

Hangover Part II

Performance

2012 extended both the economic recovery and bull market to four years, yet general stock market returns have been poor over the past five years due to the 2008 bear market. Annualized net-of-fee total returns for the ACR EQR strategy and the stock market*:

	ACR EQR	S&P 500
2008	-14.9%	-37.0%
2009	27.5%	26.5%
2010	18.6%	15.1%
2011	3.7%	2.1%
2012	10.9%	16.0%
2008 - 2012	8.1%	1.7%

** EQR (Net 1.25%) is the total return (dividends and capital appreciation) of the Equity Quality Return Advised SMA Composite calculated net of a 1.25% hypothetical annual fee. The EQR (Net 1.25%) return calculation is supplementary information based on the average recommended fee schedule across our client/partner base. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site. Actual fees may be higher or lower than 1.25%.*

The last five years is a good period for measuring investment manager performance since it covers both bull and bear markets. Beware performance presentations today of four years or less, a period dominated by strongly rising stock prices. Measuring investment manager performance only in bull markets is like keeping score only in good innings.

The ACR EQR value proposition is simple: safely generate equity-like returns. By “equity-like”, we mean something in the neighborhood of 5-7% over inflation. By “safely”, we mean doing it with bear market performance included.

We employ the following rules to deliver on our value proposition:

1. Focus on capital preservation - first, last, and always
2. Value businesses and buy at a discount
3. Ignore stock price fluctuations
4. Take advantage of low prices when others panic
5. Don't be greedy

After going up more than the stock market four years straight, we lagged in 2012. While we have always explained that falling behind the market in the short term is to be expected, we nevertheless cannot help being disappointed when it actually happens. Regardless of our feelings, we will never chase speculative markets higher, and will always stick to our stated discipline come what may.

Wide differences in returns between our portfolio and the market – both higher and lower – are actually a by-product of our strategy. The expectation of course is that higher will be significantly greater than lower over time as long as we have our valuations right.

Our strategy is to select a limited number of the cheapest quality stocks we can find and to never put too many eggs in one basket. This is in sharp contrast to the far more prevalent stock investment strategy of selecting a very large portfolio across all sectors of the economy and diversifying to limit fluctuations relative to the market. Had we structured our portfolio more like this we could produce more consistent results each year compared to the market, but almost certainly would have produced significant losses and ultimately far worse cumulative returns compared to the market over the past five years. For this reason we will continue to march to the beat of our own investment return drummer.

The following statistics help illustrate a more tangible point about our portfolio compared to the market – we believe that our strategy’s market return last year had little to do with the economics of our companies compared to the average company. The historical 10 year annualized earnings per share trend-line growth rate for our companies has been 8.0% versus 3.7% for the average S&P 500 company. The estimated earnings yield for our companies is 8.4% versus 4.5% for the average S&P 500 company. Lastly, our companies have less debt with an interest coverage ratio of 8.3 versus 6.7 for the average S&P 500 company.

Overview of Portfolio Changes

2012 was once again a busy year. We sold three positions entirely and cut three positions roughly in half. As the table below shows we have been a little more active in the past few years.

Year	Turnover
2012	21.7%
2011	20.8%
2010	21.1%
2009	14.2%
2008	18.7%
2007	10.1%
2006	3.3%
2005	4.8%
2004	17.6%
2003	24.1%
2002	9.3%
2001	10.0%
2000	11.9%
Average	14.4%

Fortunately the three positions were largely sold for good reasons – the companies performed more or less as expected and reached full value. One of the three was a company we let run above its intrinsic value because we remained confident in the quality and growth of its cash earnings stream. We prefer to hold such companies as long as possible and sell them at a premium unless we have a great replacement. The other two companies that we sold entirely had a few unseemly warts – one a potentially significant legal liability, the other a concern with management's judgment. Therefore, once they approached full value, we decided to cash out.

The three positions we cut in half were all of companies in which we have a good deal of confidence but were nearing full value. Should other opportunities come along they would be an additional source of funds. In the meantime we wanted to reduce their position sizes because they were too large at over 6% of the portfolio each. We believe a more sensible position size, given our continued confidence in their cash earnings stream, yet near full value, is approximately 3% each.

