The Forest from the Trees of Investment Returns

The stock market returned over 100% from the bottom in March 2009 to month end March 2011 – a compound annual return of over 41% per year. Start a year earlier in March 2008, however, and your return was 2% per year. Not only are these figures dramatically different, we would suggest they are not even returns.

An investment "return" implies you get something back. Unless investors bought on March 9, 2009 and sold March 31, 2011, there was no return. Nevertheless, investors slice and dice monthly, quarterly, and yearly "returns", placing great meaning on such numbers. Below we are going to engage in a little slicing and dicing, reframe the numbers in proper economic context, and hopefully shed some light on our strategy and results.

ACR EQR's top ten best and worst yearly periods relative to the market are shown below. Figures include the total gain from price appreciation and dividends for the year ending in the quarter indicated.

	1 Yr ACR EQR	1 Yr S&P500	+/-
2001-1Q	+48.11%	-21.68%	+69.80%
2001-2Q	+43.63%	-14.83%	+58.46%
2001-3Q	+24.65%	-26.62%	+51.27%
2001-4Q	+24.82%	-11.89%	+36.71%
2002-2Q	+11.34%	-17.99%	+29.33%
2002-3Q	+4.85%	-20.49%	+25.35%
2009-2Q	-2.80%	-26.21%	+23.41%
2008-3Q	+1.41%	-21.97%	+23.38%
2008-4Q	-14.55%	-36.99%	+22.45%
2002-1Q	+22.46%	+0.24%	+22.22%

	1 Yr ACR EQR	1 Yr S&P500	+/-
2005-3Q	+1.18%	+12.25%	-11.06%
2003-4Q	+17.68%	+28.69%	-11.01%
2007-3Q	+8.14%	+16.44%	-8.30%
2006-1Q	+3.48%	+11.72%	-8.25%
2003-3Q	+17.19%	+24.40%	-7.21%
2007-2Q	+14.61%	+20.60%	-5.98%
2005-4Q	-0.91%	+4.91%	-5.82%
2004-1Q	+29.66%	+35.12%	-5.46%
2006-2Q	+4.40%	+8.63%	-4.23%
2005-2Q	+2.70%	+6.32%	-3.62%

Three conclusions stand out.

1. ACR portfolio fluctuations can be very different than the market – some years are a lot better, others a lot worse. This is true, and probably always will be.
2. ACR beats the market by a lot more than the market beats us. This is true historically, and we hope this statistic persists.
3. ACR beats the market in declining markets, and the market beats us in rising markets. This is only partially true. ACR is likely to outperform in some rising markets, but not others.

We will elaborate on these three points in order.

ACR portfolios vary widely from the market and other asset managers because our strategy is different – we are absolute return focused. The essence of absolute return investing is to select a best ideas portfolio of stocks each capable of earning a specific return, without regard to the general market. The specific return reflects each stock's risk. Absolute return investing also means temporarily holding cash when prices are high and implied returns unfavorable. Absolute return investors are "benchmark agnostic". All we care about is protecting capital and generating the best return possible. If we do a good job at these two things, we will beat the market in the long run.

Some asset managers are unwilling to operate this way out of self-preservation. Institutional clients often require that portfolios perform with only minor deviations from the benchmark index, and prohibit holding cash. Managers, for their part, know they are unlikely to get fired if they underperform by only a little. Many investors also define risk as volatility relative to the benchmark, which we believe is wrong. This is remarkable to us. Having the wrong definition of risk in the investment business is like a physicist having the wrong formula for motion. In any event, we are willing to perform differently because we believe it is the best way to protect and make money.

The fact that ACR has beaten the market in yearly increments by a lot more than the market has beaten us simply reflects our long term outperformance. The real performance story is best told in the context of market conditions. We divide the past eleven years into four distinct periods. The key to assessing manager performance, in our opinion, is to review results in both an up and down cycle.

			Cumulative Return		Annualized Return	
Year	**Cycle**	**Description**	**ACR EQR**	**S&P 500**	**ACR EQR**	**S&P 500**
2000-2002	Down	Stock Crash / Recession	+67.2%	-39.0%	+20.5%	-16.4%
2003-2007	Up	Housing Bubble	+53.4%	+82.8%	+8.9%	+12.8%
2008	Down	Housing Crash / Crisis	-14.6%	-37.0%	-14.6%	-37.0%
2009-2011	Up	Profits Rebound	+59.0%	+54.2%	+9.7%	+9.0%
Total Period			**+248.4%**	**+8.3%**	**+12.0%**	**+0.7%**

Total returns are for the Equity Quality Return Composite and include dividends and capital appreciation net of all fees. Full composite performance and disclosures are updated quarterly on our web site. Composite performance summary is included with hardcopy version of this commentary. Period begins April-2000 and ends March-2011.

2000 marked the most overvalued market in at least one hundred years, and also contained some of the greatest intra-market stock mispricings ever seen. While most of the market was insanely overvalued, there were pockets of significant undervaluation. We doubt we will ever encounter market conditions as wonderful as these again, but here is to hoping!

