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Southeast Asset Advisors, LLC

Investment Management & Consulting

Thomasville – Atlanta – Tallahassee – Mobile – Charleston

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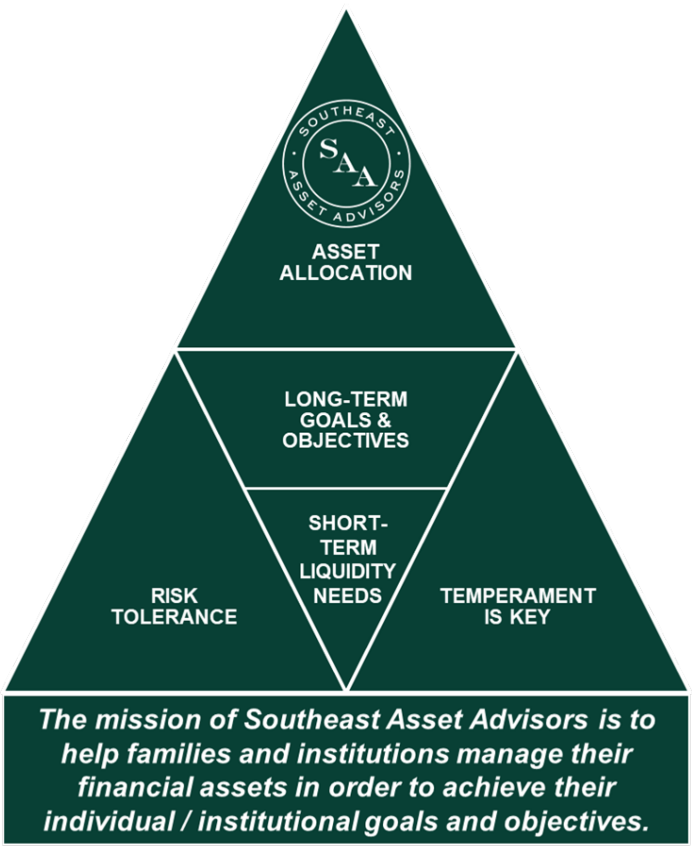
The Margin of Safety Quarterly [1]

4th Quarter 2024



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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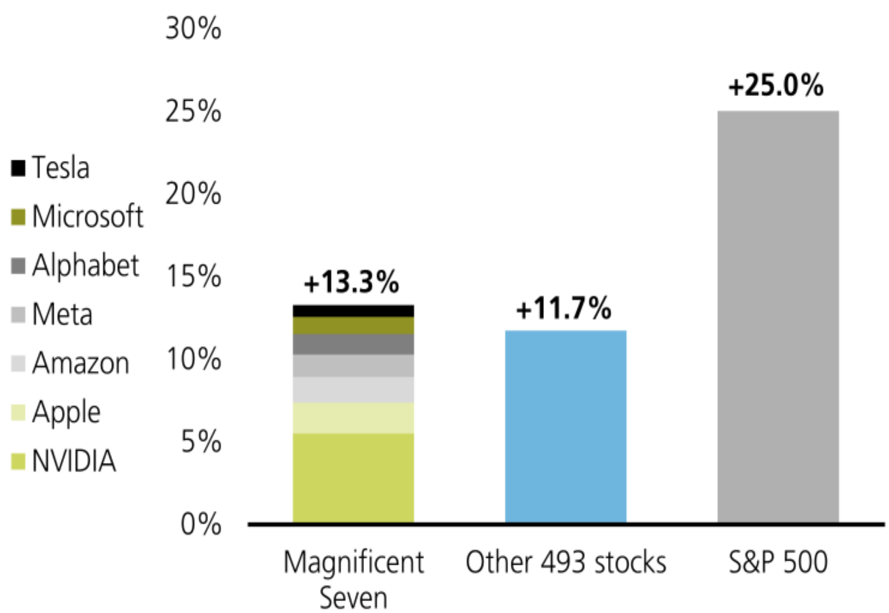
[1] Margin of Safety (MOS): Many investing greats have said these are the most important three words in investing. We agree and call our quarterly letter accordingly. MOS is key in determining anything with variables occurring in the future, i.e., price to future value, all future outcomes, etc. Its magic is that the higher your MOS, the smaller your edge needs to be to have a favorable outcome.