We added to several current holdings and purchased one new company, yet our cash position still increased this year. Current fully seasoned accounts that have been with us for the past several years hold approximately 10-20% cash and newer accounts 30-50% cash. The newer accounts are invested only in companies we consider a buy, whereas fully seasoned portfolios contain both buy and hold companies. Newer accounts will become fully invested as we add new holdings or as hold companies slip back into buy territory. We think of this as intelligent dollar cost averaging and normally expect this period to last 12-18 months. Please note clients and partners can request that new accounts become more fully invested quicker if they prefer.

There are two ways to make money in the stock market: (1) buy when all stocks are cheap, (2) buy when specific stocks are inefficiently priced. The cheaper the market, the greater the inefficiencies, the better the potential returns. Unfortunately, today's market in our opinion is not cheap, nor are we finding tremendous inefficiencies in valuations. Overall we would rate this market a C- for opportunity. That said, we do believe we will be able to work our cash down in due time after all of our selling the past few years. Of the over 400 valued companies we have on deck, there are at least 20 that appear undervalued. We are diligently studying these companies as worthy replacements, as well as continuing to explore potential opportunities not on the list.

Please note that regulators prohibit us as managers of separate investment accounts from publicly identifying and discussing our specific holdings on an ad hoc basis without discussing in equal measure all holdings past and present. Our quarterly research notes systematically cover individual companies and our rationale for holding them. Our quarterly partner/client conference calls are a great time for clients and partners who have questions about specific holdings to ask so we can discuss in greater detail.

Hangover Part II

The economy is on the mend and both consumers and investors are more optimistic today than they have been in a long time. It is odd how optimism finally breaks out after the market has increased over

125%, and equally odd how pessimism was the order of the day 125% ago when buying opportunities were most abundant.

The economic hangover from the debt induced housing bubble was the Great Recession and the now lethargic recovery. Multi-trillion dollar fiscal and monetary stimuli were required to prevent a showing of Great Depression II. We believe these tools were absolutely necessary and well used. However, Hangover Part II is coming to theatres near you. It is likely to take two forms.

The first is the removal of fiscal stimulus, better known as the fiscal cliff. While the fiscal cliff has for now turned into more of a slope, reduced government spending will sap both GDP and corporate profits. A large portion of the unsustainable spending by consumers who used their houses as piggy banks was replaced by government spending which appears to be in the early stages of official retreat.

The second form is the eventual removal of a massive, prolonged monetary stimulus and ultra-low interest rate regime. In our opinion the Fed is orchestrating a bond market bubble, and practically all asset classes will eventually have to surmount a wall of rising interest rates as the economy gathers steam. The good news is this hangover will likely come about due to economic strength, producing a growth headwind rather than a recessionary black hole.

The question for stock prices is whether or not they, like the high grade and junk bond markets, will succumb to the manna of low interest rates with expanding price/earnings multiples. We believe the market is reasonably over-valued today, and any significant short-term increase in stock prices will be a temporary bubble almost sure to eventually pop. We will not lose our valuation discipline and buy stocks at ever higher multiples that some commentators will erroneously claim are justified due to abnormally low interest rates.

It follows then that under circumstances in which a bubble forms quickly we are likely to lag the general market, but we will also avoid Hangover Part II in stocks, a story we know does not end well. The hope for continued recovery and sensible stock price gains is that the handoff from government spending and lending to private sector spending and lending comes off with a mild hangover rather than a return to recession. Fortunately we expect our portfolio companies to produce satisfactory equity-like returns over time given their quality and current valuations either way.

*Nick Tompras
Chief Investment Officer
January 2013*

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

IMPORTANT DISCLOSURES

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The Equity Quality Return (EQR) Advised / SMA Composite consists of equity portfolios managed for non-wrap fee and wrap fee clients according to the Firm's published investment policy. The composite investment policy includes the objective of providing satisfactory absolute and relative results in the long run, and to preserve capital from permanent loss during periods of economic decline. EQR invests only in publicly traded marketable common stocks. Total Return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site at www.acr-invest.com.

The S&P 500 TR Index is a broad-based stock index including reinvestment of dividends and has been presented as an indication of domestic stock market performance. The S&P 500 TR index is unmanaged and cannot be purchased by investors.