Swimming against the Tide

Let us begin our 2013 year-end commentary by celebrating. The economy is expanding, stock markets are soaring, and house values are recovering. The 2008 Great Recession was not the Great Depression it could have been. 2013 was a good year, the 5th year of recovery, tepid or not.

Now for a little cold water, not because we like playing spoiler, but because of valuations and economics.

- The 2013 stock market in our opinion crossed the threshold into the realm of unreasonably high prices from the more comfortable confines of reasonably high prices.
- Domestic stock prices are on average 26-27 times higher than our estimate of sustainable corporate earning power. The long term historical average is 16-17 times, nearly 40% lower.
- Two key drivers of the recovery are likely to become headwinds going forward. Monetary stimulus is likely to shrink and fiscal policy is unlikely to expand. Consumers and businesses will have to pick up the slack.

The good news is that the private sector seems to be kicking in. The bad news is that even a reasonably strong economy does not in our opinion support current stock prices for most companies. Our response to the over-valuation is summarized below:

- ACR equity portfolios are extremely conservative in terms of quality, value, and cash reserves – we believe this will protect our client capital and provide higher long term returns than more aggressively postured portfolios.
- Our equity portfolios are almost certain to under-perform the market significantly in the short term if prices continue rising at their current rapid trajectory.
- We do not know how long this bull market will run, but jumping on the bandwagon today for overall price gains is in our opinion a speculative undertaking with Las Vegas type odds.

The ACR EQR strategy predictably performed better in the earlier stages of the bull market, when prices were more reasonable, and is beginning to lag the market as prices become more speculative. Our objective is to add value through a full cycle of both rising and declining prices.

	EQR (Net 1.25%)*	S&P 500
2000-2013	11.6%	3.5%
2008-2013	10.6%	6.2%
2008	-15.0%	-37.0%
2009	27.5%	26.5%
2010	18.5%	15.1%
2011	3.8%	2.1%
2012	10.9%	16.0%
2013	23.5%	32.4%

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**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 at www.acr-invest.com. Actual fees may be higher or lower than 1.25%. Period begins April 3, 2000; period ends December 31, 2013.*

ACR once again finds itself swimming against the tide. The bullet point conclusions posited above largely stem from the analysis of individual companies, supplemented by macroeconomic analysis which informs key valuation inputs. The bottom-line: our valuation compass has been pointing us back toward a defensive position in the past two years as stock prices have continued their ascent.

Swimming against the tide is familiar territory for ACR's long-time investors. In the late 1990s, market participants rushed headlong into rapidly rising technology and large company growth stocks. ACR, on the other hand, entirely avoided these epically over-valued shares and found value in downtrodden mid-sized industrial companies. We profited from these investments in 2000-2002 as the overall market and tech stocks crashed.

A new bubble from 2003-2007 formed in riskier companies and financial assets. ACR's valuation compass pointed us once again in the opposite direction to defensive stocks and cash. Our EQR equity strategy under-performed the market during this period. The "cost" of under-performance, however, was well rewarded when the market crashed in 2008. ACR protected on the downside as we were able to once again deploy our ample cash reserves.

The 2008-09 decline was both deep and broad spanning all asset classes globally except cash and high grade bonds. Warren Buffett once famously remarked, "It's only when the tide goes out that you learn who's been swimming naked." The vast majority of investors, amateur and professional like, were shockingly exposed in 2008, and it was not a pretty sight. As is often the case after a violent outflow, the tide turned on a dime, and prices have risen dramatically since 2009.

In our opinion investors have once again thrown caution to the wind across most major asset classes, including an identifiable bubble in domestic small company stocks. ACR is presently holding a basket of very large high grade companies and one of the highest cash positions in our history. For the first time ever, we do not own a single small or mid-sized company. This is not due to any prejudice against smaller firms. In 2000 we were invested almost entirely in mid-sized and smaller companies. We are simply going where we believe the value is.

