A Few Reflections on Risk

The past 15 months have been an economic rollercoaster: a pandemic, market crash, severe recession, polarizing election, and dazzling recovery. We have made the best of it. ACR strategy market values surged over the past six months on both an absolute and relative basis (for updated results see www.acr-invest.com/strategies). Intrinsic values have also grown, leaving the quarter-end price/value of our flagship EQR strategy a still-reasonable 0.89[1]. Oddly enough, after all the drama of 2020 and a gross cumulative return of 40% in our EQR strategy from January 1 of that fateful year to March 31, 2021, we are positioned just as we were at the end of 2019: we own a reasonably priced portfolio in a sky-high market.

Equity prices have always been tossed about by speculative bets on economic events. These fluctuations often obscure price adjustments resulting from the rational calculation of long-term fundamental value. Yet market prices in well-functioning market economies always tend towards intrinsic values in the long term. The dichotomy of value investing is that we rely on the market to first get it wrong, then to get it right. The markets of 2020-21 have been extreme in this regard. New investment vehicles, including all manner of ETFs, have allowed market participants to place more bets than ever without conducting detailed company-level due diligence. The current betting has, for now, pushed the prices of our holdings back to more reasonable levels. It follows that the dominance of speculation in today's financial markets makes it impossible to say how the prices of our holdings will behave the rest of this year. Fortunately, it doesn't matter.

What matters are the long-term cash flows of the companies we own and the prices we buy and sell them for: these are the variables that will mathematically determine our investment return. If we thought that speculating directly on general economic events themselves—interest rates, inflation, economic cycles, or broad technological themes—was easier and more profitable, we would devote our resources accordingly. As it is, we think that most market participants are rolling the dice when placing direct bets on macroeconomic or thematic outcomes. Knowing what you don't know is as important as what you do know. Fortunately, speculative market extremes can create great buying opportunities in individual businesses. While obvious purchase candidates develop at pessimistic lows, more subtle opportunities can also develop near market peaks. In the late 1990s and the past several years, for example, capital was sucked into popular technology shares and out of more profitable businesses that failed in the sexy story department but were cheap.

In our previous commentary, we reflected on capital protection, and by extension, what risk is, and is not. Risk is the likelihood and potential magnitude of a permanent decline in the earning power of the companies we own, or the payment of a market price at purchase that is higher than intrinsic value. Risk is not volatility. Volatility oftentimes reflects risk, yet always in retrospect, and not always well. In many cases, and in many times, volatility does not reflect risk at all. Value investors are presented with this idea early in their careers when they read Warren Buffett's "The Superinvestors of Graham-and-Doddsville" in the first appendix to Benjamin Graham's *The Intelligent Investor*:

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> The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now [1984], so the person who would have paid $400 million would not have been crazy. Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people who think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million. And, as a matter of fact, if you buy a group of such securities and you know anything at all about business valuation, there is essentially no risk in buying $400 million for $80 million, particularly if you do it by buying ten $40 million piles for $8 million each.

As a green portfolio manager starting out in the early 1990s, the concepts presented in this vignette resonated with me immediately. ACR has written extensively over the past 20 years about the difference between fundamental risk and price volatility, and how volatility is our friend. Yet it took the COVID-19 pandemic to really bring home how it feels to invest in stocks that, like the Washington Post in 1973, were dirt cheap and declining faster than the market. We believed that the prices of the stocks we were buying in March of last year were not properly reflective of their risks and values. They were the victims of blind panic selling out of anything economically sensitive, as well as myopic buying into everything pandemic positive. In our view, a major risk today is the stagnation and possible collapse of pandemic-driven stock valuations that turn out to be unsupported by sufficient profitability.

