# South Atlantic Capital Management Group, Inc.

## Investment Management

# March 31, 2013 Portfolio Review

**<u>COMPOSITE PERFORMANCE SUMMARY</u>**

South Atlantic Capital (SACMG) versus S&P 500
Annualized as of 3/31/2013

| | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception* | Total Return Since Inception* |
|---|---|---|---|---|---|---|---|
| SACMG Core Equity[1] (Net) | 11.72% | 17.47% | 12.35% | 11.99% | 11.06% | 8.67% | 217.06% |
| S&P 500[2] | 10.61% | 13.95% | 12.67% | 5.81% | 8.53% | 5.09% | 83.83% |

**Inception date of South Atlantic Capital's composite is 1/1/98.*

*South Atlantic Capital is an independent investment adviser registered with the State of North Carolina. 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 independent verifier, has verified South Atlantic's compliance on a firm-wide level for the period of January 1, 2002 to March 31, 2013. All returns are net of management fees and include reinvested dividends and interest. Past results are not indicative of future investment results.*

VERIFIED

Global equity markets were up substantially in the first quarter with the Dow and S&P 500 recently hitting record highs. Our composite outperformed returning 11.6% despite the drag from JC Penney, which was liquidated in April, versus a 10.6% return for the S&P 500.

Equities are not overvalued in our opinion and remain very attractive relative to bonds, but they are not as undervalued as they have been. While we build our portfolios one stock at a time based on the company's price versus its earnings prospects, we do monitor market valuations as prices rise not to make a market call but to ***force us to reconsider whether an individual company is overvalued.*** Currently, the S&P 500 sells for about a <u>6.5%</u> earnings yield while the ten year treasury bonds yields only <u>1.92%</u>. Since World War II, the market has sold as cheaply as an earnings yield of 10-12% when interest rates were double digits but, excluding those periods, sold at an average earnings yield of about 5.5%. We believe stocks in general are not overvalued especially when you consider interest rate levels.

As prices rise, we try to stay mindful of a couple of things which are difficult to balance. First, companies such as Coca Cola, have minimal business risk but can have price risk. If their price rises such that their earnings yield or free cash flow yield becomes anemic versus alternative investments that will correct itself overtime by either a sharp drop in Coke's price, which is doubtful, or a relatively stagnant price for longer periods that brings Coke's earnings yield in better alignment with other investments. This is what you saw from June of 1998 until June of 2008 when Coke's price went from $43.6 to $25.7.

Second, since investment opportunities are so attractive during economic or market downturns, it is central to us that our portfolios be positioned to take advantage of these situations when they present themselves. We have accomplished this in the past by holding cash, investing in companies that have capital to invest during these periods, and by investing in defensive types of companies whose prices tend to do well in these periods because of their balance sheet and business strength. However, as some of our more defensive holdings such as Coke, Pepsi, and Nestlé's have risen in price, their expected returns are not as attractive. Their expected future returns will more closely mirror their dividend yields and earnings growth and are less likely to benefit from higher earnings multiples. We would prefer to reduce these holdings if we can find companies with better expected returns where we are equally confident they will be in a position to take advantage of economic or market distress.

Our returns for the quarter for our top ten holdings are below.

SACMG Top 10 Holdings (as of 3/31/2013)

| Holding Description | Net Returns* (Based on representative account) |
|---|---|
| Enterprise Prd Partners Lp | 21.9% |
| Cash | 0% |
| Berkshire Hathaway Cl B | 15.6% |
| Wells Fargo & Company | 8.7% |
| Philip Morris Intl Inc | 12.0% |
| Johnson & Johnson | 17.2% |
| News Corp Ltd Cl A | 19.6% |
| Nestlé S A Reg B Adr | 11.2% |
| Sanofi Aventis | 7.8% |
| Pepsico Incorporated | 17.3% |

**Returns include purchases and sales during the quarter.*

You can see the returns were pretty healthy across the board for the quarter except for cash at ZERO. This helps illustrate why many investors are rethinking stocks versus cash earning effectively nothing or bonds yielding 1.92% per year.

