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Southeast Asset Advisors, LLC
Lanigan Wealth Management

Investment Management & Consulting
Thomasville – Atlanta – Tallahassee – Mobile – Charleston

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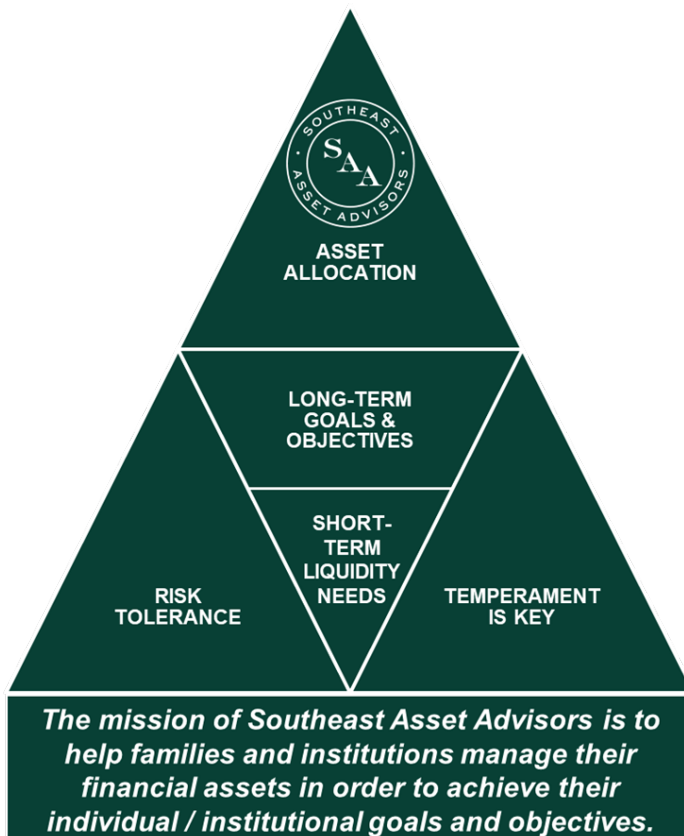
The Margin of Safety Quarterly [1]

3rd Quarter 2023



SOUTHEAST
ASSET
ADVISORS

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.

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[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.

SOUTHEAST
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TO: Clients and Friends
FROM: SAA Managing Directors
RE: 3rd Quarter 2023 Commentary
DATE: October 2023

3rd Quarter and Year to Date

The US Equity market, as measured by the "market cap weighted" S&P 500 index, returned -3.3% for the 3rd quarter and 13.1% year to date. International equities, as measured by the MSCI EAFE, returned ~-4.1% for the quarter and ~7.6% for the first nine months of 2023.

The bond market, as measured by the Bloomberg Aggregate bond index, returned ~-3.2% for the quarter and ~-1.2% year to date through September 30, 2023. Most bond maturities (Treasury Bills) now have a yield to maturity of ~5%; whether 6 months, 9 months, 10-year, or 30-year maturity. Many bond holders that bought intermediate or long bonds in the past have large unrealized losses, like many banks. At SAA we are happy to hold mostly short-term T-bills that can be easily held to maturity. Of course, we have some risk if we must eventually rollover at lower rates. For now, we will take this rollover risk and stay with short bonds, as we cannot see rates going down a lot quickly.

Where do we stand?

As we have written many times, we do not believe anyone can forecast the future accurately, but we can determine where we currently stand. Our future guesses/opinions have been best when valuations are at extremes either undervalued or overvalued. At these extremes, we can be more defensive or aggressive within our client's profile ranges. As you know, we are generally somewhat defensive unless our client target policy allocation is mandated otherwise.

Presently, we think that we are in a what we call a "wind change" after the Fed implemented eleven (11) interest rate increases. Fed chairman Powell recently said, rates may be "higher for longer." After ~14 years of very low rates we are now approaching ~5% rates for most durations of safe T-bills. This rate change is a definite "wind change" for both savers (positive) and borrowers (negative).

Thus, we are now in a "TIAA" world (There Is An Alternative). The TIAA of ~5% in safe T-bills changes our previous strong bias to an overweight equity allocation.

When reviewing client asset allocations, we look at both the IRA and regular accounts on a consolidated basis, rather than each account separately. For IRAs and non-taxable accounts, a ~5% yield is after tax (tax deferred). Thus, for the appropriate asset allocation we might have fixed income mostly in the IRA account and more equities in the taxable accounts, but on a consolidated basis we are at clients' target policy allocation.

