

South Atlantic Capital Management Group, Inc.

Investment Management

September 30, 2017 Portfolio Review

COMPOSITE PERFORMANCE SUMMARY

South Atlantic Capital (SACMG) versus S&P 500 Annualized as of 6/30/2017

	1 Year	3 Years	5 Years	10 Years	15 Years*	20 Years*	Since Inception*	Total Return Since Inception*
SACMG Core Equity ¹ (Net)	27.50%	5.29%	9.54%	8.79%	9.78%	8.54%	12.04%	1668.20%
S&P 500 ²	18.61%	10.81%	14.24%	7.44%	9.61%	6.94%	9.45%	875.19%

*Inception date of South Atlantic Capital's composite is 1/1/1992.

*Actual is 14.75 years, 19.75 years

South Atlantic Capital is an independent investment adviser registered with the State of North Carolina and the Commonwealth of Virginia. South Atlantic Capital claims compliance with the Global Investment Performance Standards (GIPS®). The firm maintains a complete list and description of composites, as well as GIPS® compliant presentations, which are available upon request by calling (910) 763-4113, or emailing info@southatlanticcap.com. Ashland Partners & Co., LLP, our previous independent verifier, has verified South Atlantic Capital's compliance on a firm-wide level for the period of January 1, 1992 to September 30, 2016. ACA Performance Services has verified our firm-wide compliance for the period of September 30, 2016 to December 31, 2016. All returns are net of management fees and include reinvested dividends and interest. Past results are not indicative of future investment results.

Danger Will Robinson

If the robot's job on Lost In Space was to keep Will Robinson from making investment mistakes instead of to keep him alive on a dangerous planet, he might have said something like this under similar circumstances:

Passive investing in index funds and etf's now make up almost 40% of the equity market. Passive investing's low fee structure requires the overweighting of large liquid companies to achieve the required scale to be profitable. This along with the momentum oriented robotic buying of passive investing where passive funds are required to buy more of the companies whose prices have risen the most when new ETF shares are issued has bid many of the companies most widely held by ETF's to extreme valuations. Furthermore, an extended period of artificially low interest rates and several years of strong market returns has led to complacency about risk and therefore excessive risk taking by the markets in general.

How much of your money do you want to have in a fund managed where nobody's thinking about the price of the stocks or the weightings within the portfolio?

Howard Marks and others have raised this question to address the risks of passive investing that few seem willing to acknowledge. As the robot already mentioned, passive investing refers to investing in index funds and ETF's, exchange traded funds, which invest in a preset index of companies. As money flows into these funds they are forced to buy more of a company whose price rises faster than the index since that company becomes a higher percentage of the index and likewise buy less of a company whose price falls or rises less than the index itself.

If Amazon was 6% of the index to start with and significant price appreciation takes it to 9%, as new ETF shares are issued 9% of the funds will be invested in Amazon not 6% and investors will be forced to have a 50% increase in exposure based solely on price and regardless of the company's outlook.

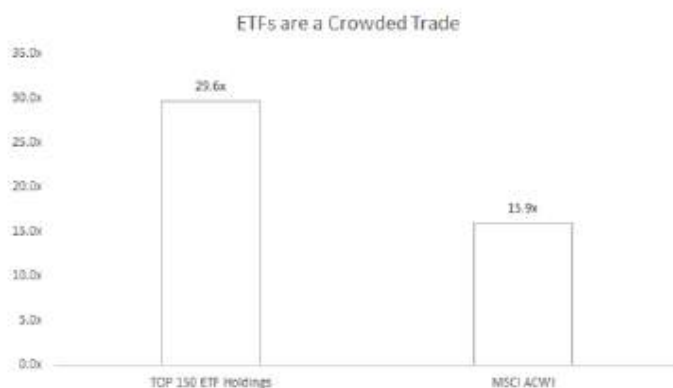
Passive investing has increased dramatically since 2007, growing from roughly 7% of the U. S. equity market to approximately 37% today. This large inflow of momentum based buying is at least partly responsible for considerable price increases for large, highly liquid tech companies such as Apple, Facebook, Google, and Amazon. Certainly, strong business models and dominant market positions from their internet based platforms is also responsible for their rising stock prices.

