

South Atlantic Capital Management Group, Inc.

Investment Management

March 31, 2016 Portfolio Review

THE DANGERS OF MARKET TIMING

The dangers of market timing have been studied by Dalbar and Associates a Boston based financial services research firm. In a recent study, they compared the annualized returns by asset class for various markets versus returns for the average investor.

<u>Asset Class</u>	<u>Returns</u>
Stocks	9.9%
Bonds	6.2%
International Stocks	5.0%
Average Investor	2.5%
Inflation	2.3%

Trying to time the markets has been a major mistake for the average investor over the last twenty years. Simply holding on for the twenty year market return would have grown a \$100,000 investment to \$660,623 versus the growth in value for the average investor trying to time the market versus \$163,862.

While Great Britain's vote to leave the EU will certainly cause a great deal of uncertainty and probably lead to a lower growth rate for the world economy, we think it would be a mistake to start practicing market timing. We don't think this will be a cataclysmic event for the financial markets or our portfolios.

Partly this is due to a much stronger banking system today when looking at balance sheets and capital ratio as compared to 2007 when the mortgage crisis caused legitimate fear over the stability of our financial system

The Federal Reserve last week released the results of their stress tests for the balance sheets of the 33 largest U. S. banks. All 33 banks passed the tests as to having adequate capital under the following fairly draconian assumptions and all of the banks we own were deemed to have excess capital:

- A nine quarter period in which the unemployment rate fell to 10%
- A 50 drop in the stock market
- A 25% drop in housing prices
- Negative short term interest rates

That said there will be periods of economic weakness and chaos which the markets often overreact to. In the past, we have typically held stocks with low volatility not by design but because that's where we thought the best values were. Recently, the huge increase in funds invested in "low volatility" ETF's has bid those types of stocks such as utilities and consumer staples to levels we don't think are attractive with P/E ratios much higher than the market P/E. In our opinion that has a lot to do with the increase in the volatility of our portfolios recently.

As the economic uncertainty over Brexit unfolds, please remember that your portfolio is built on the outlook for that specific company. During the weakness and chaos, people always seem to underestimate that there is an offset for stronger companies that can benefit from companies in a weaker position. We have benefited from that in the past and will again in my opinion.

Several examples of companies that benefit from what might unfold are outlined below.

1. Berkshire Hathaway has very little debt and owns several very strong companies outright including Burlington Northern, Precision Castparts and Geico. Berkshire should generate approximately \$25 billion in earnings this year which along with \$50 billion in excess cash compared to a market value for the company of \$343 billion gives them ample opportunity to use any weakness to build long term value.
2. Oaktree Capital is one of the world's most highly regarded distressed debt investors. It trades at about \$45 per share and generated distributable earnings over the last twelve months of \$2.70 per share \$2.20 of which they paid out as dividends. They have raised approximately \$23 billion over the last twelve months in contractual commitments bringing assets under management to approximately \$97 billion. They are disciplined, risk averse investors and about \$21 billion of that is dry powder and not yet invested and \$12.5 billion is not yet earning management fees. That means if markets weaken, they can put that money to work. Management fees on the \$12.5 billion would represent 20% of current management fees and is a strong cushion against any fall in the value of assets currently invested. From 2007-2009, the financial crisis created

a great deal of opportunity for Oaktree which along with their highly regarded reputation allowed them to grow assets under management from \$53 billion to \$73 billion.

3. Twenty First Century Fox has over \$5 billion in cash which they are currently using to aggressively buy back their stock which we think is undervalued due to excess fear over “cord cutting.” We think they will report strong earnings in early August as ratings for many of their channels are up significantly and advertising money is flowing out of digital ads due to poor results and back into broadcast and cable television.
4. Phillips 66, Enterprise Partners, and Lyondell Basell are all involved in the energy sector not in the exploration side but in refining, petrochemical production (using oil or natural gas as a feedstock), and in the midstream energy business processing transporting and exporting oil, natural gas, and natural gas liquids. In our opinion, they are all in a stronger position to grow their business, increase dividends, or buyback stock than many of their competitors who are suffering from taking on too much commodity risk and too much debt for this low commodity price environment.

Top 5 Performers in 1Q16		Bottom 5 Performers in 1Q16	
Scripps Network Interactive	18.9%	PNC Financial Services Warrants	(29.3%)
Boeing	12.5%	JP Morgan Chase Warrants	(25.3%)
Lyondell Basell	11.3%	Wells Fargo Warrants	(23.6%)
Berkshire Hathaway	7.5%	CF Industries	(21.7%)
Discovery Communications	7.3%	Bank of America	(19.4%)

I strongly suggest that you don’t follow your investments predominately by looking at quotes or statements that can reflect prices driven by nervous, short term investors. To capture the upside in markets over time and avoid selling at the wrong time, I strongly encourage you to follow your investments by meeting with me to discuss the companies in which you own shares. The best time to do that is after companies report quarterly earnings. This quarter most will have reported by the first week of August.

Please feel free to contact me.

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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