The Margin of Safety Quarterly [1]
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The Lanigan Group of Companies

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 3rd Quarter 2022 Commentary
DATE: October 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.

Year-To-Date Market Recap

The Fed's shift from talk of "transitory inflation" to significant interest rate increases and a stated resolve to do whatever it takes to slow inflation to their target has caused significant drawdowns in YTD market returns. Equities are down ~23%, intermediate bonds down ~9%, long bonds (which we do not own) down ~28%, and even short-term bonds (we do own) are down ~4% YTD.

2021 S&P returns of 29% are now a distant memory.

[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. MOS is key in determining anything with variables occurring in the future, i.e., price to future value, all future outcomes, etc. Its magic is that the higher your MOS, the smaller your edge needs to be to have a favorable outcome.

We cannot remember a time when equities were down meaningfully and bonds in a typical 60-40% balanced portfolio did not help returns or reduce equity volatility. These are strange times!

The recent villains are inflation and the Federal Reserve. Fed Chairman Powell clearly said they would raise interest rates at whatever pace it took to slow inflation to their ~2% target range. The chance the Fed makes further mistakes is high because if they tighten too slowly inflation could get further out of hand but if they tighten too much, they could throw the economy into a severe recession.

As we stated in our October 2021 letter, inflation, and higher interest rates, along with their effect on valuations, were on the top of our list of worries. Also, we have repeatedly written about the risk of long bonds and MegaCap 8 high valuations. As we stated the inflation risk was augmented by the pandemic stimulus, or "helicopter money," by governments globally.

Where Do We Go from Here?

Fed's Trick or Treat Coming?

The many macro pundits are predicting an unknown range of outcomes from one extreme to another. As we often say, macro predictions teach us more about the predictors than they do about the economy. Our North Star is trying to determine the intrinsic value (IV) of an investment with a margin of safety (MOS). However, in the short term, psychology and market sentiment are key. Hence the question, "How much optimism is prevailing in Mr. Market?" The answer to this question is key in the short term.

From a technical view, it is difficult to value anything because of the uncertainty about interest rates given inflation persistence and the Fed's determination to bring it under control. Increased interest rates are the gravitational pull on asset values from a technical standpoint. Interest rates are used to determine discount rates and with so much uncertainty in interest rates we do not know what discount rate to use.

So much for our mechanical or discounted cash flow (DCF) valuation.

Negative sentiment is currently extremely high in the markets. As one economist said, "If indeed we have a global recession, it will be the most anticipated recession ever."

We think it is very likely that we will have a “rolling recession,” where the timing and degree of the downturn depends largely on the industry or product, etc. We believe, GDP is likely to be low, if not negative, in the short term. We hear very mixed views from our sources on both revenues and profits.

We continue to be slightly defensive in our equity allocations, other than for the most aggressive investors and also plan to keep bond maturities very short. We do not like the current market environment, but we do like the price-to-value of many opportunities it presents for the long-term investor and many of our outside managers.

In Closing

We are not selling down equities, but at the same time, we are careful about buying more equities until we get more clarity on future interest rates, etc. We are keeping bond maturities short, and we like the strategy of holding high quality bonds to maturity.

Though we are cautious in this market, we are reminded of the analogy, “Spring is almost over when you see robins.” Thus, we would not try market timing but alternatively prefer to stay with our tried and true “time in the market” philosophy for long-term investors.

We are confident that owning a diversified group of qualifying equities is 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 their near-term cash needs and their risk tolerance. Long-term volatility is the admission ticket to higher returns for those who have the temperament and are long-term investors. Temperament is key in this market environment.

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.

Your SAA Team

P.S. Please read the footnote (1) on page 1 of this letter as we have added to our margin of safety (MOS) comment to include MOS in outcomes, etc.