These results, which for some companies are more about sales growth than earnings or cash flow growth, has led to persistent and somewhat euphoric media reports on these companies. This adds to the momentum in their stock prices which feeds on itself as it leads to robotic increases in the purchase of the shares by index funds and ETF's.

Passive investing is meant to lower costs, which it does, and lower risks through diversification compared to active investing. We have doubts about the second part, particularly in a market where valuations have gotten expensive because ETF's don't sell a stock that has become more expensive they buy more of it. Considerable price appreciation increases the risk to future returns but in the case of ETF's the price increases create forced buying and more exposure to these high-priced companies than ETF holders may realize.

Barron's recently called passive investing the opposite of buy low sell high which is what we attempt to do. The low fees mean passive fund sponsors must focus on large, liquid stocks to obtain the scale required to be profitable. This has resulted in people being less diversified than before the large price increases in these stocks. This price momentum in a small basket of large liquid stocks as money flows into passive investing means passive investors have meaningful exposure to stocks whose return risk is increasing.

With the large inflows to passive investing which now represents almost 40% of the equity market, it stands to reason that the stocks most widely held by ETF's will be more expensive than stocks less widely held the ETF's. Templeton and Phillips Capital Management has done research indicating that is the case. They found that the 150 stocks most commonly held by ETF's were priced materially higher than broad market indexes which includes stocks not widely held by ETF's.



The need by fund sponsors for large liquid stocks seems to be undercutting what is perceived to be a diversified way to invest. Again, Templeton & Phillips found that, for example, Apple is held in 155 ETF's by their count including six value ETF's, five momentum, and ten growth ETF's. An ETF holder thinking he was diversifying between value and momentum stocks which are basically polar opposites would be surprised to find they held Apple in both as well as holding Apple in any shares they owned in the Catholic Values ETF despite Apple's lack of any apparent Catholic values. Investors don't have the diversification that they think they have.

While we have nothing against concentrated investments and in fact practice that strategy, being concentrated due to forced buying in companies as their prices rise through passive investments is another matter. Looking at buying the Nasdaq 100 through the PowerShares Nasdaq 100 ETF(QQQ) which has approximately \$50 billion invested, you would have had 41% invested in Apple, Google, Microsoft, Amazon, and Facebook as of June 30, 2017.

NASDAQ 100 Top Five Holdings

		<u>Weight</u>
AAPL	Apple Inc.	11.75%
GOOG, GOOGL	Alphabet, Inc. (Google)	8.84%
MSFT	Microsoft Corp.	8.21%
AMZN	Amazon.com Inc.	6.82%
FB	Facebook Inc.	<u>5.42%</u>
<i>Source: PowerShares QQQ</i>		41.04%

ETF's Are a Crowded Trade

Many large cap tech companies have seen price increases resulting from strong business performance as the original catalyst. Further price increases have been fueled by excessive optimism in the media that large cap technology names will grow to the sky. Coupled with large inflows into passive investing concentrated in those names which boosted share prices for these companies again and feeds on itself as more money flows into the ETF's and index funds. This means more and more money is going into fewer and fewer stocks.

This has happened before. If you didn't own the nifty fifty stocks in the early 1970's, you underperformed. If you didn't own the internet stocks in 1998-1999, you also underperformed which put pressure on active managers to own these same stocks similar to the pressure to own the FANG stocks today. Both prior trends did not end well as the stocks that had been bought the most eventually were the stocks that were sold the most in the correction.

We don't expect any price correction in these crowded trades to lead to the same amount of pain for the economy that the unwinding of excesses in the housing market did, but when the markets break, as they always have, the ETF's could be destabilizing forces. To whom are they going to sell in these crowded trades when about 40% of the equity market is now comprised of passive funds which are mandated to hold no cash and many active managers have reduced cash holdings due to business risk. This could lead to significant price declines for these overbought stocks.

Is This an Environment of Excess Risk Taking?

We don't believe in making investment decisions by trying to time the market through market or economic forecasts, but we try to monitor the level of risk in the market. The reason for this is if we feel investors in general are taking too much risk then maybe we are too. Monitoring market risk helps compel us to take a second look at our holdings to see how we are managing risk.

