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Southeast Asset Advisors, LLC

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

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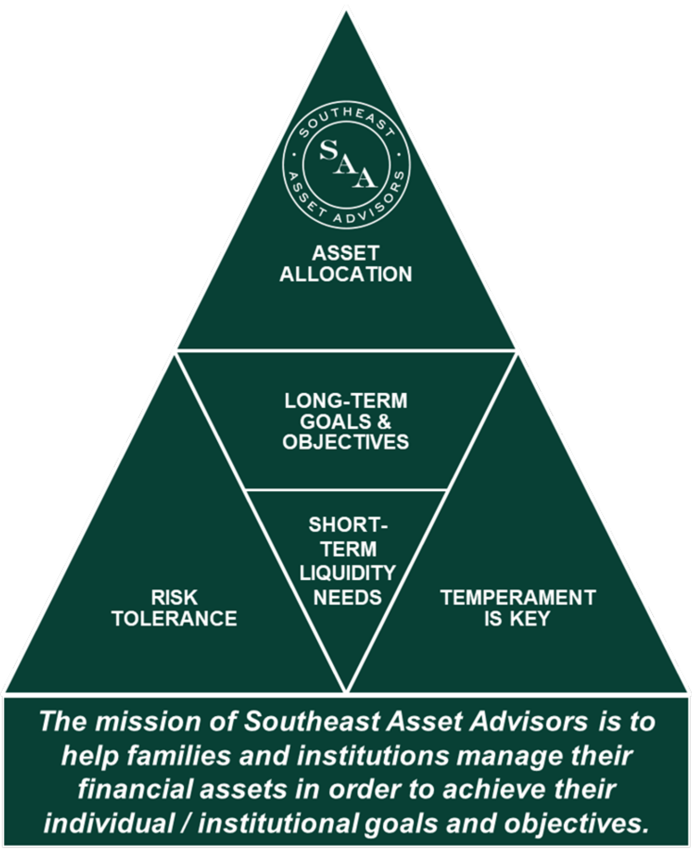
The Margin of Safety Quarterly [1]

2nd Quarter 2024



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.

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 2nd Quarter 2024 Commentary
DATE: July 2024

Market Update

As we go to press, Nvidia, the AI darling, has lost ~4.7% since its peak on June 18; but it is still up 160.7% YTD in 2024. It is example that nothing grows to the sky as valuation matters even in the AI hype world. Nvidia trades for a multiple of 41.4x next year's earnings.

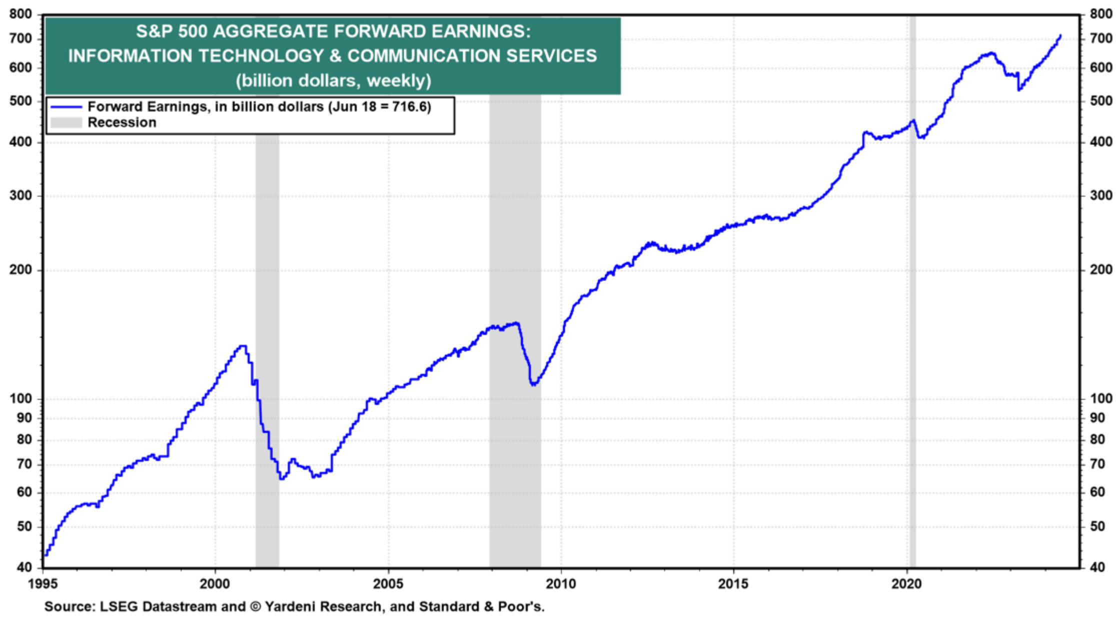
Through June 30, 2024, the S&P 500 (market cap weighted) has returned ~15.3%, primarily driven by a few large stocks largely related to the "AI" boom. In comparison, the S&P 500 Equal Weighted Index has returned ~4.6% through the same time period.

