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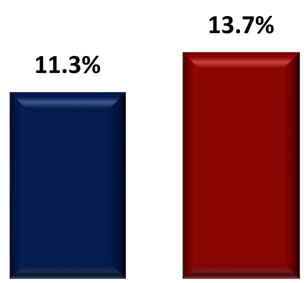
alpine capital research

Rolling Along, with Lots of Insurance

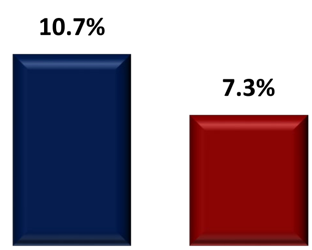
2014 marked another year of economic recovery, and the now six year old bull market continued to roll along. ACR's EQR portfolios delivered a double-digit return, despite being structured defensively.

2014 Net 1.25% Return vs Market[1]



ACR is generally not concerned with market results in any particular year. We believe that yearly results reflect mostly random price movements driven primarily by investor behavior, rather than increases in intrinsic stock values via the accumulation of corporate profits. Our objectives, in addition to protecting capital, are to generate sound absolute returns and to beat the market over a full market cycle. A full market cycle is defined as a period which includes a large contraction and expansion in production and stock prices. It encompasses enough time for companies to reinvest or return a meaningful amount of corporate profit, and for stock prices to reflect intrinsic corporate values. 2008 marks the beginning of the most recent full cycle.

2008-2014 Net 1.25% Return vs Market[1]



[1]EQR (Net 1.25%) is the annualized 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%.

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The market has been catching up with us over the past few years. During the later stages of a strong bull market, our absolute return (the standalone return not compared to the market) is likely to strengthen and our relative return (the return compared to the market) to weaken. We would not be surprised if over some future period several years out, our absolute return will have weakened and our relative return strengthened.

The reason that our absolute return will likely weaken is based on our view that stock prices are high relative to intrinsic values, and the undeniable reality that our portfolios are not immune from general stock market movements. ACR does not seek to protect capital from market declines or low returns in the short term, an impossibility for an equity investor. Rather we seek to protect capital from permanent loss or a low return over a full market cycle.

"Insurance" refers metaphorically to the two general methods we employ to protect the equity capital under our stewardship from permanent loss or low returns.

1) Relentless pickiness: Instead of investing in the stock market, we buy a limited group of stocks which can have very different characteristics than the market.

2) Relentless discipline: We hold cash until the particular stock price of a company we know well is low enough, relative to its intrinsic value, to buy.

Today we have lots of insurance. A fully seasoned EQR portfolio contains just 14 stocks, and the average cash balance across all EQR accounts is 36%. It would be nice if one could time the purchase of insurance, paying the first premium just before disaster strikes. Unfortunately that is not how insurance works, nor is that how protecting capital from riskier markets works.

The insurance we "acquire" occurs one stock at a time. Since 2012, we have sold 12 stocks and purchased 7. We traded stocks that had become high priced for stocks that we believe are cheap, or at least reasonably valued. The end result of 12 sales and only 7 purchases is a steady accumulation of liquid reserves.

The deficit in purchases and the accumulation of cash is a product of our valuation framework. High prices may lure some into changing their valuation framework to spur relative performance. Many other professional equity market participants don't pay attention at all to absolute returns. They focus solely on relative values and returns. The problem is that – a little better than really bad – is still bad. We have always believed that beating the market should not come at the expense of a poor absolute return. Our approach may seem quaint given today's modern allocation methods, but it has proven to work well over the past 15 years.

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The upshot is that avoiding high prices and remaining disciplined presents us with opportunities when the prices of individual stocks or the general market declines. We remain confident that the market, as it always has in the past, will present us with sufficient volatility to reduce our purchase deficit in the future.

Nick Tompras
January 2015

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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All statistics highlighted in this research note are sourced from ACR's analysis unless otherwise noted.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the examples discussed. You should consider any strategy's investment objectives, risks, and charges and expenses carefully before you invest.

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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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