The remainder of this commentary will include a summary of recent portfolio changes, an explanation of our valuation rationale, and a discussion of our cash position. (Please note, we would prefer to discuss individual stock decisions, but the SEC prohibits us as a separate account manager from naming recent transactions without discussing in equal detail all current holdings and past transactions. ACR's Research Notes published quarterly contain summaries of individual companies and are rotated in a way that complies with SEC regulations).

ACR closed 3 positions, trimmed 3 positions, and purchased 1 company in 2012. We closed 7 positions, trimmed 2 positions, and bought 3 companies in 2013. In short, we sold 10 companies and purchased 4 companies over the past 2 years. The reason our cash balance rose was these “bottoms up”, one-company-at-time changes that left us with fewer companies than before, not “top down” analysis of values or any attempt to forecast stock prices. We believe the best way to understand corporate values is by studying companies, not the market.

The lack of purchases relative to sales was not for lack of looking. One might think that with three portfolio managers and over 4,000 public companies, we could find *something* to buy. Despite turning over stone after company stone, few companies appear attractively valued. The reason is our basic framework for valuing companies and our stubbornness in sticking to it.

Valuation calculations can be broken down into three basic inputs: a required return or discount rate, current cash earning power, and the future growth of cash earnings. The required return is the interest rate that takes the future cash flows of a company and discounts them to a present intrinsic value. The intrinsic value can then be compared to the stock price for a purchase or sale decision. ACR is not lowering our required return because interest rates are low (our July 2013 commentary discusses this issue in greater detail). Investors who lower their required return on stocks can justify paying much higher prices relative to profits.

A simple question will help answer why we will not lower our required return: what happens if interest rates rise? The difference in valuation for a 30-year bond when rates rise from 4% to 6% is a decline of 27%. If the reason stock prices are higher today is that interest rates are lower, then stock prices could very well decline by a similar magnitude to a 30-year bond if interest rates were to rise. Note that it is possible for nominal interest rates to actually decline while real interest rates (after inflation) rise. A low inflation or mildly deflationary period could produce such a phenomena. Stocks we believe would decline as described above due to a rise in real interest rates.

We have spoken often in past commentaries about current cash earning power and the importance of adjusting earnings for the economic cycle. Another way of thinking about this is to view earnings as a long term continuum of yearly earnings rather than earnings in a current year coupled with a future growth rate. Viewing earnings as a continuum, one sees that periodic peaks and troughs naturally require smoothing to establish the true path of earnings at any single point in time. Our evaluation of cash earning power calls for a significant discount to current earnings for more economically sensitive companies.

Could our framework be flawed? We certainly consider the possibility – over and over again. Obviously we have not changed our conclusions, but what are the consequences if we are wrong? The most likely consequence is that we earn a lower return than we otherwise would. Nevertheless, we believe this lower return would still prove satisfactory in absolute terms, meaning something in the neighborhood of inflation plus 5%. We certainly hope to do better, and have done better in the past, but for planning

