

## The Low Rate, High Profit Value Mirage

ACR has been taking more profits than investing recently – in the past two years we have sold eight companies while purchasing just four. The reason is a market for stocks which in our opinion has become increasingly unattractive due to soaring prices relative to underlying values.

Prices are soaring because investors are buying at ever higher prices, and the case for unfettered stock buying remains strong. The economy is improving. Interest rates are at historic lows. Stock dividends of 2-3% are better than cash at 0%. Best of all, stock valuations are relatively cheap with a price-to-earnings ratio of 16.

We agree the economy is improving, albeit at a snail's pace. GDP per capita growth and employment gains may be disappointingly weak, which our macroeconomic adviser Steve Fazzari correctly forewarned, but they continue to inch forward nonetheless. While no credible prognosticator can promise continued economic growth, there is no tangible evidence that a new recession is at hand either.

Interest rates are a different story. They may be at historic lows, but what happens when they rise? The recent small bounce in rates and attendant decline in bond and stock prices is a small harbinger of what is likely to happen when a more enduring increase takes hold. Note that bond prices should remain permanently lower given rising rates, but stock prices are likely to be buoyed by longer term economic growth and therefore should face more of a headwind than a permanent decline. While we may know the outcome of rising rates, we have no idea of the timing, whether tomorrow or in twenty years. Still, we want to protect our client capital.

Protection from rising rates requires avoidance of companies with excessive short-term debt or financial institutions that borrow short and lend long. Financial firms that hold long-term loans at historically low rates and borrow at short-term rates are vulnerable. In the EQR portfolio, our industrial companies have limited debt and our financials should generally benefit from rising rates due to their diverse business lines and asset/liability mix.

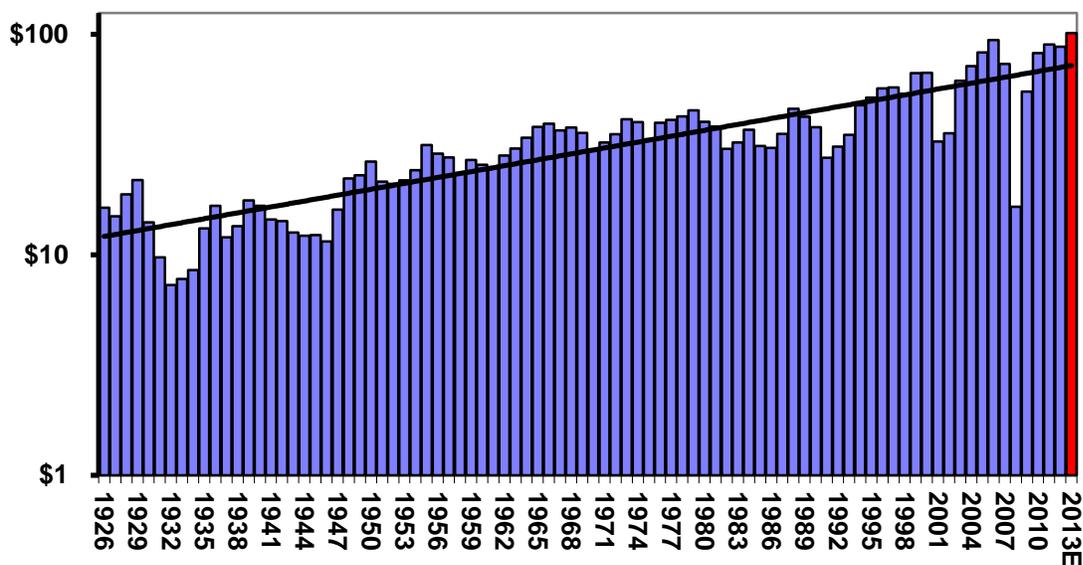
The larger issue regarding interest rates centers on valuation. The blanket statement that low interest rates should produce higher stock values is in our opinion flawed. This idea is usually supported by two arguments. First, there is no other place for money with rates so low. Second, low interest rates mean lower discount rates in stock valuations, the mathematical upshot of which is higher stock prices<sup>1</sup>.

Taking the second argument first, we believe lowering discount rates on stocks would be a major valuation mistake. First, real yields (after inflation) are the correct barometer for an apples-to-apples comparison of stock yields and interest rates, since stocks are a hedge against inflation in the long term and bonds are not. An increase in stock values under the lower discount rate theory would require the following to be true: long term real yields will be permanently lower because the Federal Reserve is temporarily holding down nominal yields. We find this statement illogical, and would find any case for permanently lower real yields improbable.