The things we view as important to monitor include:

- interest rate levels
- volatility
- the ease of raising capital for risky transactions...funny money
- investor psychology and the level of greed versus fear
- the level of valuations

Interest Rate Levels

Interest rates have been at historically low levels for a very extended period and are artificially low, pushed down by extreme central bank measures and driving investors towards riskier assets in hopes of earning decent returns.

The markets are not greatly overvalued if you compare the forward earnings yield (inverse of price to earnings) of about 5% to the current rate of 2.34% on ten-year treasuries but that assumes interest rates don't rise. Buffett said in February, and stock prices have risen considerably since then, that market levels were not expensive when compared to interest rate levels but went on to say that the risk is always interest rates go up a lot bringing equity valuations down. **Are you happy counting on continued low interest rates when the Fed has begun a series of rate increases?**

Volatility

The VIX or volatility index shows how volatile investors in options on the S&P 500 expect it to be over the next 30 days. It measures whether investors expect major up or down moves but increasing attention has been paid to the VIX recently as a measure of complacency or investor fear gauge.

A low level for the VIX has historically meant not much risk is priced into the market. Currently, the VIX is at 9.65 up slightly from the 27 year low on November 3rd of 9.14 and down considerably from the elevated fear levels and VIX levels of 44.28 and 59.9 when the markets hit turbulent down periods in July 1998 and October 2008.

Not much fear is priced into the markets which might be accurate if conditions stay benign, low interest rates, low inflation, and solid economic growth but it's apparent that excessive fear levels after the 2008-2009 credit crisis which created low valuations and a good tailwind are well behind us. We'll go into this later in more detail later, but we try not to join the market in being complacent about risk and are holding large cash levels as we recently sold some investments that no longer meet our criteria.

In a 2005 portfolio review when we had similar difficulty finding attractive investments we said the following:

..... Much of our long term out performance is having the flexibility(cash) to take advantage of real opportunities when they become available. If you get too complacent, chances are that flexibility won't be there the next time an opportunity arises. Complacency in general is probably not a good habit. Consider Wilbur Wright's ideas on flying, "In flying I have learned that carelessness and overconfidence are usually far more dangerous than deliberately accepted risks"

We were early in 2005 in terms of being mindful of the risks as you never know when prices will correct but you still need to try to know when the market or more importantly your stocks are overvalued. Our attempts to monitor risk did end up working out well for us:

**Performance During Down Markets
Cumulative Net Returns**

	2000-2002	2008-2009
SAC	Gain of 13.2%	Gain of 6.1%
S&P 500	Loss of 37.6%	Loss of 19.7%

Funny money, the Ease of Raising Capital.

Corporate debt instruments can be clear indicators of excessive risk-taking behavior. In early May, Netflix issued 1.3 billion of Euro denominated bonds at 3.625% which was its lowest cost debt ever. There were few covenants and the bonds were rated single B- which indicates high credit risk. Netflix's supposed GAAP earnings run about \$200 million a quarter but for the year ended March 31 they had negative cash flow of about \$1.8 billion.

Netflix has done a very good job streaming content directly to its rapidly growing subscriber base free of commercials but without advertising revenue they can't pay for all their content with operating cash flow and must borrow money and hope that they continue to grow very rapidly to pay for it all. Much of the content that was provided to them by larger media companies and was instrumental in growing their subscriber base in the beginning won't be made available by Time Warner, Disney, Fox, and CBS as they focus on their own direct to consumer streaming product. In addition, Apple, Amazon, Facebook, and Google are now competitors for content viewing. It seems to us that positive, if not euphoric, investor sentiment towards Netflix's equity has driven a curious investment by bondholders who have accepted a 3.625% return to lend to a low-grade credit despite having no upside in the equity.

While not reminiscent of the tsunami of sub -prime mortgage issuance in 2005-2007, there has been a troubling doubling of car finance firms' in the U. K. issuing bond backed by low credit auto loans to 5.5 billion pounds as well as banks in the U. K. and the US competing for mortgage business by increasing the multiple of annual income they will lend against.

Investor Psychology and the Level of Greed Versus Fear

There are some conditions evident today that are necessary for an overexuberant market.

