and interest rates, increasing oil and food prices, and extended high prices for most investment assets. We pray the war in Ukraine will end soon.

Our Worry List and Uncertainties Revisited

As outlined in our 3rd quarter 2021 SAA letter and prior letters, there are many uncertainties and valid worries in areas pertinent to investing. Of course, seldom are there no worries from a macro standpoint. The key theme for a long-term investor – this too shall pass!

We have written in prior letters of our concern about inflation, the Fed increasing rates, and possible recession risks later in the year. We continue to look at companies that do well in early stages of inflation, and thereafter. The supply chain issues have complicated many businesses; although, we hear from many CEOs that they are starting to abate.

Uncertainty About Valuation

One of the biggest uncertainties is determining the proper market valuation multiple. There is a tug-of-war between the Fed's hawkishness and all the liquidity accumulated over the last several years. At some point, the Fed's increase in interest rates will eventually control inflation. What will then be the new interest rates norm and the all-important PE multiples and growth rates of the various sectors, indexes, and companies?

As we have written, there is also a tug-of-war between the MegaCap 8 and remaining 492 of S&P stocks. A lot of high valuation stocks are in these 8 stocks. There are also many speculative stocks, many with little earning or earnings forecast in the distant future (if ever) and/or the latest "new thing" that is promised to change the world – think Tesla!

For the most part, the MegaCap 8 stocks are superior businesses that deserve to be priced at some premium to most businesses, because of their size, market power, growth rate, and most important, amount of cash that can be used for stock buybacks or other prudent capital allocation.

For example, let's say the MegaCap 8 sell for an average ~30x forward earnings, or a ~3.3% earnings yield, while the PE of S&P market without these 8 stocks trade at a more reasonable ~17.5x, or a ~5.7% earnings yield. A MegaCap 8 ~3.3% earnings yield (valuation) is priced for perfection with little margin of safety if anything goes different than expected. However, their massive cash holdings allow them significant optionality to do large stock buybacks to support their stock price, etc. We continue to hold some of MegaCap 8, as do many of our managers, but we are very selective, keeping sustainability as a foremost criteria.

In Closing

As always, we thank you for your continued support and for entrusting us with your investment assets. **Deserved trust** is so very important to us. Lastly, the best compliment we can receive is a referral from a satisfied client. Thank you!

Happy Easter! Hug your loved ones.

Your SAA Team

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Any professional advisor, at his best, is only as good as their client!

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We recently were given a copy of notes from a client's file taken in a 1960 investing seminar she attended on Investment Policies, the note read;
"Successful investing requires the right temperament, patience and being a long-term investor and knowing competitive advantages and intrinsic value of your holding."
Well said then and now!