## 15 Years On: The Worst of Times Revisited

April 1st marked the 15 year anniversary of ACR's investment record. An ironic sense of humor is required to begin the very serious endeavor of investing other people's money on April Fool's Day. Indeed our first few investors probably thought we were joking when they opened their April statement to find a return of -5.6%. Fortunately the following month marked the beginning of the best period in our history. The full fifteen year record is below.

**EQR Annualized Return Since Inception**

| | EQR Net 1.25%[1] | S&P 500 |
|---|---|---|
| 4/1/00-3/31/15 | 11.3% | 4.1% |

*[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%.*

The title of our first commentary in Q1 of 2000 – "The Worst of Times" – was borrowed from Charles Dickens. For stock market buyers, it was indeed the worst of times. Our view on the overall stock market then was clear:

> While we are not in the business of predicting bear markets (it hasn't been very profitable), we are in the business of protecting our clients' capital. The figures ... support our position, for the record, that stock market returns are going to be very low in the future. We only wish we knew when this period was going to begin. But we don't. Nor do we know how. It may come in one fell swoop or slowly over a decade or two.

Interestingly, both predictions came true. A Bear Market immediately ensued "in one fell swoop" with a decline of 39.0% from April of 2000 to December of 2002. Stock market returns were also very low over the next "decade or two". The S&P 500 returned 1.9% per year after inflation (i.e., in real terms) over the past 15 years. The likelihood is high of both major short term declines and poor long term returns when prices are spectacularly high upon investment.

In large part, it is the worst of times again for stock market buyers. Stock prices in general are high. The difference between 2000 and today is one of extremes. The Normalized P/E is a sound reference point for comparative valuations.

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**Valuation Comparison – Then and Now**

| | Normalized P/E |
|---|---|
| March 31, 2000 | 35.3 |
| March 31, 2015 | 27.2 |
| Historical Average (1926-2014) | 16.1 |

*The Normalized P/E for the S&P 500 is based on the index price divided by the historical least squares trend-line of As Reported earnings from 1926-2014. Source: Robert Shiller, ACR.*

One of the easiest ways to make money over a 10 year period is to buy the stock market when it is cheap. Conversely, a great way to earn a lousy return over a prospective 10 year period is to buy the stock market when it is expensive. A table of the subsequent annualized ten year returns after inflation from historical valuation highs and lows is below.

**Valuation and Return Table (10 Year Returns after Inflation)**

| (1926-2014) | Average Normalized P/E | Annualized 10 Year Returns after Inflation |
|---|---|---|
| Top 20 Years | 24.1 | 0.8% |
| Bottom 20 Years | 8.8 | 11.7% |

*The Normalized P/E for the S&P 500 is based on the index price divided by the historical least squares trend-line of As Reported earnings from 1926-2004. Source: Robert Shiller, ACR.*

The other way to make money in the stock market is to buy cheap stocks when there are significant discrepancies in company valuations intra-market (i.e., old fashion stock picking). The year 2000 was even more extreme when measured by its valuation discrepancies among various companies. The opportunity to purchase a full portfolio of cheap stocks in what was arguably the most over-valued market in US history was a wonderful anomaly. Today is different as the following metrics reveal.

**Valuation Discrepancies and Cash**

| | Approximate Market Overvaluation Compared to EQR Portfolio | EQR Portfolio Cash Balance |
|---|---|---|
| March 31, 2000 | 3.7x | 0.2% |
| March 31, 2015 | 1.9x | 39.1% |

*Approximate Market Overvaluation Compared to EQR Portfolio is based on the estimated Normalized P/E of the EQR portfolio and the Normalized P/E of the S&P 500. The Normalized P/E of the EQR Portfolio is the weighted average price per share of the portfolio divided by our estimated cash earning power per share of each portfolio company. The Normalized P/E for the S&P 500 is based on the index price divided by the historical least squares trend-line of As Reported earnings from 1926-2014. Source: Robert Shiller, ACR.*



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In 2000 there were sufficient opportunities to put all of our excess cash to work. Today there are not. A valuation difference of 3.7x, and more remarkably, the rapidity with which it was extinguished, may never appear again. EQR returned 65.1% as the market declined 39.0% from April of 2000 through December of 2002.

Some may call this lucky beginnings. Certainly it was. We would also argue that there was no better time for an asset management firm to prove its worth. The year 2000 presented a once-in-a-lifetime opportunity to protect capital from an epically over-valued stock market and to purchase significantly under-valued stocks all at the same time.

What we are likely to experience in the future is something more like the most recent market cycle. EQR's results over this period were sound on an absolute basis and significantly better than the overall market.

**EQR Annualized Return since 2008**

| | **EQR Net 1.25%[1]** | **S&P 500** |
|---|---|---|
| 1/1/08-3/31/15 | 10.2% | 7.2% |

*[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%.*

The difference between good and great investment results is part luck of the market draw. The closing of the price/value gap is one important factor that will make a difference. The quicker the price of our portfolio reaches its intrinsic value, the better our results. The bad news is that the velocity of the portfolio price/value gap closing is impossible to predict. The good news is that it always closes based on business results, whether sooner or later.

Volatility is another important factor that will make a difference. Significant market volatility is almost guaranteed. The more volatile markets become, the more opportunity we will have to sell at higher prices and buy at lower prices. While downside market volatility in recent years has been scant, there has never been a 10 year period in modern economic history without significant downside volatility.

In the meantime the ACR investment team is not wasting time sitting on our hands. We continue to search far and wide for opportunities to buy cheap stocks regardless of general market conditions. We also stand ready with plenty of dry powder to take advantage of the next major market decline when it arrives.

*Nick Tompras*
*April 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/*



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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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