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The Margin of Safety Quarterly [1]

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: 2nd Quarter 2022 Commentary
DATE: July 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.

Quarter and Year-To-Date Drawdowns

"If you can keep your head when all about you are losing theirs."

If – R. Kipling

As valued by quoted market prices, the S&P is down ~16.1% for the quarter and ~20.0% year-to date. The NASDAQ is down ~22.3% for the quarter and ~29.2% year-to-date. More than 40% of stocks in the Russell 3000 Index are down year-to-date greater than ~25.0%. The MegaCap 8 stocks that we have repeatedly written about are combined down ~39.3% and many of the memes and other speculative stocks are down multiples of the overall market.

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

The current environment is one of the most complicated we have seen. The Fed quickly changed its view on inflation after thinking it was "transitory", caused by the pandemic supply chain issues and temporary Government stimulus payments, etc. As former Secretary Larry Summers said recently, Powell just missed the inflationary effect of the massive government stimulus, making an unfortunate error that he has been slow to correct.

If the Fed makes a mistake on an issue this big, how can we expect to believe the Fed in the future. This is our relearned lesson! Shame on us!

Hopefully, the Fed will act prudently in handling inflation in the future months. This is our biggest risk going forward and a substantial one indeed.

The Future…

Mr. Market is a voting machine, in the short term, as seen in the first half of this year. The Fed increasing interest rates to control inflation, as well as the ongoing Ukraine war, supply chain, lockdown, etc., creates negative psychology resulting in drawdowns in most equities and bonds of all duration after a big run up in the markets in 2021.

It is no surprise that in a polling of members of a leading individual investors association, the bearish sentiment reached the highest level since 2009. We view this as a bullish sign that the market may be closer to a bottom than one may think.

What follows are comments and timely quotes that help us to stay positive as long-term investors:

- You will note the underlined words in this letter's beginning paragraph "As valued by quoted market prices." Of course, this is the only price that we can theoretically buy or sell. However, over the long-term, prices and resulting returns reflect the performance of the underlying Company fundamentals, not what Mr. Market temporarily prices them. Especially in periods of fear (2022) or greed (2021).

- We, as well as our managers, think the portfolio holdings are now generally more valuable than the market drawdowns are pricing them. Time will tell and depends largely on interest rates and inflation going forward.

- We are reminded of the great long-term investor, Shelby Davis, father of our friend and manager, Chris Davis who said, in times like these, *"You make most of your money in a bear market although you don't know it at the time."*

A few facts from market history are helpful as we look to the future:

- Since 1945, a period of the 77 years, there have been 12 bear markets. The median bear market low occurred 117 days following when the market was down 20%. If this bear market behaves like its predecessors, it is coin flip whether it bottoms by October or before[1]. Successful market timing, however, is impossible for us or anyone. We are being careful on buying equities at this point until we see the outcome of Fed rate increases, the second quarter individual company earning calls reporting on price increases to offset cost inflation and resulting effect on demand, etc.

- High inflation almost always leads to higher interest rates, which erode the value of long-duration assets because they make future cash flows less valuable. Bonds, with their fixed interest payments and maturity values, are the hardest hit. Some businesses can offset inflation by raising prices, but historically that has only been a partial offset.

- Though it is tempting to believe that one should sell stocks following the onset of a bear market, a recession or a period of high inflation, the data suggest otherwise. Stock prices anticipate future events before they occur. After the news is out, it is typically too late to profit. That's what makes timing the stock market so hard, and that is why we suggest not trying. Instead, we encourage dollar-cost averaging for investing new capital and rebalancing the portfolio after large market moves[1].

- At some point the negative noise from the Fed, etc., will stop mattering to Mr. Market. As Warren Buffett wrote in his October 16, 2008 opinion piece in the

[1] Information from Oakmark's 2nd quarter letter and not verified by us.

New York Times: "What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So, if you wait for the robins, spring will be over."

- There have been 12 bear markets since 1945 including the current one. For the 11 previous bear markets, the median additional decline after the market was down 20% was another 10% loss. Despite those declines, two years from the time the market first hit down 20%, the median gain was 33%. That statistic is especially interesting because the two-year price increases from a random purchase date has been just over half as much, 17%. Perhaps the advisors who are now urging extra caution are being driven by their emotions rather than data[1].