TO: Clients and Friends
FROM: SAA Managing Directors
RE: 4th Quarter 2024 Commentary
DATE: January 2025

2024 was another great year for equity investors. After rising 26% in 2023, the S&P 500 had a stellar follow-up year clocking in a return of 25%. Similar to 2023, the largest positive contributors to the S&P performance were the mega-cap growth companies called the "Magnificent Seven" (Mag 7)[1], which were responsible for more than half of the S&P 500 total returns.



However, if portfolios did not have market exposure and concentration to these seven stocks, it is not all great news. Only 28% of the S&P 500 stocks beat the index return in 2024. Since 1985, there have been only three years when this number was below 30%: 1988, 2023, and 2024. As a result of the top-heavy results, the Equal Weighted S&P 500 (RSP) returned ~13% in 2024 as compared to the market cap-weighted S&P return of ~25%, as noted in the first paragraph.

[1] The Magnificent Seven includes Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla.

In general, most other asset classes underperformed the S&P 500. Mid cap stocks returned ~9.4%, small caps ~9%, and developed international markets ~5%. The MSCI ACWI (global index which includes US) returned ~17%. Any diversification away from the Mag 7 had negative impact on portfolios in 2024 relative to the S&P 500.

Finally, the bond market returned ~1.3% as represented by the iShares core US Bond ETF. However, it paid to stay short duration as we have in most portfolios. The iShares short Treasury bond portfolio returned a respectable ~5.1% for the year.

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AI Comments

The five biggest companies that in our opinion participated in an AI melt up (NVIDIA, Apple, Microsoft, Amazon, and Alphabet) accounted for ~29% of the value of the total S&P index. Apple, Nvidia, and Microsoft are all worth over $3 trillion; Alphabet and Amazon are over $2 trillion each. These numbers are staggering, yet they continue to grow. These are all great companies, and their businesses are much different than industrial companies of the past. Technology companies are much more efficient, require somewhat less investment capital, and have greater scale. Thus, they produce and maintain significant profit margins (cash flows) and are forecast to continue to grow. We worry about high expectations for AI, just as we worry about those for Trump 2.0. Great concentration, high expectations, and high valuations create risk for investors.

The trillion-dollar question is: What happens if the Mag 7 fail to beat expectations for a quarter (or more)? Will the investments they are making in AI show a return? (Microsoft will spend ~$80 billion on AI data centers in 2025.) Also, when? Or will AI underperform? The capital-light model may indeed be a thing of the past as the billions invested in the buildout of massive data centers and the expensive semiconductor chips, servers, and other equipment inside them are a necessity for these companies to remain competitive and grow.

While diversification was counterproductive in the last couple of years, we continue to try to remain diversified. However, we do want to continue to have some exposure to these great companies. We are looking carefully at how best to invest in data centers as well as in the other "picks and shovels" of the AI boom.

As one politician said recently, "Artificial Intelligence is likely one of the most consequential changes of our time and possibly of all times. At the same time AI offers huge risk to our economy and security." Our key question is, "Who will be the AI sustainability winner – the first movers – mega caps or will everyone benefit in increased productivity of labor?"

Data centers require abundant access to power, water, and fiber. As such, we like the power providers, especially natural gas, as well as the backup power suppliers, i.e., generators, cooling, etc. Also, the investment in chips, semiconductors, and massive technology inside the data centers can be many multiples of the construction cost.

