The Recovery and Stock Prices

A quarter is all it takes – the investing public turned from brooding pessimism over Europe to tepid optimism in hopes the worst has passed. Credit the European Central Bank for riding to the rescue, momentarily stemming a devastating rise in weaker Eurozone country interest rates. Optimism invariably brings rising stock prices, so 2012 got off to a rousing start.

First Quarter 2012
EQR (Net 1.25%)*: 9.5%
S&P 500: 12.6%

*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%.

Short term fluctuations like these are not meaningful in our view. Stock intrinsic value is created in the long term via dividends, share retirement, and business growth. Additionally, price increases of under-valued stocks can take several years to develop. ACR long term returns – seen through the prism of rising and declining markets – are shown below.

		Cumulative Return		Annualized Return	
Years	**Period**	**EQR***	**S&P 500**	**EQR***	**S&P 500**
2000-2002	Stock Crash / Recession	65.1%	-39.0%	20.0%	-16.5%
2003-2007	Housing Bubble	49.6%	82.9%	8.4%	12.8%
2008	Financial Crisis	-13.9%	-37.0%	-13.9%	-37.0%
2009-2012	Sluggish Recovery	71.5%	67.3%	18.1%	17.2%
Total Period 2000-2012		**260.1%**	**17.6%**	**11.3%**	**1.4%**

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The more pressing question is not where we have been, but where we are going. The economy is in its third year of a spotty recovery. Corporate profits are strong and stock prices have followed suit, yet employment is barely inching higher and housing is still near bottom. The data and mood stateside is, nevertheless, one of a slow return to normalcy, and we subscribe to this view.

Continuing economic recovery would seem to imply stock market prosperity. The truth is more complicated. Stock prices are driven by corporate earnings, and we believe earnings are near a cyclical peak.

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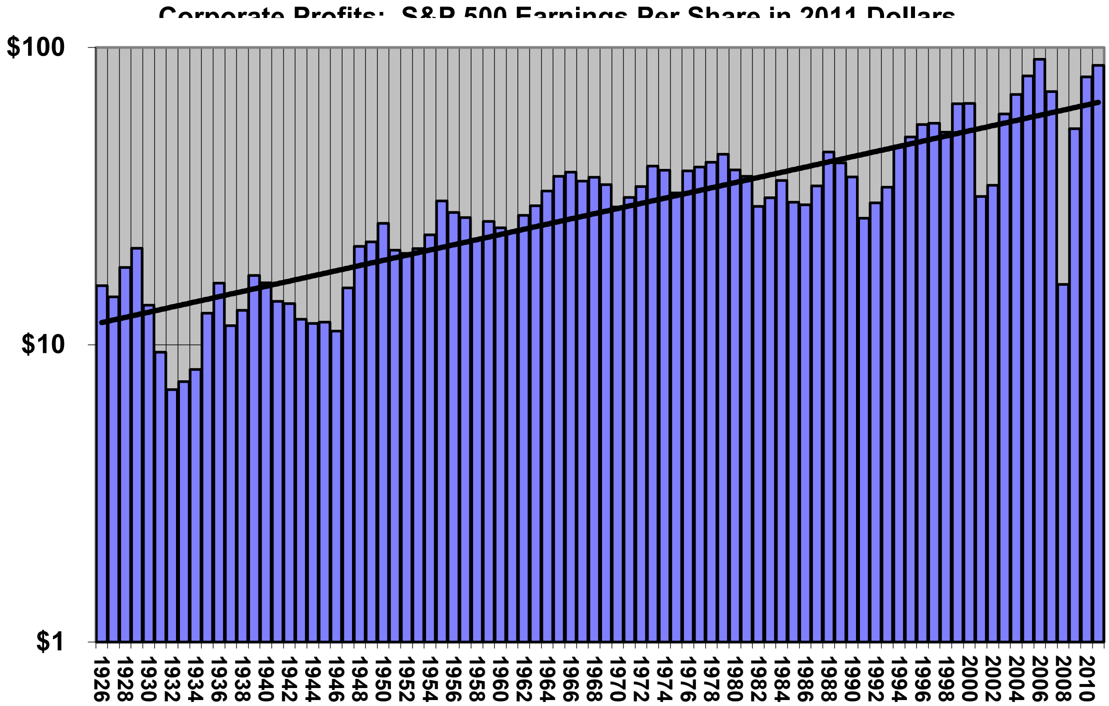

Current earnings as shown above are well above their historical trend, and corporate profit margins are at all-time highs. A common mistake when valuing stocks is to base the valuation on a multiple of current earnings. The problem is that the current year may be at a peak or trough, and therefore does not represent the proper starting point from which to estimate earnings growth. For the overall market, the trend-line is a better place to start.

The earnings trend-line in the chart above is at $63 per share, whereas As Reported earnings for 2011 were $87 per share. While our earnings estimates are at the company level, we apply the same conservative framework to each company. This is one important reason that it is more difficult for us to find attractively valued stocks today.

Why the potential overshoot in current earnings? There are numerous theories. First, $1.5 trillion annually of government stimulus is likely to be reduced. Corporate profits will almost certainly suffer when this demand is removed. Second, wages are likely to rise in the short term and reduce profits, as declining unemployment over the next several years yields greater bargaining power for wage earners. Third, wages are likely to rise in the long term as well. Cheap Asian labor has held wage costs down for years. Someday that will change. Lastly, rising interest and tax rates are both distinct possibilities over the next decade.

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Theories aside, we believe that intelligent stock investment requires a policy of employing cyclically adjusted earnings in stock valuations to smooth out the inevitable highs and lows and to arrive at a truer level of sustainable profits.

The implications for stock market valuations are significant. At quarter end the market was selling at a price 22 times higher than $63 in trend-line earnings, whereas it was selling at a price 16 times higher than $87 in As Reported earnings. 16 times happens to be the long term historical average. So the market could be considered "fairly valued" using current earnings; or it could be considered 28% "over-valued" using trend-line earnings. While we would prefer fairly valued, we think it wiser to conclude that the market is reasonably over-valued today.

Being at a cyclical peak in earnings does not mean we are destined for recession and a major decline in earnings. The economy in our opinion is likely to keep recovering as measured by goods and services production, and unemployment is likely to continue its slow decline. Earnings could even rise meaningfully in the next few years. The key idea is that earnings growth from this particular point is likely to be weak over some future period, and the exact way it plays out is anyone's guess. Earnings could at some point fade lower (see the late-1960s above), rise slowly then decline (see the late-1970s above), or decline sharply in recession (see lots of times above).

Owning the right basket of stocks rather than the stock market can mitigate the risk of a potentially over-valued market. Careful estimates of company earning power and growth rates can prevent costly valuation errors. Being relentless about paying the right price can produce a portfolio with superior valuation characteristics. Our estimate of price to normalized cash earnings for our equity portfolio today is 12 times earnings, which we believe both protects ACR capital from permanent loss and bodes well for future returns.

Nick Tompras
Chief Investment Officer
April 2012

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 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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