The returns from the top holdings were reduced because of the poor investment in JC Penney. JC Penney tried to use its low cost real estate to transform their run of the mill department store into a "specialty store mall" by enticing higher quality merchants that generate higher sales per square foot and appeal to a different customer base to expand nationally through JC Penney's locations rather than leasing or buying their own locations. JC Penney owns almost 40% of their stores and most other stores had long term leases below the market rate at approximately $4/sq. ft. If it had worked, the returns would have been excellent but it didn't work because they alienated too many customers during their attempt to transform the company. Retail is a very competitive industry. Competitors tend to watch each other closely and can generally copy whatever is working for a competitor. Basically, we invested in a company which was trying to create a competitive advantage through a dramatic transition. *As our clients unfortunately realized*, this approach has much lower odds of success than investing in a company that already has a competitive advantage.

We recently read an excellent book, *The Outsiders* by William Thorndike, that reviewed which companies had the best long term per share stock performance and analyzed what the CEO's that produced the results had in common.

Thorndike found that:

1. The CEO's were quantitatively adept which made them excellent capital allocators
2. The operating philosophy of the companies was very decentralized with little corporate overhead or activity other than full control of capital allocation.
3. A shared focus on optimizing per share value of the business not organizational growth.

One of the CEO's chronicled in *The Outsiders* was Warren Buffett, who I believe had the best long term outperformance and whose company has been a large holding of our clients for a while. His view on decentralization has not changed much and is described in his most recent quarterly SEC report:

> "*Through our subsidiaries, we engage in a number of diverse activities. Our operating businesses are managed on an unusually decentralized basis. There are essentially no centralized or integrated business functions (such as sales, marketing, purchasing, legal or human resources) and there is minimal involvement by our corporate headquarters in the day-to-day business activities of the operating businesses*".

Warren Buffett is a great example of the long term value per share that a CEO can create if he is focused and stays focused on the right things.

Lastly, we continue to see anecdotal and direct signs that our philosophy of investing client funds in concentrated portfolios is preferable to excess diversification. First, while low volatility is not our goal, the standard deviation of our returns overtime is lower than the standard deviation of the S&P 500 while our returns are higher. Portfolios of twenty stocks can have lower volatility than the market. We believe our lower historical volatility is due to investing in companies that have stronger balance sheets and more durable businesses relative to the S&P 500 as a whole. Second, there continues to be a wide variation in returns among companies in the S&P 500. On average in the last five years, 37% of the stocks in the S&P 500 have generated a negative return including dividends every year. Over the last twelve years, the lowest spread between the returns of the top 100 stocks and the bottom 100 stocks in the index has been 60% and it has been as high as 145%. Hopefully, this variation will continue and offer at least an opportunity for concentrated portfolios to outperform the index in the future.

On a personal note, our Director of Marketing, Will Brown, has left the company to pursue an opportunity to own his own business. Will made our marketing efforts much more presentable to the investment world, increased our presence in the industry, and has left us with many great opportunities to pursue. We wish him well and would be happy to pass on his contact information per your request.

Please contact us if you would like to discuss our services in more detail.

## 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 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.*

*South Atlantic Capital is an independent investment adviser registered with the State of North Carolina. 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 by emailing info@southatlanticcap.com. Ashland Partners & Co., LLP, our independent verifier, has verified South Atlantic's compliance on a firm-wide level for the period of January 1, 2002 to March 31, 2013.*

*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.*

ASHLAND VERIFIED

**EDWARD D. NOWELL**

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

Mr. Nowell has over twenty-five 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 Bank 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.