<u>Predictions for 2025 of Mr. Market Returns</u>

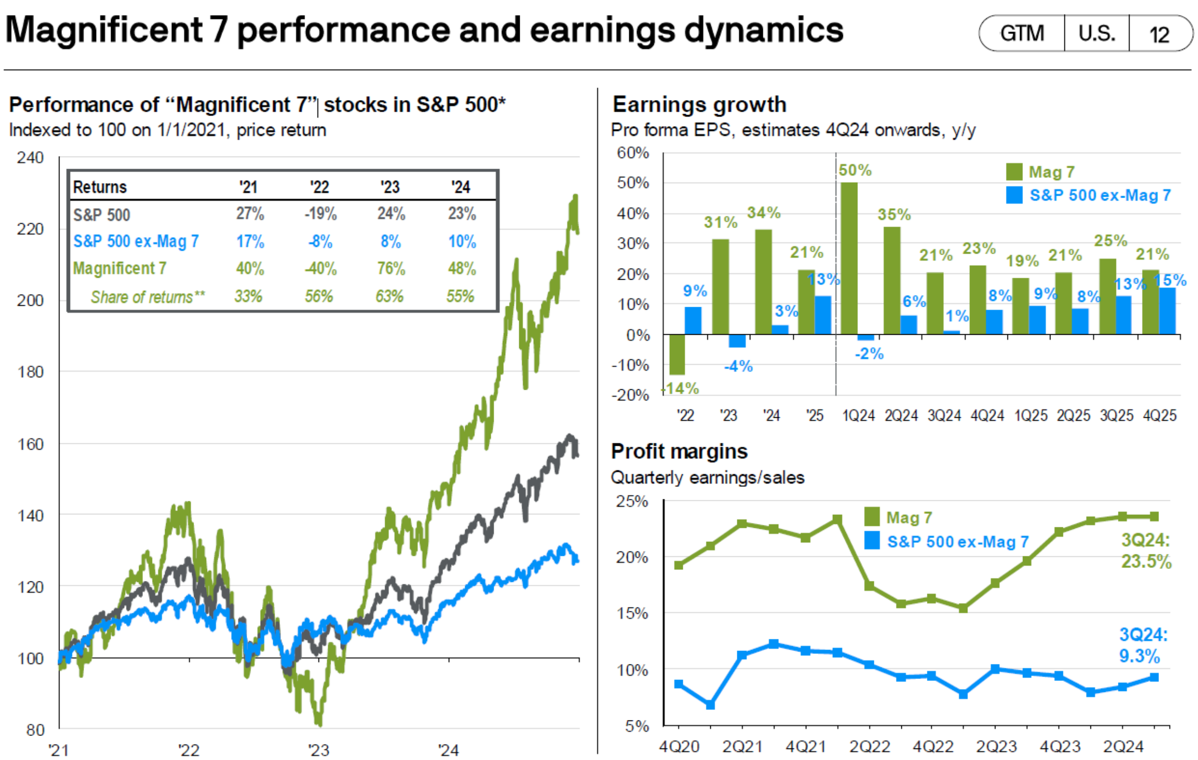
In December and early January, forecasters have been everywhere, and we are reminded of what one wise man once said, "A forecast of Mr. Market returns are like a person looking in an unlit cave at midnight for a black cat that is not there." Or as Warren Buffett said, "You learn more about the forecaster than his forecast."

As 2024 began, market strategists average forecast return for the S&P 500 was 7.4%. The actual return was ~25% (with dividends).

According to one publication, the correlation of strategist forecasts and actual markets returns over the past 20 years is minimal. A Ouija board may be as good a forecaster. When we are pressed to give our market forecast, we say, "We expect the market to be volatile." We also say with conviction, "The market is not cheap by comparison to past market PE multiples." As discussed, the market is dominated by only a few mega cap stocks. One of our managers recently said that this period had similar characteristics of concentration that the Nifty Fifty stocks had in the 60s and early 70s. FOMO (fear of missing out) was the temperament theme of that period as it is increasingly the dominant sentiment now.

