The Margin of Safety Quarterly [1]

Southeast Asset Advisors, LLC

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TO: Clients and Friends

FROM: SAA Managing Directors

RE: 4th Quarter 2022 Commentary

DATE: January 2023

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.

Goodbye 2022!!

After a very high return in 2021, the market fell substantially in 2022. There were few places for investors to hide as nearly every corner of the financial markets posted big losses. A traditional 60/40 stock and bond allocation had one of the worst performances ever using the S&P 500 Index to measure stocks and the Bloomberg Aggregate Bond Index to measure bonds with a combined performance down ~16%. In 2021, the supply chain issues and the disruption caused by the pandemic helped the Fed talk of "transitory inflation" to be believable, perhaps. It was clear that many assets were inflated or overvalued if interest rates increased from a very low rate.

[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 generally avoided intermediate and long bonds, speculative stocks, SPAC, crypto, and meme stocks, and tried to avoid the high price part of MEGA-8 tech stocks and new technology companies with no cash flow or cash flow potential far in the future, though our managers had some, but hopefully less than normal. However, even avoiding these, we still experienced our share of downdraft as almost all managers were down significantly.

Most parts of the bond market (intermediate as well as long bonds) also posted substantial losses, meaning fixed income failed to live up to its traditional role of providing a cushion to ride out the decline in equities.

Consumer staples, health care, and energy provided a limited cushion to the substantial equity drawdown.

In the background, decades-high inflation remained much hotter than many expected in 2022, including Fed Chairman Powell. Interest rate surges were led by the Fed talk and action of raising rates, as the Fed finally abandoned their “transitory inflation” belief.

Where are we now in the cycle as far as valuation and psychology?

In recent months, a positive bias has emerged, reflected in the downward expectation of interest rates and upward movement in the market since mid-October 2022.

There is now a broad-based debate about how extreme will the recession be in 2023. Many believe the Fed will continue to increase rates to slow inflation and push the global economy into at least a mild recession. Some believe the Fed will possibly pivot to lower rates due to slower job growth, dismal economic survey data, falling property values, negative real wage growth, etc. Indeed, recessions are a viable short-term concern, but possibly good news on inflation and the Fed easing rates. A mild recession does not concern us. In fact, if a recession slows inflation permanently, it would be welcomed. Recessions are a normal part of an economic cycle and have a limited time duration. The banking system is in good shape, for the most part, and totally different than in the GFC of 2008.

Our short-term game plan is to proceed defensively and with caution, maintaining a diversified equity allocation and also continuing to buy short-term treasuries (i.e., 3 to 12 months) at 4% plus yields. The recent upward move in interest rates allows us to make a reasonable return on very risk-free short-term bonds. We think it is too early to ladder bond duration as we believe investors are not paid for the risk of going out to longer durations at the present time. This bond strategy is for the fixed income part of a portfolio as well as a short-term opportunistic portfolio that may end up in long-term equities at some point in time.

As we have said many times, we do not think we, nor anyone, can predict the future macro… However, we do try to gauge being defensive or aggressive in predicting the extremes in the cycle if they appear based on valuation and prevailing psychology or "risk taking" observations at extremes. We think our firm has a good "real time lab" on prevailing psychology or main street attitude to risk, etc. We are keen observers and on the lookout for extremes, as we were beginning to see in years prior to 2022 and including 2021 attitude to risk.

We see better market valuation after the market drop but fear we could have more drawdowns to come if the Fed moves interest rates much higher. Interest rates are like gravity to stock prices. We expect continued volatility as the Fed actions as well as FOMC (Fed Open Mouth Committee) try to manage rate and inflation expectations.

The sectors that performed the best in 2022 (i.e., consumer staples, health care, and some energy) trade at lofty multiples, while financials and insurance look cheap, if reserves are correct. We are looking carefully at both sectors and talking to CEO's and our managers. We are getting very mixed opinions thus far.

As we go to press, many future markets are pricing in interest rate cuts late in 2023 or 2024. Time will tell!

<u>Our Long-Term Crystal Ball</u>

As discussed previously and outlined in Howard Mark's book, *Mastering the Market Cycle,* all we hope to do is be right on the present general macro cycle points, at extremes of either defensive or aggressive posture. The valuation of the market and

most sectors do not appear at extremes, especially if inflation and rates stay in present range. However, the risk of the Fed- tightening or easing rates is a significant risk and uncertainty. Hopefully one's asset allocation range and spending will allow for a "margin of safety," so even if outcomes are not exactly as expected, long-term goals can be achieved. We have encouraged all our team to read and reread Howard Mark's terrific book. We worry that with an uptick in certain sectors as we enter 2023, we again see some excesses in behavior (e.g., meme, crypto, private equity, etc.). We think the FOMC talk and rate action will create volatility, both positive and negative, as 2023 unfolds.

As discussed, long-term inflation and higher interest rates continue to be our primary concern. Of course, the ~$30 trillion accumulated U.S. deficits and many trillions of entitlements that are unfunded are also of long-term concern and should be to all our elected politicians!

Presently, our guess is that long-term, higher inflation over ~3% will be the norm (and may be much higher at times). Also, we expect that higher income and estate taxes will be in the future (after 2025) as the Government is forced to attempt to fund the ever-increasing deficits and the unfunded entitlements. Our long-term predictions could change as rarely have we had this much long-term uncertainty.

<u>Interest Rate Musing</u>

Many commentators talk about today's high interest rates. Rates are still low when compared to history. It has been only the last 14 years that rates have been kept at very low rates, which along with a low cost of capital, have led to unusually high returns in the stock market and influenced most asset prices upward. As WEB says, high interest rates are like gravity to asset prices. In theory, stocks and other financial assets are priced at the discounted present value of the stream of cash flow. Thus, if rates are ultra-low and the discount rate is low, most assets will be inflated as we have experienced since 2008. We had an abrupt change with increased rates in 2022 and anticipation of more increases in the first half of 2023.

In Closing

We remain confident that owning a diversified group of qualifying equities (as to people, business, and price) is a better investment than intermediate or long-term 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 for sure and is the admission ticket to higher returns for those who have the temperament and are truly long-term investors. Temperament is key in this market environment.

Please let us know 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.

Enjoy your family and friends. Life is short. Happy New Year!

Your SAA Team

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"While we never know where we're going, we ought to know where we are."

– Howard Marks

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"To know if the pendulum of psychology and valuation are at extremes is our only possible macro goal. Knowing this is not easy, but we only try to be in defensive or aggressive camps at extremes."

– SAA

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"Your success in investing will depend in part on your character and guts and in part on your ability to realize, at the height of ebullience and the depth of despair alike, that this too, shall pass."

– Jack Bogle

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"The best financial talent is to know how to value a company (with a margin of safety in P to V) as well as to have a temperament and asset allocation to be a long-term investor."

– BL, Sr.