Lessons and Myths

The performance of most equity asset classes has been very good in the past two years. A more important question is how did an investor fare through both good times and bad? Results for the past three years answer this question – they include the crisis year of 2008 and the rebound years of 2009-2010.

	2008-2010		2009	2008
ACR Equity Composite	9.3% Per Year	19.2%	28.1%	–14.6%
S&P 500 Index	–2.8% Per Year	15.1%	26.5%	–37.0%

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.

We are thrilled to have come through the greatest financial crisis since the Great Depression relatively unscathed.

A crisis can be a great teacher if the right lessons are learned. Below are six investment lessons which we believe the crisis revealed, and six myths which we fear have been learned instead.

Lesson #1: Diversification is Not Enough

Most professional investors pray at the altar of diversification. Valuation and quality, however, are equally critical, and were indispensible for protecting capital during the crisis. Adhering to the principles of valuation and quality during the crisis required moving from one asset class to another (i.e. holding cash) or focusing on a narrow group of investments with very different characteristics from the market. ACR employed both methods.

The typical professional investor did not. The problem can be found in two common industry practices. Professional advisors and consultants oftentimes construct widely diversified portfolios across asset classes with very small allowances for asset class shifts. They then hire money managers who operate widely diversified portfolios in narrow categories which in effect prohibits them from significant movements in asset classes or concentrations in the right assets. The result is a market portfolio on market return autopilot.

Lesson #2: You Can't Spend Relative Returns

When market returns are poor by a mile, there is little glory in beating the market by an inch. No long term period in market history better emphasizes this point than equity market performance since the worldwide market peaks in 2000.

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	2000-2010 Annualized Return
US Stocks (S&P 500)	0.2%
World Stocks (MSCI EAFE)	–0.5%
US Real Estate (MSCI US REIT)	–1.2%
US Housing (S&P/Case Shiller)	2.9%
World Real Estate (S&P Global REIT)	5.9%
ACR Equity Composite	11.9%

Annualized return beginning 3/31/2000 and ending 12/31/2000 except for the S&P/ Case Shiller which ends 9/30/2010. 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.

Our results were satisfactory because we insisted on absolute returns rather than relative returns, and because we had the latitude to go where the value was.

Lesson #3: Market Volatility is Frightening and Painful

The broad based feeling of terror in financial markets from late 2008 to early 2009 we never want to forget. We underestimated everyone's, including our own, emotional susceptibility to market declines.

In addition to emotional turmoil, market declines produce real financial pain. Consumers stop spending when they feel terrorized. Revenues and profits decline, and asset prices decline further. The process is self fulfilling. Reading about it is one thing, but there is nothing like having been there to truly appreciate the difficulty of making rational decisions in an historic financial panic.

Lesson #4: Market Volatility Presents Opportunity

Fortunately, we were able to push through the fear, and even more fortunately, we have wonderful clients who trust and understand what we do. This allowed us to take advantage of the opportunities then available rather than cashing out at exactly the wrong time or staying on the sidelines as so many investors did.

Our return of 9% per year the past three years, if measured to our estimate of full intrinsic value, would be approximately 14% per year. Neither result would be attainable at the end of 2007 were it not for the wonderful buys which became available in 2008 and 2009.

Lesson #5: Financial Institutions are by Nature Unstable

The boom, bust, and flight cycle is familiar to any student of economic history. The bust is generally economic in nature. An unsustainable speculation comes to an end, and the economic flows and values so produced crash. Flight is more of a fear induced psychological phenomenon. Financial institutions –

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bank, hedge fund, or money manager – are by nature vulnerable when everyone panics and decides they want cash at the same time. The long bank lines during the Great Depression and the massive withdrawals from money market funds in 2008 are one and the same. The only difference today is we have new tools to try to stem such events, but ultimately it is impossible to stop investors from fleeing to cash in a crisis.

Lesson #6: Government Intervention Saved the Day

For an honest account of how panicked and uncertain our leaders were during the crisis, read longtime Goldman Sachs chief and Treasury Secretary Hank Paulson's *On the Brink*. The mass fear was magnified in leaders like Paulson who felt the weight of the world on his shoulders. Their response was to throw everything they could at the economy to stop it from hemorrhaging.

It is easy to be critical after the fact. Certainly more was done than necessary, and much was done poorly. In our opinion, however, the decision to stand behind the money and commercial paper markets, which stemmed the flow of funds from critical working capital functions such as payroll and inventory, saved us from what could have become a far more severe contraction. The final chapter has yet to be written, but we believe government played a critical role as lender of last resort.

Myth #1: Next Time – Sell before it Falls; Buy after it Stabilizes

Our defensive posture in 2007 was not in anticipation of a major market decline. Our defensive posture was based on our analysis of valuations – both market prices and corporate profits were dangerously high (see our May 2007 Commentary *Risk Control*).

Attempting to sell in anticipation of a major decline is something altogether different. In our opinion, it is next to impossible. Of course, someone is always cashing out, and so someone cashed out at the end of 2007. That does not mean they will do so the next time, nor does it mean they got back in at the right time.

Even more foolish is attempting to buy after prices have stabilized. By the time the market has stabilized, it is usually too late. The perverse behavior of otherwise intelligent human beings in relation to market prices is a remarkable phenomenon to behold. The same investors who were selling or frozen in 2009 when the Dow was at 6,500 are creeping back in the market as the Dow approaches 12,000.

Myth #2: Hedge Fund Absolute Return Strategies will solve the World's Problems

The infamous quote, "there's a sucker born every minute," rings loudly when hedge fund promoters promise equity-like returns with bond-like volatility. In the old days, hedge funds promised high returns. Downside protection strategies became more popular after 2008. Of course, the stock market has nearly doubled since.