- **The fear of missing out.** As an example, I hear lots of comments today concerning whether I know anything about such and such highflying tech stock but I hear no discussion about whether it might be overvalued or about selling anything.
- **A willing suspension of disbelief regarding risks towards any of the highflying tech stocks**
Sound familiar? For example, I hear no discussion that Amazon's purchase of Whole Foods's might represents a failure for their nine-year attempt through Amazon Fresh to gain share in the \$675 billion grocery business despite their recent announcement that they were shutting down Amazon Fresh's grocery service in parts of nine states.

Instead, the consensus view from what I read is similar to a recent CNBC headline, "Amazon's acquisition of Whole Foods is a threat to everyone, even restaurants". So, given Amazon's valuation at three hundred years' worth of earnings an investor is supposed to have basically zero skepticism about Amazon's ability to dominate the grocery business despite their lack of success over the last nine years because they bought Whole Food's 474 locations? Walmart has over 5,300 locations and much higher cash flow to reinvest in the business and has successfully fought off Amazon for a decade.

Other headlines pertain to the affect the Whole Food's acquisition could have on the pharmacy industry. "Hearing Amazon's Footsteps, the Pharmacy Industry Shudders", which refers to CVS's interest in buying Aetna where discussions were underway well before Amazon's surprise announcement to buy Whole Foods. Again, very little skepticism about Amazon's ability to dominate the pharmacy business even though on line pharmacy has been around for a while without making great inroads and Whole Foods has 474 locations while CVS and Walgreen's each have about 10,000.

Amazon's potential success shouldn't be discounted as they have been excellent disrupting several industries, but they have failed in others. My main point isn't that they won't succeed. The main point is the lack of any apparent skepticism about their ability to dominate so many industries is a sign of **the quest for gain overcoming a healthy degree of risk aversion in the markets.**

I wonder whether Amazon had much choice about the acquisition. Why make a \$13 billion acquisition if internal efforts to enter the grocery or pharmacy businesses were going well. Amazon may be on a treadmill stuck on fast mode which are hard to jump off. If they don't have fast growth, what happens to their stock which assumes they will, and what happens to their cash flow if their stock craters since they paid \$4 billion in stock to employees last year in lieu of putting it in their paychecks. In other words, standing pat is not a good option when the market expects a treadmill stuck on fast.

Our sense is Amazon's valuation at three hundred years of earnings reflects almost a complete lack of doubt about what would be an unprecedented ability for a company to disrupt and dominate virtually any large industry they wanted. Skepticism priced into a stock's valuation and resulting undervaluation is what we look for to have conviction in the future returns of an investment and, more importantly, to avoid the large losses you would incur if Amazon's

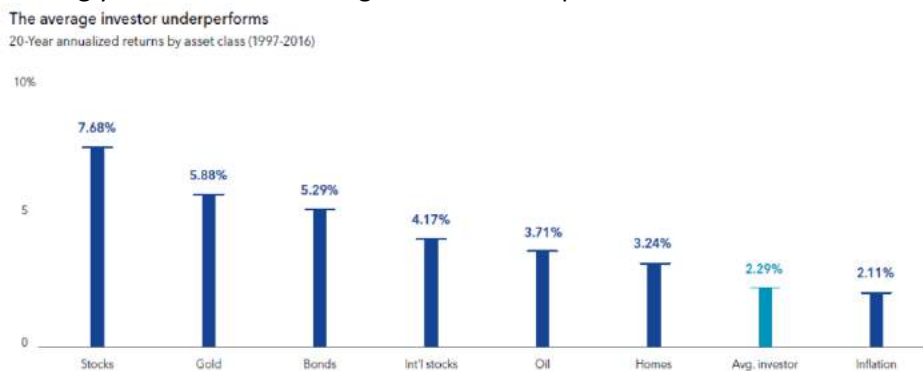
multiple came back to earth. Amazon probably deserves a multiple of earnings higher than the market but if Amazon went to twice the market multiple tomorrow shareholders would suffer a loss of approximately 85%.

- Super stocks. A view has developed which certainly has some truth to it that a group of stocks has captured the future and are sure to be winners for years to come. This phenomenon is prevalent during periods of excess risk taking such as the nifty fifty stocks can't lose stocks of the 1970's including Kodak, Polaroid, Xerox, Sears, and Simplicity Pattern, the oil stocks of the 60's, disk drive companies in the 80's, and tech/media/telecom in the late 90's including Cisco Systems whose stock price today remains 50% below where it was at its peak in Feb/March of 2000. While it may not happen with regard to the FANG stocks, in each of those cases, competition arose, business models turned out to have hidden flaws, or it was shown even great fundamentals can become overpriced, all of which led to losses.