The top 10 holdings in the S&P have grown to be ~37% of the index's allocation, and YTD have contributed ~11.1% to the index's return (~73% of the index's return), while the other 490 stocks only contributed ~4.2%. Last year's return of S&P of 26.3% was also concentrated in 8 stocks which returned 16.6% or ~63% of S&P total.

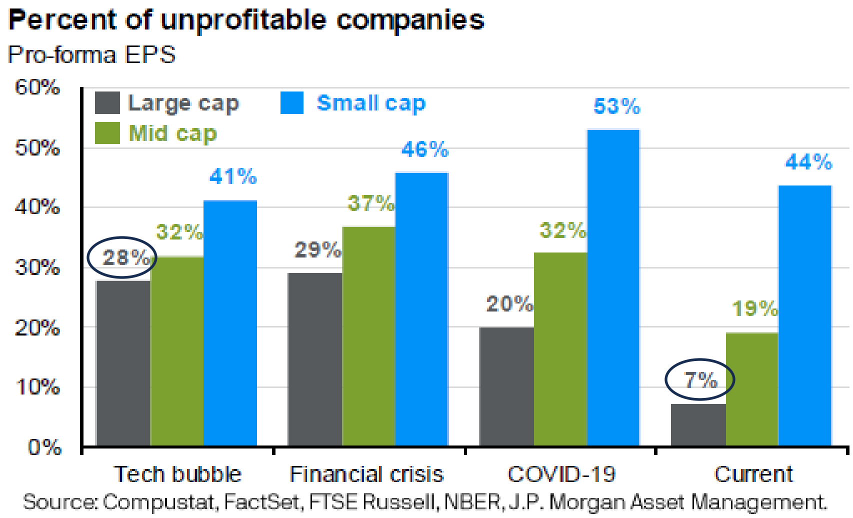
The continued concentration of a few stock returns stands out when looking at other indexes as well. The Dow Jones, Russell 2000, and tech heavy Nasdaq have returned 4.8%, 1.7%, and 18.6% YTD, respectively. Diversification from the top-heavy S&P 500 has not benefited portfolio returns recently. However, we believe it is prudent portfolio management to stay diversified and this should pay off over time.

Is This Time Different?

The recent performance of stock markets and current concentration in a few mainly AI related stocks has invited comparisons to the late 90's Tech Bubble and subsequent 2000 Tech Wreck. We ask the question, "how much is the current concentrated melt-up due to 1) earnings increase vs. 2) valuation (multiple expansion)." It appears the short answer is that it is a combination of both. Of course, future earnings are only analyst estimates. The earnings forecast could change depending on AI sustainability and the return on the huge investment therein. Time will tell!