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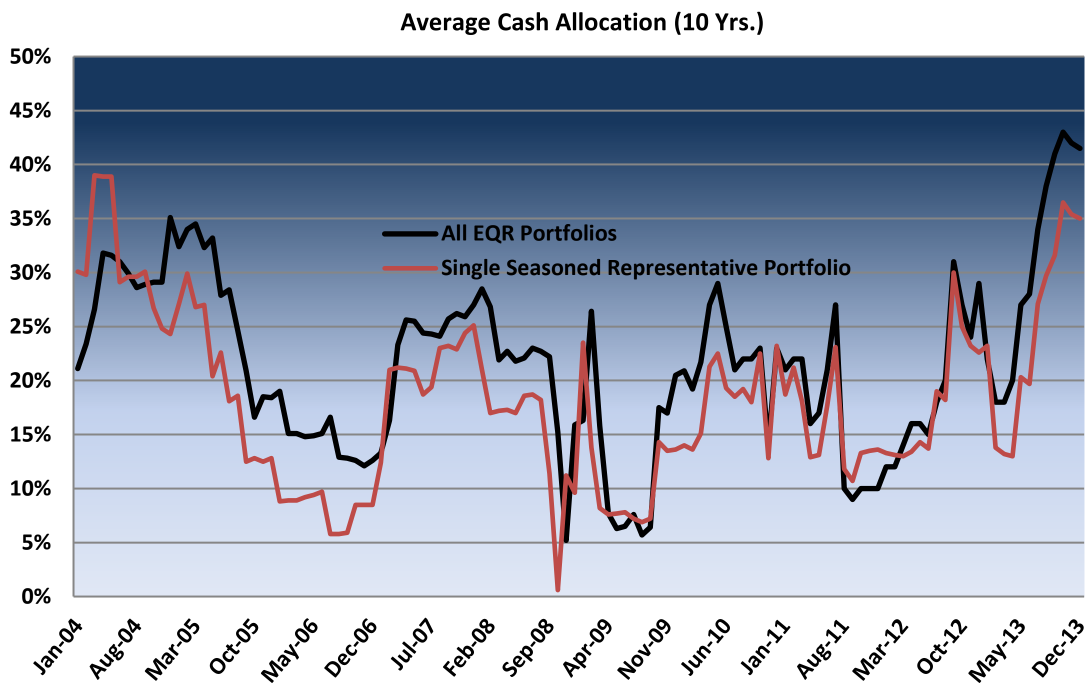
purposes 5% plus inflation is in our opinion a reasonable estimate. We also believe the overall market from here is likely to do materially worse based on current valuations.

The next chart shows the average EQR cash balance for essentially all EQR accounts and the cash balance for a seasoned representative portfolio with no cash flows.



Source: ACR's analysis

Note: Average cash includes all EQR strategy managed accounts; newer portfolios may have higher cash allocations and older portfolios may have lower cash allocations than averages shown on above chart. Single Seasoned Representative Portfolio is an actual portfolio invested in the EQR strategy and has had no cash flows since its inception.

Holding cash in a stock portfolio is controversial. It seems a lot more controversial when the market is going up, whereas the controversy mysteriously dissipates when the market starts going down. Either way, holding substantial amounts of cash is unusual for a traditional stock fund manager. We have talked at length about this subject in the past, but with many new investors in the ACR fold, and because we are at historically high cash levels again, it is an opportune time to delve into our rationale for holding cash.

The EQR investment policy published in 1999 offers the following statement about cash holdings:

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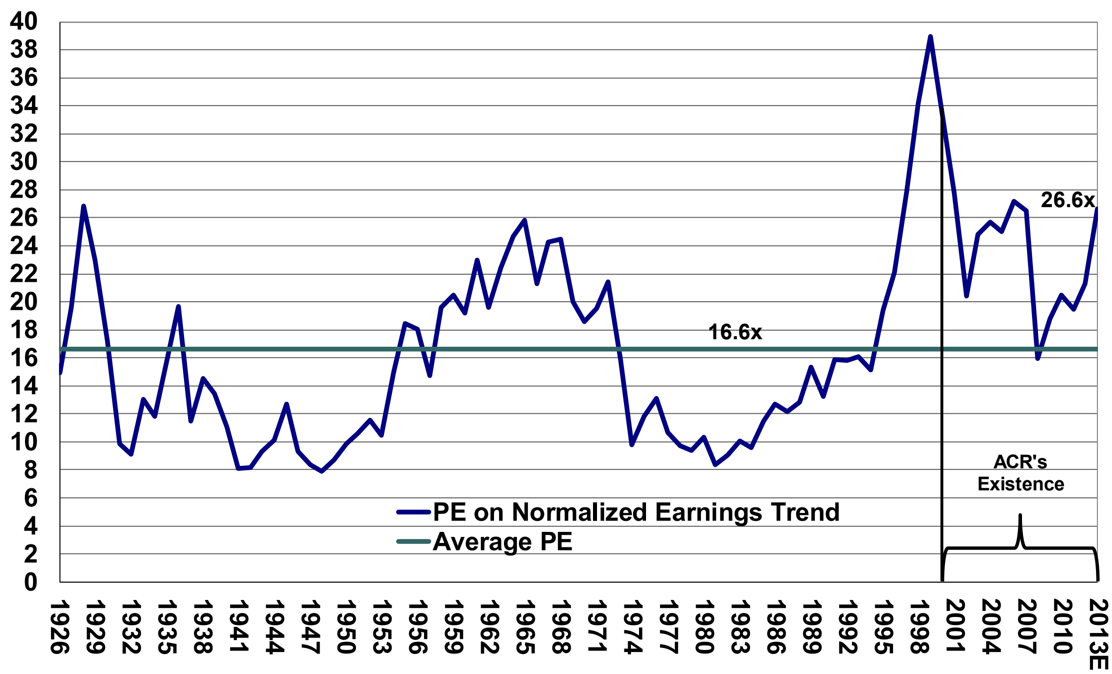
EQR strategy preference is to remain fully invested. However, cash is oftentimes held. The strategy is to own a select group of businesses with the orientation of a private investor; therefore, when a new account is established, businesses are selected one at a time. Cash is held when there are no attractive opportunities and prices exceed values in the selection universe.