*©2011 South Atlantic Capital Management Group, Inc.*

# SOUTH ATLANTIC CAPITAL MANAGEMENT GROUP, INC.
## CORE EQUITY COMPOSITE
## ANNUAL DISCLOSURE PRESENTATION

| Year End | Total Firm Assets (millions) | Composite Assets (USD) (millions) | Number of Accounts in Composite | Annual Performance Results Composite | | S&P 500 | Composite Dispersion | Three Year Annualized Ex-Post Standard Deviation* | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Gross | Net | | | Core Equity | S&P 500 |
| YTD | 31.7 | 19.6 | 48 | 12.00% | 11.72% | 10.61% | 1.55% | 11.41% | 14.80% |
| 2012 | 28.6 | 17.3 | 47 | 13.20% | 12.12% | 15.98% | 1.88% | 11.19% | 15.09% |
| 2011 | 25.3 | 15.2 | 43 | 3.60% | 2.56% | 2.12% | 2.54% | 15.55% | 18.70% |
| 2010 | 22.0 | 14.4 | 40 | 20.20% | 19.02% | 15.07% | 3.42% | 17.94% | 21.85% |
| 2009 | 18.6 | 13.0 | 36 | 46.24% | 44.79% | 26.46% | 5.32% | 17.27% | 19.63% |
| 2008 | 12.4 | 8.4 | 38 | (25.99%) | (26.69%) | (37.00%) | 2.30% | 12.61% | 15.08% |
| 2007 | 17.4 | 11.9 | 37 | (2.03%) | (2.97%) | 5.49% | 2.69% | 9.33% | 7.68% |
| 2006 | 22.4 | 12.6 | 36 | 12.10% | 11.13% | 15.80% | 2.50% | 8.74% | 6.82% |
| 2005 | 12.4 | 10.8 | 33 | 0.79% | (0.16%) | 4.89% | 3.12% | 11.08% | 9.04% |
| 2004 | 12.3 | 11.1 | 30 | 20.37% | 19.24% | 10.87% | 3.37% | 12.64% | 14.86% |
| 2003 | 9.2 | 8.5 | 23 | 35.31% | 33.95% | 28.69% | 4.38% | 13.78% | 18.07% |
| 2002 | 6.9 | 6.4 | 21 | (3.36%) | (4.34%) | (22.10%) | 6.43% | 14.12% | 18.55% |
| 2001 | 7.4 | 6.8 | 18 | 6.92% | 5.86% | (11.88%) | 6.23% | 13.89% | 16.71% |
| 2000 | 6.8 | 6.3 | 15 | 14.35% | 13.35% | (9.11%) | 4.23% | 13.17% | 17.42% |
| 1999 | 6.4 | 5.9 | 15 | 8.55% | 7.48% | 21.05% | 10.45% | | |
| 1998 | 6.3 | 5.7 | 15 | 4.51% | 3.25% | 28.57% | 3.69% | | |

***Core Equity Composite* contains all fully discretionary accounts invested in equities excluding accounts that use significant leverage and for comparative purposes 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 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. The minimum account size for this composite is $50,000.**

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, 2002 to March 31, 2013.

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, 2002 to March 31, 2013. The verification and performance examination reports are available upon request by calling (910) 763-4113, or by emailing info@southatlanticcap.com.

South Atlantic Capital is an independent registered investment adviser registered with the State of North Carolina. 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 by emailing info@southatlanticcap.com.

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. 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.

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. Beginning 2002, net of fee performance was calculated using actual management fees applied quarterly. Prior to 2002, the highest applicable management fee of 1% was applied. The annual composite dispersion presented is a size-weighted standard deviation calculated for the accounts in the composite the entire year. The annual dispersion and the standard deviation are calculated based on net returns. 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 $500,000 is 1.5%. For accounts with assets between $500,000 and $5,000,000, the management fee schedule 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.

*Ashland Partners & Company LLP*

ASHLAND

525 Bigham Knoll, Suite 200
Jacksonville, OR 97530
541.857.8800
Fax: 503.213.7245
www.ashlandpartners.com

**Independent Accountant's Verification Report**

Mr. Edward D. Nowell, President
South Atlantic Capital Management Group, Inc.:

We have examined whether (1) South Atlantic Capital Management Group, Inc. (the "Firm") has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firm-wide basis for the periods from January 1, 2002, to March 31, 2013, and (2) the Firm's policies and procedures are designed to calculate and present performance results in compliance with the GIPS standards as of March 31, 2013. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures. Our responsibility is to express an opinion based on our examination.

**Scope of Work**
Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

**Opinion**
In our opinion, in all material respects,

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis for the periods from January 1, 2002, to March 31, 2013; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of March 31, 2013.

This report does not relate to any composite presentation of the Firm that may accompany this report, and, accordingly, we express no opinion on any such performance.

Ashland Partners + Company LLP

Ashland Partners & Company LLP
May 28, 2013