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The conservative return, low volatility hedge fund model is enormously appealing. Here is how it works. Form a well pedigreed team. Come up with a clever value proposition. Raise a tidy war chest. Give the appearance of low volatility with infrequently traded derivative securities. Generate pedestrian returns similar to an old fashioned stock and bond balanced fund. Get rich charging a 2% management fee and 20% of profits incentive fee.

The most likely end games are to (a) get away with it, (b) blow up when actual risk strikes. How do they get away with it? The fund provides positive "risk adjusted" returns by performing like a balanced stock and bond index fund with less volatility. Unfortunately, less volatility is mistaken for less risk, which is either never properly understood, or is understood all too well after a market crash.

Worse, hedge funds are neither transparent nor subject to fundamental analysis. Analytical tools and openness will either have to improve, or an ever larger part of the world financial system will go dark. While we hope to be wrong, we are not optimistic on this score.

To be fair, some hedge fund managers are brilliant and some consultants and advisors can get enough information to make an intelligent decision about the risk being taken. The point is that the Lake Woebegone world of traditional stock fund managers applies to hedge funds in spades. Everyone is better than average, and for that everyone gets the big bucks.

Myth #3: Volatility is Risk

Orthodox investment analysis until the 1960s held that risk could be understood by studying company balance sheets and income statements, or by assessing the capacity of a borrower to pay back a lender. "Modern" risk tools changed the world of finance by defining risk as price volatility. Instead of figuring out how risky a mortgage was by assessing the creditworthiness of a homeowner, "value at risk" would describe the riskiness of a mortgage pool based on its historical market price fluctuations. This works fine, at least until the mortgages begin defaulting.

One would think the 2008 financial crisis would have put an end to this nonsense and the orthodox methods of old would return to preeminence. Widely adopted ideas and the people who propagate them, however, die hard. Regardless, our risk analysis will continue to be based on key concepts like corporate earning power and debt ratios.

Myth #4: Assets that Didn't Fail this Time Won't Fail Next Time

The financial crisis of 2008 will be perceived by many as a low water mark – some will believe it cannot get worse. While we would like to think this is the case, we will not count on it. Our objective will continue to be protection from a 100 year economic flood. 2008 was not quite that bad. Certain riskier assets that made it through the crisis this time may not the next time.

Myth #5: Financial Institution Failure is Tantamount to Economic Failure

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Financial institutions may always be unstable, and they may even fail en masse, but that does not mean the economy will fail with them. Financial institutions house financial assets which are ultimately claims upon real wealth. Real wealth consists of factories, machinery, workers, software, computers, entrepreneurs, know-how, houses, and cars.

The wealth itself is not destroyed by financial market turmoil. Economic failure can only come from a society which abandons its economic system and the rule of law. The failure of financial institutions may precipitate such events, but by no means is this fate inevitable or even common in economy history. Free enterprise systems have continued to grow and thrive for the past three hundred years, despite intermittent financial institution failure and financial market turmoil.

Rules for the orderly restructuring of large financial institutions are one of the most important financial reforms that could come out of the crisis. The objective is for a financial institution to continue operating while its capital is being restructured. Airlines have been in and out of bankruptcy for decades. Yet, we readily board a bankrupt airliner and soar 30,000 feet high without qualm. An orderly restructuring of a financial institution is by definition more challenging, but not insurmountable.

Of course, prudent standards of investment and lending are most preferable, but unfortunately, such behavior has no precedent over any extended period of time.

Myth #6: Lack of Government Intervention Guarantees Armageddon

Standing behind failed financial institutions is the government. What happens when government is either unwilling or unable to serve as lender of last resort? The economy comes to a grinding halt.

The duration of the halt is important and directly related to the severity of a contraction. The 2008-09 contraction could have been longer and deeper. We still suffer from high unemployment, and the climb out has been longer than past recessions, but the gears of the economy are working again.

Lack of government intervention potentially produces the 100 year instead of the 50 year economic flood. Nevertheless, the quote attributed to Baron Rothschild, “buy when there is blood in the streets”, remains apropos. 50 and 100 year floods are both buying opportunities, although we much prefer the former. The widespread economic pain and social unrest produced by major depressions are clearly to be avoided.

Importantly, neither scenario is Armageddon. Moreover, there is something to be said for expeditiously calculating and clearing away the economic wreckage instead of artificially propping up asset prices and kicking the can down the road.

Parting Thoughts

The idea of passing the buck to government brings us to today. The growing debts of the United States government, states and municipalities, and the ailing governments of the European Union are a serious concern. Yet, we do not believe these problems are cause for alarm presently. The issue is one of scale.

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Consider a US government helicopter which drops $1.4 trillion of fresh cash onto our $14 trillion economy. In the event that all the cash is spent without employing a single unemployed worker or idle economic resource, we would in effect have created a one-time jump in inflation of 10%. Now this would be bad. Stable money is required for reliable market prices, the lifeblood of a free market system. On the other hand, it is not debilitating. 10% spread over 10 years is a 1% annual increase. This is why we consider the much maligned $600 billion QE2 insignificant in the scheme of things.

On the other hand, a trillion here, a trillion there, and one day you are talking real money. One of our continuing macroeconomic objectives is to understand when we have gone too far, and so we will continue to keep a probing and wary eye on the data.

We will also continue to cast a wary eye on stock prices, which in our view are moving too high for comfort. Individual companies can still be found here and there at respectable prices, but many of our portfolio companies are reaching full value, and it is getting more difficult to find replacements. We will continue our work of turning over stones and employing our client capital, but will resist the temptation to buy dear today what may be on sale tomorrow.

Nick Tompras
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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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