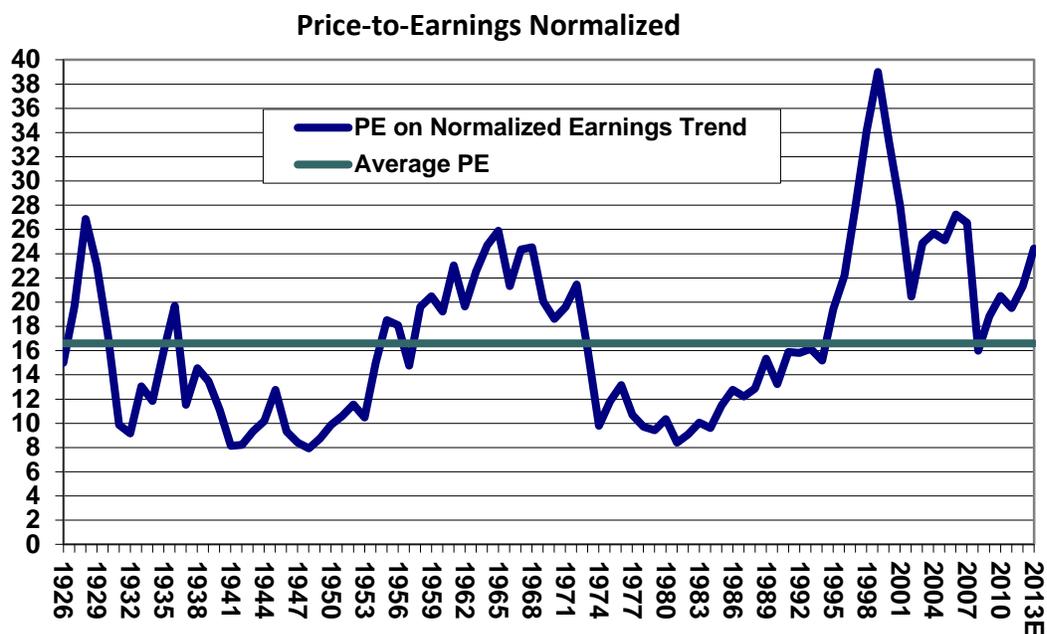
Under the first argument, that there is nowhere else to put money with rates so low, the strategy response would be to own stocks as long as they continue rising due to lower rates, then sell once rates start to rise. If one can predict exactly when the Fed will end its policy of low rates, and sell stocks and bonds just at the right time, more power to them. In our opinion, this is the same argument that called for selling technology stocks just before the Internet bubble burst. ACR will not speculate with our client capital based on unpredictable short-term events.

This leads us to the final and real valuation problem: the price-to-earnings ratio of 16 assumes current profits are normal and the base on which future earnings will grow at historic rates. The chart which follows illustrates our belief that there is a very large difference between current reported profits and normalized profits. The trend-line in the chart above is at \$69.31 per share and current estimated 2013 earnings per share are \$101.31, a difference of about 1/3<sup>rd</sup>.

**Corporate Profits – S&P 500 Earnings per Share Adjusted for Inflation**



Using \$69.31 for earnings rather than \$101.31 produces a price-to-earnings ratio of 24 rather than 16, 50% above the historical average. The chart below shows that today's normalized price-to-earnings ratio is at the upper end of the historical range, especially if you remove the seemingly anomalous stock market bubble of the late 1990s.



Please note our argument is not that current earnings will suddenly drop. Earnings could rise in the short-term, eventually taper off, and then reach more normalized levels after the next recession. We have no idea precisely how the earnings cycle will play out. Rather, our argument is simply that earnings are forever cyclical, and that properly evaluating the dynamics of earnings peaks, valleys, and growth rates is essential to getting stock values right.

The figures and two charts presented here for the overall market illustrate our point that stock prices are stretched relative to underlying values. However, our company valuations are what really matter. Unfortunately, the story is much the same at the individual company level. The vast majority of companies that we are evaluating today appear over-valued to us.

Despite these conditions, the ACR investment team continues to search exhaustively for under-valued stocks. Fortunately there are still a few. We are confident that the current EQR portfolio is comprised of under-valued to reasonably valued quality companies. Additionally, our on-deck group of approximately 450 valued companies currently contains several that could be under-valued. We are doing additional research on these companies and others as we write.



Hopefully our work will turn up a few more stocks to buy in the near term. Regardless, we believe that over time opportunities will appear – they always have. In the meantime we will exercise patience. Cash may not provide a return *on* capital today, but we are assured it will provide a return *of* capital.

*Nick Tompras  
Chief Investment Officer  
July 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/>*

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<sup>i</sup> The discount rate is the interest rate that is used to calculate the present value of the future cash flows of an investment. Discount rates vary inversely with present value, holding future cash flows constant. Intuitively, if a higher investment value is paid today, holding future cash flows constant, the rate of return on those cash flows is lower.

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