INSIGHTS
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A Rising Tide Tends To Lift All Boats But You Find Out Whose Swimming Naked When The Tide Goes Out

SPONSORED CONTENT PROVIDED BY EDDIE NOWELL
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The second part of this headline should be credited to Warren Buffett as his way of describing how dangerous complacency about investment risk can reverse abruptly when a company is finally forced to face the risks in its business.

Two things that can make investors overly complacent about risk are low default rates and long economic periods without a recession, both situations exist today and shouldn't be ignored. Looking back at the credit crisis, ignoring the significant risks that existed in the mortgage market caused large losses for investors in some financial service companies when mortgages started defaulting. It became very clear after the crisis which companies had managed their companies in a risk averse way and which companies were swimming naked. No down payment loans, negative amortizing loans where you could borrow the interest for a period of time, and no doc loan were not sound. The companies that were the most willing to make unsound loans were allowed to grow the fastest and with high levels of leverage on the belief their real estate prices which served as collateral could only go up.

Eventually, as teaser rates began to reset, defaults ramped up and the companies most involved in these loans didn't have the balance sheet to withstand the financial crisis while others which had maintained more sound underwriting criteria and more conservatively managed balance sheets fared reasonably well. The result was higher stock prices for US Bancorp and Wells Fargo since December 31, 2007 and a more than doubling in JPMorgan's stock

price while the ones swimming naked as Warren Buffett puts it such as Lehman Brothers, Bear Stearns, Citicorp, Countrywide Credit and Washington Mutual have either suffered material drops in their prices or have gone out of business entirely.

Who Might Be Swimming Naked going Forward?

- A general area to watch out for is lower quality companies that have been able to issue too much debt due to ultra- low interest rates, a growing economy, and yield starved investors seeking yield. Either higher interest rates or a downturn in the economy could lead to problems for these companies.

- There has been a great deal of positive press and skyrocketing stock prices for disruptors that have had success gaining share and transforming certain industries, companies such as Amazon, Facebook, Netflix, and Tesla. We feel their stock price increases are partly driven by the huge inflow of money into passive momentum- based funds.

We are skeptical of the prospects for Netflix and Tesla's stock prices going forward. Their sky -high valuations imply future earnings growth that has been hard to come by historically and their balance sheet leverage seems to assume little could go wrong and little competitive threats to their business exist. Despite a lot of success for Netflix and some for Tesla, their stock prices and balance sheets seem to ignore that they are generating negative cash flow and they both may soon face a host of new, better financed competition.

In Netflix's case, in the next few years they will be losing access to much of the content that has helped them build their business as legacy media companies cancel licensing contracts to focus on their own streaming products. According to a recent study by Allan Wolk, these cancelled licensing contracts involve content that represent about 60% of viewing time for Netflix subscribers. At the same time, Disney and Apple, (formidable competition) will soon be competing with Netflix for streaming subscribers in addition to the current competition, Hulu, HBO/Time Warner and Amazon.

Our Best and Worst performers for the quarter ended March 31, 2019

Worst 5

CVS Health	(17.1%)
Cf Ind.	(5.1%)
Berkshire	(1.6%)

Fox A	.9%
Disney	.9%

Best 5

Moody’s	29.7%
Oaktree Cap	27.2%
Lennar A	25.5%
Apple	20.9%
Enterprise Pd Prtns	20.2%

Please feel free to contact Florence Ellen Cowden @ 910-763-4113 if you would like more information about our investment philosophy.

Mr. Nowell has over thirty years of experience in the finance business. Prior to founding South Atlantic Capital he worked in the leveraged lending 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 salesman 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 MBA from the University of Virginia.

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