The 2003-2007 market rose from a bottom in 2002 which was still somewhat high. This entire period for us was one of caution. Stock prices kept rising and were too high relative to earnings. Worse, earnings were inflated by an unsustainable consumer debt binge. We did not mind underperforming. Risk was ignored and mispriced. Protection was the order of the day.

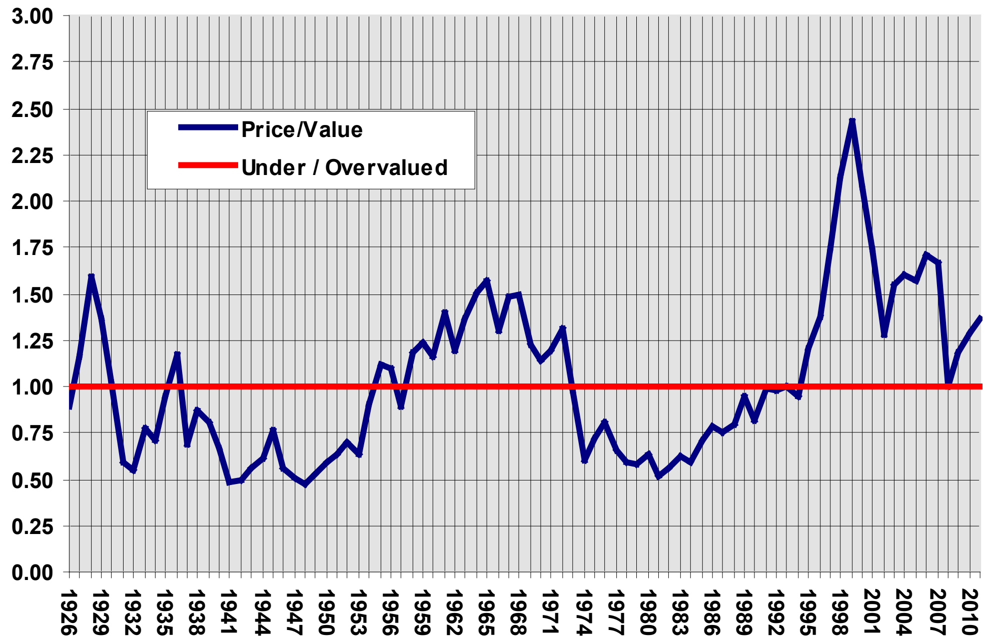
2008 marked the greatest financial crisis since the Great Depression. In the financial markets, the pendulum usually swings from one extreme to another, and this period gave us the opportunity to become aggressively invested again. The market, in our opinion, briefly became undervalued at the bottom late February and early March of 2009, and there were many bargains underneath the surface.

Please see pages 4-5 for additional important disclosures.

The 2009-2011 rebound has been nearly as sharp as the 2008 crash. We have participated on the way up, but at this juncture prices are getting rich again. This leads us to our final point.

ACR is likely to outperform in some rising markets, but not others. The reason why requires an even greater step back to really see the nature of the markets in which we have been participating.

S&P 500 Historical Price/Value for Investor Who Desires 8-9% Return



The chart draws a line at a Price-to-Earnings ratio of 16, suggesting the market is over-valued above and under-valued below this level. A return of 8-9% is implied by a P/E of 16, which we believe is reasonable for stock market risk. A P/E of 16 is also the historical average over this period. The earnings part of the P/E ratio is based on a smoothed trend-line of As Reported earnings to account for economic cycles and special charges. While our primary valuation work is always one company at a time, and a chart like this represents a crude framework for assessing value, it still allows us to make some general statements about market conditions.

The market passed through five distinct phases over this history. Overvaluation before the Great Depression, undervaluation during the most of the Great Depression to the early 1950s, overvaluation from the mid 1950s to mid 1970s, undervaluation again through the 1980s until the early 1990s, then overvaluation from the mid 1990s to today.

Generally, the time for defense is in over-valued markets, and the time for offense is in under-valued markets. The correct approach to the general market from the late 1990s to present was to play defense. In markets like these, we are likely to provide excellent downside protection, but may underperform in speculative markets when prices move from high to higher. However, we endeavor to

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still perform as well or better than the market when prices move from undervalued to somewhat overvalued, which is what happened in 2009-2011.

The correct approach to markets like those of the mid 1970s and 1980s was to play offense. Our goal would have been to aggressively seek the highest returning quality companies in a marketplace full of opportunity. Moreover, while always concerned with protecting against permanent losses, we would have been less concerned with downside volatility because prices were already so low. Regarding performance, we would expect to perform equally well whether prices were rising or declining in undervalued markets such as these.

We hope to never get there, since an undervalued market is a long way down from here. In our opinion, the market is selling for a P/E on normalized earnings of around 22 today – a potential 27% decline to the historical average P/E of 16, and a potential 55% decline to a historically low P/E of 10. There is no reason to believe the market will drop to these levels, but at the same time there is always the possibility. This is the reason we own a basket of stocks, not the stock market. And this is the reason we are still playing defense, after all these years.

Nick Tompras
April 2011

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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