Valuations

- The S& P 500 trades for at approximately 25 times trailing earnings versus a long- term median of 15.
- The Buffett yardstick- total stock market capitalization as a percentage of GDP, which is immune to company level accounting issues at around 145 is close to an all-time high compared to the 1995-2017 median of about 100.

Before reviewing the most important thing which is the valuations of the companies in our portfolios, we should comment that, despite a negative view of some of the risk taking in the market, we feel strongly that our portfolios have much less risk and better long- term return prospects than the market, particularly versus the "crowded etf trade" which could see major losses. Timing the market, i.e. selling fairly-valued stocks because you think the market will go down and then you can rebuy is basically impossible and a mistake per the graph below which reviews market returns for the past twenty years compared to average returns for the individual investor obviously trying to time the market. We do however strongly believe in monitoring the risks in our portfolios.



Sources: Blackrock, Dalbar

RISK REVIEW

Our favorite tool to monitor valuations is free cash flow yield. Operating cash flow less capital expenditures as a percentage of the market value of the company. It's a good measure of a company's valuation. Equally important, it indicates with their with cash flow exceeding capital expenditure needs an ability to take advantage of attractive opportunities that typically flow from stress in the markets or the economy whose timing is impossible to predict. A seven six percent free cash flow yield for example gives a company the flexibility to pay a 2% dividend and buyback as much as 5% of their shares which is a safeguard towards future earnings per share growth

Below is a comparison of the free cash flow yields of our top seven holdings compared to the seven tech oriented stocks I hear the most about

Free Cash Flow Yield after deducting excess cash on balance sheet

South Atlantic Holdings

1. Enterprise Products Partners	8.3%	} Weighted Average	7.5%
2. Twenty First Century Fox	6.4%		
3. Berkshire Hathaway	6.5%		
4. Oaktree Capital	10.0%		
5. Boeing	6.6%		
6. Home Depot	4.7%		
7. CVS Health	8.8%		

Super Stocks

1. Apple	6.0%	} Weighted Average	3.4%
2. Google	3.9%		
3. Amazon	1.3%		
4. Facebook	3.1%		
5. Netflix	negative cash flow 2.3% of market value		
6. Tesla	negative cash flow 9.1% of market value		
7. Nvidia	2.0%		

*South Atlantic's portfolio holdings use negligible stock based compensation. The Super Stocks have material stock based compensation. Adjusting free cash flow to exclude that their free cash flow yields would be as follows for a weighted average yield of 2.4%.

Apple – 5.5%	Nvidia – 0.7%
Google – 2.6%	Tesla – negative 9.9%
Amazon - 0.6%	Netflix – negative 2.3%
Facebook – 2.4%	

So, for example, looking at the weighted average free cash flow yield a \$1 million investment in our top 7 holdings would generate \$75,000 in free cash flow available to shareholders compared to \$1million invested in the super stocks which would generate about \$34,000 or \$26,000 if you assume problematic stock prices meant they had to replace stock based compensation with cash. Lastly, over half of the free cash flow would be generated by Apple. So, the valuations of the super stocks assume much, much faster growth in earnings and cash flow than the market as a whole which we think overstates the ability of such large companies to grow and represents a lot of risk to shareholders if market sentiment for these stocks changes.

Looking forward

In the current market, it's difficult to find stocks that meet our criteria, so we hold approximately 14% in cash some of which we will most likely invest in 90-day treasury bills after the December Fed meeting where we expect them to raise rates. We feel the positions we do hold have attractive return prospects given their free cash yields and business prospects. Given that, we are comfortable with how we're positioned despite a view that parts of the market are very overvalued and the market itself is somewhat overvalued. Lastly, if opportunities do arise we think we'll be able to take good advantage of them through the balance sheets and cash flow of the businesses we own plus our cash position.

Please let me know if you would like more information or if you've had a meaningful change in your financial situation or outlook that you would like to review.