- Looking at the 12 recessions that have occurred since 1945 and during the two years after it was known that a recession had begun, we find the median two-year price increase in the S&P 500 was 25%, and only one of the 12 periods showed a negative return. Remember that the median two-year price increase from random purchase dates during those 77 years was only 17%, so the recession returns were higher. If the late July announcement of the second-quarter real GDP turns out to be negative, don't be bothered as there is no evidence that below-average investment returns are likely to follow[1].

- If inflation is a negative for equities, does that mean we should sell stocks when inflation is high? We went back to our 77-year data on S&P 500 prices and examined what the two-year returns were following inflation rising above 8%. Before this quarter, there were only five periods since 1945 when inflation exceeded 8%. An investor purchasing the S&P 500 following the announcement that the trailing annual CPI increase was above 8% and holding for two years showed a median price increase of 17%, the same as for a random two-year period over the past 77 years[1].

- We believe that one positive in an otherwise current bleak investment landscape is the unwinding of many speculative excesses. The substantial damage already suffered in Crypto, IPOs, and meme stocks. Many equities that have no cash flow or distant prospects, thereto are also good examples.

[1] Information from Oakmark's 2nd quarter letter and not verified by us.

- A recession can continue to "washout the excesses" and eventually reduce inflation as it is the worst tax of all, hurting the ones that can least afford it the most. Employment still appears solid for those that can and will come back to work. The Fed is determined to attack the spiraling inflation even at the expense of a recession which at this point in time we guess will be a "mild one."

- A recession will surely be the most anticipated on record. Banks are in excellent shape and consumer balance sheets are actually very good. This is a totally different situation than the Great Financial Crisis of 2008. However, much data is surely confusing by mixed ongoing supply chain issues, prior pandemic lockdowns, consumer behavior i.e., hybrid and remote work, and general pull forward on demand for many goods. The increased level of home pricing is slowing due to affordability, but a shortage of inventory remains. The second home market of the HNW is a wild card but will surely slow if the market continues the drawdown.

As most of our long-term clients know we are "value investors." To us, value means quality foremost with a growth-at-reasonable-price. Quality means companies that have a durable competitive advantage that can raise prices as their costs go up over the long-term and have an adequate return on invested capital. Growth is one component of determining intrinsic value, usually a positive but sometimes a negative. Determining the correct interest rate to discount the free cash flow to the present value is very difficult at the present time.

Seth Klarman, author of Margin of Safety, commented on value investing as follows:

"Value investing is simple to understand but difficult to implement. The hard part of value investing is discipline, patience, and judgement. 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

In Closing

We think that neither us nor anyone else can time the market successfully or predict future macro factors such as the Ukraine war, pandemic, interest rates, inflation, etc. However, we do try to determine generally where we are "in the cycle." Our guess is we are closer to the cycle bottom now as the market seems to anticipate the Fed tightening over next few months. We do expect continued volatility. Hopefully the Fed will act prudently and not increase rates more than the minimum required to slow inflation.

We continue to be confident that owning a diversified group of qualifying equites are a better investment than bonds, and for the long-term investor equity returns should outperform. Of course, everyone has different goals and different asset allocations to handle both near term cash needs and their risk tolerance. Long-term volatility is the admission ticket to higher returns for those that have the temperament.

Please call us if you would like to have a meeting or a call to discuss further our thoughts or if you need to make us aware of any changes to your goals, etc.

As always, we thank you for your continued support and for entrusting us with your investment assets. Thank you!

Your SAA Team

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"Buying something for less than its value. In my opinion, this is what it's all about – the most dependable way to make money. Buying at a discount from intrinsic value and having the asset's price move toward its value doesn't require serendipity; it just requires that market participants wake up to reality. When the market's functioning properly, value exerts a magnetic pull on price (in the long-term)." Howard Marks

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"Guessing at the future rate of interest is, in my opinion, one of the most puzzling problems in the world." John Maynard Keynes