We constantly remind ourselves: "Trees do not grow to the sky." "Size is the enemy of outperformance." "Nothing fails like success on Wall Street." "Price is what you pay, value is what you get."

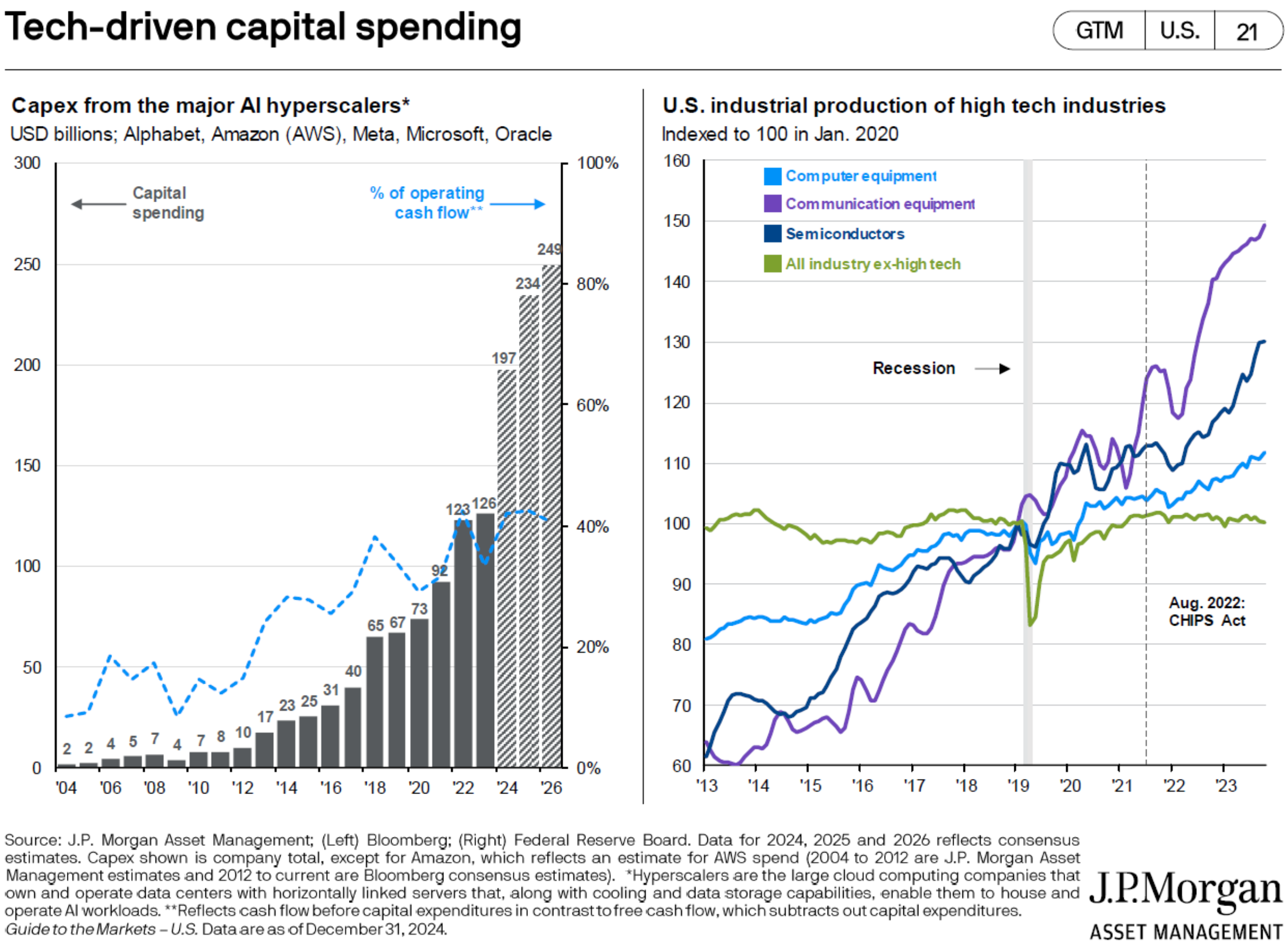
JPM shared the following chart that shows the Mag 7 relative to performance, earning growth, and margins in the last few years:



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
*Magnificent 7 includes AAPL, AMZN, GOOG, GOOGL, META, MSFT, NVDA and TSLA. Earnings estimates for 2024 and 2025 are forecasts based on consensus analyst expectations. **Share of returns represent how much each group contributed to the overall return. Numbers are always positive despite negative performance in 2022.
Guide to the Markets – U.S. Data are as of December 31, 2024.

J.P.Morgan ASSET MANAGEMENT

JPM also shared a chart that puts the current AI capital spending (showing tech companies are no longer an asset-light model) into historical perspective:



The Mag 7 forward PE is now ~30x vs. the S&P 500 forward PE at ~22x, while S&P 400 (mid cap stocks) forward PE is at ~17x.

Will the outcome of the returns of mega cap companies as to their AI investment, etc. be different than the internet and dot com boom and bust?

We put this question/answer in our “unknown unknown file” as we develop our future game plan. It starts with knowing what you own and being diversified in accordance with a client’s overall asset allocation plan and profile.

A client's temperament may be tested by FOMO before this melt up reaches its peak. We believe "temperament" is key and perhaps the most important part of one's investment success.

Several facts are worthy of being top of mind and repeated in this letter:

- The S&P was up ~26% in 2023 and ~25% in 2024 for the best two year stretch since 1997-98.
- The new thing of "AI and enthusiasm applied to anything related to AI" adds degrees of positive psychology to many other high tech related areas.
- Bitcoin has risen some ~450% over the last two years.

Howard Marks' latest letter, which we highly recommend, highlights that rarely has a market at today's PE of ~22x returned over 2% in a subsequent 10-year period (actual returns plus 2% and minus 2%). Granted, many of the large caps that have dominated the S&P recently are great companies with great balance sheets. Most are significant beneficiaries of AI potential productivity. We have questions internally and debate AI's future - both pro and con, sustainability, and ultimate winners.

<u>Trump 2.0</u>

We also worry about high expectations for the immediate success of Trump 2.0 unlocking a wave of "animal spirits." We continually ask ourselves if the US can implement tariffs, protect our borders, deport illegal immigrants, keep taxes as they are or lower, reduce government regulations and spending, and increase growth enough to reduce the deficit (which is critical.) As the Secretary of Treasury nominee recently remarked, "We must maintain the US dollar as the reserve currency of the world." He further stated, "The US needs to get its fiscal house in order, control spending, enact pro-growth policies, and extend the tax cuts."

These are all great goals and have promises of success. However, we must keep our expectations of Trump 2.0 realistic, expect varied outcomes, and be prepared for market "volatility" and various degrees of success in the next few years. Time will tell!

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We are so grateful to live and work in the USA! We are also thankful for our past and future politicians for working to make the USA the greatest land in the world.

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We are pleased to officially announce that Jacob Odum, CPA, CFP has become a managing director and a shareholder. He has been with SAA for 11 years and has gained the respect of all our team.

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Thank you for your trust and confidence. We continue to strive to make your "deserved trust" the most valuable asset we can earn.

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We wish you a very prosperous and Happy New Year. Call any of us if we can help you in any way or if any of your goals have changed. The enclosed Appendix has many words of wisdom and is worth a read and a reread.

Your SAA Team

P.S. Also, please revisit the cover page of this <u>Margin of Safety Quarterly</u> letter and the diagram, as it helps us, and you, focus on the critical rules for successful investing that never change.