Best regards,

Eddie Nowell

DISCLOSURES

¹**Core Equity Composite** contains all fully discretionary accounts invested in equities excluding accounts that use significant leverage. For comparative purposes it is measured against the total return for the S&P 500. It includes accounts managed for capital appreciation as well as accounts managed for a combination of capital appreciation and current income. The equity securities are typically mid cap and large cap value oriented U.S. equities and ADR's of similar capitalization. The portfolios also include equity securities that provide higher current income such as master limited partnerships, real estate investment trusts and similar securities that "pass through" most of their cash flow as distributions. The portfolios may from time to time invest in fixed income securities and various hedges such as gold backed ETF's as conditions warrant. The portfolios are typically invested in 15-25 positions but have held fewer than 15 positions in the past.

²**S&P 500 Index** has been widely regarded as the best single gauge of the large cap U.S. equities market since the index was first published in 1957. The index has over U.S. \$4.83 trillion benchmarked, with index assets comprising approximately U.S. \$1.1 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities and includes the reinvestment of dividends of companies in the S&P 500.

Returns are presented net of management fees and include the reinvestment of all income. The U.S. Dollar is the currency used to express performance. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request, as is GIPS compliant presentations and lists and descriptions of South Atlantic Capital's composites, by emailing Info@SouthAtlanticCap.com or calling (910) 763-4113. Portfolio composition is subject to change at any time and references to specific securities, industries, and sectors referenced in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk.

The discussion of our firm's investments and investment strategy (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) represents the firm's investments and the views of the investment adviser, at the time of this letter, and are subject to change without notice.

Past results are not indicative of future investment results. An investor should further understand that future results may result in losses for account holders.

EDWARD D. NOWELL

Edward D. Nowell is President, founder and sole portfolio manager of South Atlantic Capital Management Group, Inc.

Mr. Nowell has over thirty years of experience in the finance business. Prior to founding South Atlantic Capital he worked in the structured finance department of Bankers Trust Company, New York as an Assistant Vice President. His primary responsibility was arranging bank financing for leveraged buyouts led by Kohlberg Kravis Roberts & Company. During graduate school, he interned with Merrill Lynch's Capital Markets Group in New York. Later, he served as an institutional fixed income sales representative for Carolina Securities/Prudential Bache Securities and worked with Fox, Graham, and Mintz, Securities. Mr. Nowell graduated from the University of North Carolina with a B.S. in Economics and received his M.B.A. from the University of Virginia.

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South Atlantic Capital claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. South Atlantic Capital has been independently verified by Ashland Partners & Company LLP for the periods January 1, 1992 to September 30, 2016 and by ACA Performance Services for the periods September 30, 2016 to December 31, 2016.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Core Equity Composite has been examined for the periods January 1, 1992 to December 31, 2016. The verification and performance examination reports are available upon request by calling (910) 763-4113, or by emailing info@southatlanticcap.com.

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Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite policy requires a three month, temporary removal of any portfolio incurring a client initiated external significant cash inflow of at least 25% of portfolio assets. The temporary removal of such an account occurs at the end of the prior month in which the external significant cash flow occurs and the account re-enters the composite at the end of the second full month after the cash flow. In 2014, South Atlantic Capital switched to a new database reporting software and switched our composite fee calculation methodology to using the highest fee in the account, 1.0%, effective 7/1/2014. Additional information regarding the treatment of significant cash flows is available upon request. Composite returns represent investors domiciled primarily in the United States. Past performance is not indicative of future results. As of December 31, 2014, less than 1% of composite assets represent non-fee paying accounts.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Returns are presented after trading expenses but before any applicable taxes. The annual composite dispersion presented is a size-weighted standard

deviation calculated for the accounts in the composite the entire period. The annual dispersion and the standard deviation were calculated based on net returns prior to 12/31/2014, and gross of fees beginning 1/1/2015. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request, as is GIPS compliant presentations and lists and descriptions of South Atlantic Capital's composites, by emailing info@southatlanticcap.com or calling (910) 763-4113.

South Atlantic Capital's management fee schedule for accounts with assets up to \$5,000,000 is generally set at 1.0% per annum, and is negotiable for accounts with assets over \$5,000,000. Actual investment advisory fees incurred by clients may vary.

The Core Equity composite was created on March 1, 2011.