Investment approach, capital protection, and valuation discipline are the key concepts behind our cash policy.

Our investment approach is that of a private investor who purchases a company for the cash profits it generates. The profit value of a company is not generated in a quarter or year, but over many years as dividends are paid and profits reinvested. Carefully selecting the right companies for the next five to ten years, rather than trying to capture short term market price increases, is our main concern.

Our foremost principle is capital protection. Equity markets can become over-valued. We will not force cash to work at the risk of large losses. The chart below shows our view that markets have undergone periods of long term over-valuation and under-valuation, as well as our belief that ACR has been investing in a secular over-valued market for its entire existence as a firm. Periods of over-valuation in our opinion call for a defensive posture which may include significant cash reserves when prices approach extreme levels. Conversely, if we came into a period of normal or extended stock price under-valuation, ACR would likely remain fully invested over a period which could extend for a decade or longer.

S&P 500 Historical Price-to-Earnings Ratio



Sources: S&P Statistical Service; S&P Index Services

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The secular periods illustrated above offer a 30,000 foot view of potential opportunity. ACR invests "on the ground" in a portfolio of companies, not the stock market. The general market can be high, and there can still be numerous bargains due to wide intra-market discrepancies in values. The year 2000 epitomized such conditions. The greatest stock market bubble in US history was peaking, and ACR was able to remain fully invested because the market at that time was so absurdly inefficient at pricing companies. Today is not one of those times. We are able to find a few companies that we believe are significantly under-valued, but not nearly enough to deploy all of our cash.

The best defense can also be the best offense. Cash has "optionality" – the option to buy at a future price which may be lower than today's. Put another way, volatility and patience can be our friends. Holding cash for 3-6 months to catch a stock when it is down 20-30% improves our return commensurately.

Given the key concepts of investment approach, capital protection, and valuation discipline as developed above, portfolio level cash is held under three general circumstances: (a) "defensive cash" is held in highly over-valued markets in which we cannot find sound opportunities; (b) "new account cash" is held and invested slowly in less attractive markets; (c) "frictional cash" is held when one or more stocks have been sold and due diligence is not yet complete on their replacements.

While a by-product of holding cash is lower volatility, our objective is still to provide an equity-like return on the investor's total portfolio. We will always ask investors to judge us on bottom-line portfolio returns, regardless of how much cash we decide to hold along the way. Our cash position and our highly focused group of holdings means our returns can be very different from the market year-by-year, higher or lower. On that score, we do not know what the coming year will bring, but remain confident that we are positioned well for the next several years.

Nick Tompras
Chief Investment Officer
January 2014

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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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.

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