We are reminded, that some of the most dangerous words in investing are "it's different this time." But compared to the Tech Bubble of the late 90's, this melt up by a few mega stocks may truly be different. Thus far, the primary difference is the concentration/leaders with high returns that are driving the S&P 500 index return today are mainly asset light companies with strong cash positions, great balance sheets and generating a lot of cash flow. Correspondingly, in the Tech Bubble of the late 90's, 28% of large cap companies were unprofitable, compared to a mere 7% presently as shown in the following chart:



In the 2000 Tech Bubble unprofitable large cap companies where 28% of the market vs 7% now. The top 10 companies today contribute ~27% of the S&P 500's earnings, whereas in 2000 the top 10 companies only contributed ~18% of the S&P's earnings.

The S&P index presently is much more concentrated now in just a few great companies. This is concerning but may be an opportunity if indeed the other 490 companies grow earnings and returns.

<u>Also, valuations (multiples) today do not appear as extreme as in the late 90's Tech Bubble</u>. The S&P currently trades at ~21x forward earnings, compared to the peak of ~25.2x in March 2000. Currently, the top 10 stocks of S&P trade for ~30.3x earnings, while the top 10 of the S&P 500 traded for a whopping ~43x earnings in 2000. We know 2000 was a huge bubble and it declined ~49% in subsequent years led by the Tech stocks.

The remaining 490 companies now in the S&P 500 are not nearly as expensive (using multiples) as they were in 2000. The remaining 490 S&P stocks today trade at ~17.6x forward earnings versus ~22x forward earnings in March 2000.

The current concentration reminds us of 2000, but today appears very different as most of these companies are not startups, have loads of cash and are higher-quality businesses. Bottom line, stocks in general do not appear to be nearly as expensive as the late 90's Tech Bubble using valuation multiples and forecast earnings. However, they are not cheap and must continue to have high growth rates over many years in the future to justify their prices. We are not sure if AI will be an engine of a few or benefit productivity of many.

However, our strategy is to limit our AI bets and make sure we are diversifying our equity holdings. At the same time, we want to own some of the AI leaders that have huge cash to withstand market volatility and use to their advantage, i.e., buy their own stock, etc.

What's In the Price?

While valuation multiples of the top stocks may not be as extreme today as they were in 2000, we consider it important to inspect what amount of growth in earnings is priced into the Mag 8. As we stated earlier, many of these companies today are much better companies that have huge cash holdings. As a group the Mag 8 at the end of June traded for a collective multiple of ~30.7x next year's estimated earnings. We believe the earnings growth must be substantial to justify these prices as well it will be important for management to use good value enhancing capital allocation.

Fiscal Disfunction – Crushing Debts await November Election Winners

We have repeatedly written about the U.S. deficit and out of control spending by Washington. We are repeatedly asking ourselves "how long can this spending go on?" The continued short answer is "we do not know." The U.S. dollar is the reserve currency of the world and no one else is even a close second. A significant risk is a failed auction / issuance of treasury bill / notes, i.e., no one buys unless there is a major increase in interest rates. While many consumers and businesses with debt are locked in at low interest rates, the Fed has done the opposite, issuing more short-term debt rather than long term notes at lower rates (possibly trying to manage long term rates). Time will tell. We recommend preparing for different, maybe radical outcomes as our present spending with present tax levels is not sustainable.

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Thank you for your trust. We will do our best to continue to deserve your trust. Please reach out to any of us at SAA if you need anything.

We have gratitude for our clients. Also, we are lucky to be in the USA even with our share of disfunction.

Have a great summer!

Your SAA Team

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"There are only three ways to meet the unpaid bills of a nation. The first is taxation. The second is repudiation. The third is inflation."

- Herbert Hoover

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"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

- W. Buffett

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"Worry top down but invest bottom up."

- Anonymous

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"In all macro predictions you learn more about predictor than you do about their prediction."

- Anonymous

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"As we express gratitude, we must never forget that the highest appreciation is not to utter words but to live by them."

- J.F.K.

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"Deserved trust is the highest honor."

- C. Munger

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"Gratitude is a choice. It's also the quickest way to turn yourself from negative to positive. It doesn't matter what is going on around you. You can always find something to be grateful for."

- D. Donnelly