Just because we focus on investing in companies rather than speculating on macroeconomic events does not mean macroeconomic variables are unimportant. Indeed, they have become more important in recent years as central banks and governments have intervened in the economy on an unprecedented scale outside of wartime. Because we rely on a functioning economy for *all* our investments, and because we own more economically sensitive holdings today, it makes sense to spend some time on big-picture economic observations and risks. Before getting to specific points, a blanket statement is in order. Many economic and political events cannot be forecasted. The only way to protect against unforeseen calamitous events is to own a quality portfolio capable of surviving a one-hundred-year economic flood. ACR's foremost objective of protecting capital means we endeavor to always maintain such quality. We may leave some money on the table by not owning a riskier basket of holdings when such assets are unduly cheap, but we are comfortable doing so to protect against an uncertain future.

Our observations begin with good news: the economy is likely to be very strong in the coming year or two. This is a relief. In our opinion, had the US Federal Reserve and Treasury not acted with a very large and immediate monetary and fiscal response to fill the severe decline in output and employment beginning in March 2020, we would likely have fallen into a deep and lasting depression. Two common risks are cited resulting from this response: inflation and an unsustainable debt load. Regarding inflation,

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our macroeconomic advisor, Professor Steve Fazzari, raised the possibility of pricing pressure this year for the first time since we began working together 14 years ago. This is in marked contrast to Steve's steadfast opinion that the large (at the time) monetary and fiscal stimulus of 2008 and 2009 would *not* cause inflation, and that the recovery thereafter would be anemic. Steve's heterodox views were spot on, which is why we took notice when he indicated that the current stimulus is finally large enough to possibly, not probably, affect *short-term* inflation. He believes long-term higher inflation from the stimulus is much less likely. We do not consider inflation to be a major concern for two reasons. First, disruptions from higher inflation in the short term would be unlikely to impair the intrinsic value of our holdings, and could even create opportunity, as fears of the unknown and rising rates cause asset price declines. Secondly, our overall equity portfolios ought to do reasonably well under longer-term inflationary conditions since our companies have strong enough competitive positions to raise prices with costs.

A potentially greater concern is a US government debt crisis. The first step in assessing this risk is to quantify one-time balance sheet debt compared to annual production and income levels. The Congressional Budget Office (CBO) projects that US government debt held by the public will reach $23.5 trillion by the end of 2022. This is the total amount of debt that citizens of the United States owe to each other (~2/3rds) and the rest of the world (~1/3rd). A large number indeed! However, this figure must be understood in the context of GDP, which is earned *annually*. The CBO forecasts $23.0 trillion in GDP in 2022. Since the debt/GDP ratio is approximately 1.00, the math is simple. A real interest rate of ~2% per year (the current rate is ~0%) is equivalent to ~2% of GDP per year. A percentage this size, or even somewhat larger, appears manageable. Therefore, our primary concern today is not a US government debt crisis. That said, debt/GDP ratios cannot rise forever. While we have reasons to believe that they will not, a more complete discussion of debt/GDP dynamics is beyond the scope of this commentary. We are happy to address this topic further in Q&A during quarterly conference calls and client presentations.

Our foremost concern today remains the extremes in equity and debt security prices driven by persistent *monetary* stimulus. We highlighted in our Q1 2020 commentary the failure of monetary stimulus as an economic growth engine, especially near the zero bound, as well as its inability to cause runaway inflation, which so many incorrectly predicted for so long. While spurring neither growth nor inflation, the monetary lever of central-bank asset purchases is holding rates lower than they otherwise would be. Inordinately low government debt rates are in turn contributors to insufficient corporate credit yields and all-time-high cyclically adjusted price-earnings ratios, a theme which we have elaborated on in various commentaries since 2013. Therefore, in our view, while a strong economy may fool investors in the near term, today's greatest risk is high financial asset prices on normalized profits and growth rates. ACR will continue to deploy capital at satisfactory *absolute* rates of return, which we believe will be a necessary tonic for the low-return environment of the 2020s.

Nick Tompras
April 2021

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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IMPORTANT DISCLOSURES

[1] The Price/Value is ACR's estimate of undervaluation based on market prices and Fundamental Value. Fundamental Value is ACR's estimate of what a company is worth based upon our estimate of its future cash flows and their riskiness. Ultimately, Fundamental Value represents the portfolio manager's subjective estimate of business value.

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