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"Good, better, best. Never let it rest.
'Til your good is better and your better is best."
- St. Jerome

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"Meaning (in life) is not something you stumble across, like the answer to a riddle or the prize in a treasure hunt. Meaning is something you build into your life. You build it out of your own past, out of your own talent and loyalties, out of the experience of humankind as it is passed on to you, out of your own talent and understanding, out of the things you believe in, out of the things and people you love, out of the values for which you are willing to sacrifice something. The ingredients are there. You are the only one who can put them together into that unique pattern that will be your life. Let it be a life that has dignity and meaning for you. If it does, then the particular balance of success or failure is of less account."

\- John Gardner

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"One of the tests of leadership is the ability to recognize a problem before it becomes an emergency."

\- Arnold H. Glasow

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"The more you look at market history, the more you realize that irrational behavior never changes."

\- Jack Schwager

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"Fear and greed drive the markets."

\- Warren E. Buffett

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"Charlie (Munger) and I are not stock-pickers; we are business-pickers."

\- Warren E. Buffett

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"The keys to success are patience, persistence, and obsessive attention to detail."

- Jeff Bezos

APPENDIX A
4th Quarter 2024 Letter

Our team and other students of Berkshire Hathaway, now the seventh largest US company by market value, turn to the annual Chairman's Letter as a source of education and wisdom. We recently saw an article on past letters that has a few of the more memorable passages, which we have listed below. We have also added a few comments, which are in italics.

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"It is more than silly, however, to make judgments about Berkshire's investment value based on 'earnings' that incorporate the capricious day-by-day and, yes, even year-by-year movements of the stock market. As Ben Graham taught me, 'In the short run the market acts as a voting machine; in the long run it becomes a weighing machine.'"
2023

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What We Do

"Our goal at Berkshire is simple: We want to own either all or a portion of businesses that enjoy good economics that are fundamental and enduring. Within capitalism, some businesses will flourish for a very long time while others will prove to be sinkholes. It's harder than you would think to predict which will be the winners and losers. And those who tell you they know the answer are usually either self-delusional or snake-oil salesmen."
2023

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"At Berkshire, we particularly favor the rare enterprise that can deploy additional capital at high returns in the future. Owning only one of these companies – and simply sitting tight – can deliver wealth almost beyond measure. Even heirs to such a holding can – ugh! – sometimes live a lifetime of leisure.

We also hope these favored businesses are run by able and trustworthy managers, though that is a more difficult judgment to make, however, and Berkshire has had its share of disappointments."
2023

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Searching for acquisitions

"The company has been searching for suitable acquisitions within, and conceivably without, the textile field. Although to date none has been successfully concluded, we continue to have an active interest in such acquisitions."
December 2, 1966 (signed by Berkshire Chairman Malcolm Chace Jr. and President Kenneth Chace)

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Shows how even Berkshire had to move on from buying tough businesses to picking good businesses. The profits and return on the CapEx went to customers rather than staying with the ones who invested in capital.

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Kissing toads

"Investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toad, those kisses had better pack some real dynamite. We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses—even after their corporate backyards are knee-deep in unresponsive toads."
February 26, 1982

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Expectations of turning toads into princesses rarely ends well. Buy great companies with a sustainable competitive advantage and do not interrupt the compounding if you buy a jewel of a company with a great capital allocator.

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Fear and greed

"Occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."
February 27, 1987

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Says it all. Some things never change, fear and greed. Temperament is one of those things as well and for investing, may be more important than ones IQ.

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As in baseball

"It's true, of course, that, in the long run, the scoreboard for investment decisions is market price. But prices will be determined by future earnings. In investing, just as in baseball, to put runs on the scoreboard one must watch the playing field, not the scoreboard."
February 28, 1992

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The future earning is always uncertain. That is why having a margin of safety in P and V is so important and thinking long-term is a competitive advantage.

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Who's been swimming naked?

Hurricane "Andrew destroyed a few small insurers. Beyond that, it awakened some larger companies to the fact that their reinsurance protection against catastrophes was far from adequate. (It's only when the tide goes out that you learn who's been swimming naked.)"
March 1, 1993

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What's our duck rating?