Everyone is influenced by their past experiences, i.e., if you have only experienced low interest rates, you may think they are normal. For example, a ~8% current home mortgage rate seems high relative to a year ago when you could get a ~3% rate. Another example, those of us that experienced the 2000 tech bubble and the tech wreck are maybe more skeptical about the recent AI hype or the next new thing. Correspondingly, those of us that went through the GFC (Global Financial Crisis) are usually more worried about the potential for real estate decreases or bank crisis more than ones that only have read about the history of the 2007-8 GFC.

However, risk is generally something new and different rather than a repeat of what has happened in the recent past or what is talked about in the press, etc.

<u>Current Market Valuations Comment</u>

The long-term S&P price to earnings multiple is ~17x (or ~6% earning yield) and today's PE is ~18.1x (or PE of 16.1x for S&P 492 excluding Mag 8.) Many of Mag "8" have sold off in the 3rd quarter or subsequently, but the S&P index returns are still somewhat narrowly focused on a few big winners.

We see most stocks and other assets in a high valuation range due to a long period of low interest rates and/or a high demand and limited supply in some industries.

<u>We Think the Key Questions for Investors and Advisors (?)</u>

The key questions that we continue to focus:

1) Will inflation turn out to be "transitory" and what will be the new normal inflation rate going forward?
2) Where will the long and short-term interest rates settle in both nominal and real terms?
3) Based on answers to the above questions (1) and (2); how should we adjust our fixed income duration?

We have our base case ranges. However, we make few big decisions on having the correct answer to these questions. Currently, we try to prepare for an unusually wide range of answers in this very uncertain environment.

We regularly meet with many CEOs of companies as well as management of our many varied clients' businesses. Currently, we are getting an unusually wide range of answers on the health of the consumer. We are watching the data carefully as finally the "helicopter money" from Washington appears to slow, other than in perhaps the environmental areas.

Fed Chairman Powell is trying to be transparent and finally convey an unusual unsure stance. He made the following comments recently that only added to our uncertainty about future inflation and interest rates:

- Recent data shows a resilient economy so far, as spending data is strong.
- The US story is one of higher demand.
- Possibly more inflation in the future, but we do not know if current rates will slow the demand, or if it will take even higher rates.
- The risk of the Fed doing too much (in rates) or too little is high!
- Financial conditions have indeed tightened; sentiment does affect inflation and interest rates eventually; Fed dual mandate is price stability and employment remaining strong.
- Strong job market currently, but we see some signs of the job market moderating.
- It may be rates have not been high enough for long enough?

- The present fiscal path (deficits) and monetary policy cannot continue unconstrained and on the same pathway; however, short-term deficits do not affect near term Fed policy.
- We see some signs recently that the labor market is getting back to balance and wage increases at a more normal level.
- We do not know how this economy can ultimately grow with higher rates.

In summary, the Fed (and us!) think the potential future ranges of events and resulting rates are wider than normal. The Fed Chairman made it clear that he sees no evidence of rates being too high for now. A rise in bond yields appears to be caused largely by term premiums. Bond yields are not showing a lot of higher inflation expectations. Of course, bond demand (and supply) are key, as the government must refinance many T-bills in the next few years. So far, the refinance of maturing government debt appears orderly, and this has had little effect on rates. Time will tell. The government deficit pathway, in our opinion, cannot be sustained in the long term. However, the near election year is not the time for Washington to say "No" to spending of any kind.

Future rates and inflation are unknown unknowns! However, we do not see inflation falling to the Fed's 2% target. Our base case is that we need to prepare for "higher rates for longer."

The world's many conflicts, our US deficits, and the many geopolitical issues remain our top long-term concerns.

Summary

We see interest rates at least staying in their present higher ranges for longer. If so, we believe equity prices will rise only by future earnings increases and not by additional expansion of their PE multiples. This probably means lower equity returns in the years ahead and for most assets, as higher rates drive values down. It also may temper further the widespread risk attitude and limit widespread use of leverage, both of which we have seen excessive over the last decade.

Have a great balance of the Fall. Enjoy your family and pray for our world and those in harm's way!

Your SAA Team

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"Happiness is for most people:

- *Something to do!*
- *Somebody or something to love!*
- *Something to hope for!"*

\- Author unknown

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"Good, better, best. Never let it rest. Til your good is better and your better is best."

\- St. Jerome