"In a bull market, one must avoid the error of the preening duck that quacks boastfully after a torrential rainstorm, thinking that its paddling skills have caused it to rise in the world. A right-thinking duck would instead compare its position after the downpour to that of the other ducks on the pond.

So what's our duck rating for 1997? The table on the facing page shows that though we paddled furiously last year, passive ducks that simply invested in the S&P Index rose almost as fast as we did. Our appraisal of 1997's performance, then: Quack."   *February 27, 1998*

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Only in the long term do you see who is the real deal and plays the Mr. Market game – psychology is most important in the short term, and cash flow is the game (weighing machine) in the long term.

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A tough report card

"Even Inspector Clouseau could find last year's guilty party: your Chairman. My performance reminds me of the quarterback whose report card showed four Fs and a D but who nonetheless had an understanding coach. 'Son,' he drawled, 'I think you're spending too much time on that one subject.'

My 'one subject' is capital allocation, and my grade for 1999 most assuredly is a D. What most hurt us during the year was the inferior performance of Berkshire's equity portfolio—and responsibility for that portfolio, leaving aside the small piece of it run by Lou Simpson of GEICO, is entirely mine."
March 1, 2000

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Don't literally think birds

"The oracle was Aesop and his enduring, though somewhat incomplete, investment insight was 'a bird in the hand is worth two in the bush.' To flesh out this principle, you must answer only three questions. 1) How certain are you that there are indeed birds in the bush? 2) When will they emerge and how many will there be? 3) What is the risk-free interest rate (which we consider to be the yield on long-term U.S. bonds)? If you can answer these three questions, you will know the maximum value of the bush—and the maximum number of the birds you now possess that should be offered for it. And, of course, don't literally think birds. Think dollars."
February 28, 2001

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Simple but complex investing valuation and add MOS – margin of safety - as all future is a guestimate.

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Riding the wave

"It's been an easy matter for Berkshire and other owners of American equities to prosper over the years. Between December 31, 1899, and December 31, 1999, to give a really long-term example, the Dow rose from 66 to 11,497.... This huge rise came about for a simple reason: Over the century American businesses did extraordinarily well and investors rode the wave of their prosperity."
February 28, 2006

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Capitalists and Kitty Hawk

"The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money. Think airlines. Here a *durable* competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down."
February 2008

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The importance of price

"The first law of capital allocation—whether the money is slated for acquisitions or share repurchases—is that what is smart at one price is dumb at another."
February 25, 2012

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Bubbles pop

"Over the past 15 years, both Internet stocks and houses have demonstrated the extraordinary excesses that can be created by combining an initially

sensible thesis with well-publicized rising prices. In these bubbles, an army of originally skeptical investors succumbed to the 'proof' delivered by the market, and the pool of buyers—for a time—expanded sufficiently to keep the bandwagon rolling. But bubbles blown large enough inevitably pop. And then the old proverb is confirmed once again: 'What the wise man does in the beginning, the fool does in the end.'"
February 25, 2012

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Not ready for Tinder

"Nothing rivals the market system in producing what people want—nor, even more so, in delivering what people don't yet know they want. My parents, when young, could not envision a television set, nor did I, in my 50s, think I needed a personal computer. Both products, once people saw what they could do, quickly revolutionized their lives. I now spend ten hours a week playing bridge online. And, as I write this letter, 'search' is invaluable to me. (I'm not ready for Tinder, however.)"
February 27, 2016

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Washtubs, not teaspoons

"Charlie and I have no magic plan to add earnings except to dream big and to be prepared mentally and financially to act fast when opportunities present themselves. Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons."
February 25, 2017

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Is this why Berkshire has ~$325b in short-term cash –- time will tell.

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In February, we will be awaiting Berkshire's Annual Chairman's letter, our favorite read of the year.