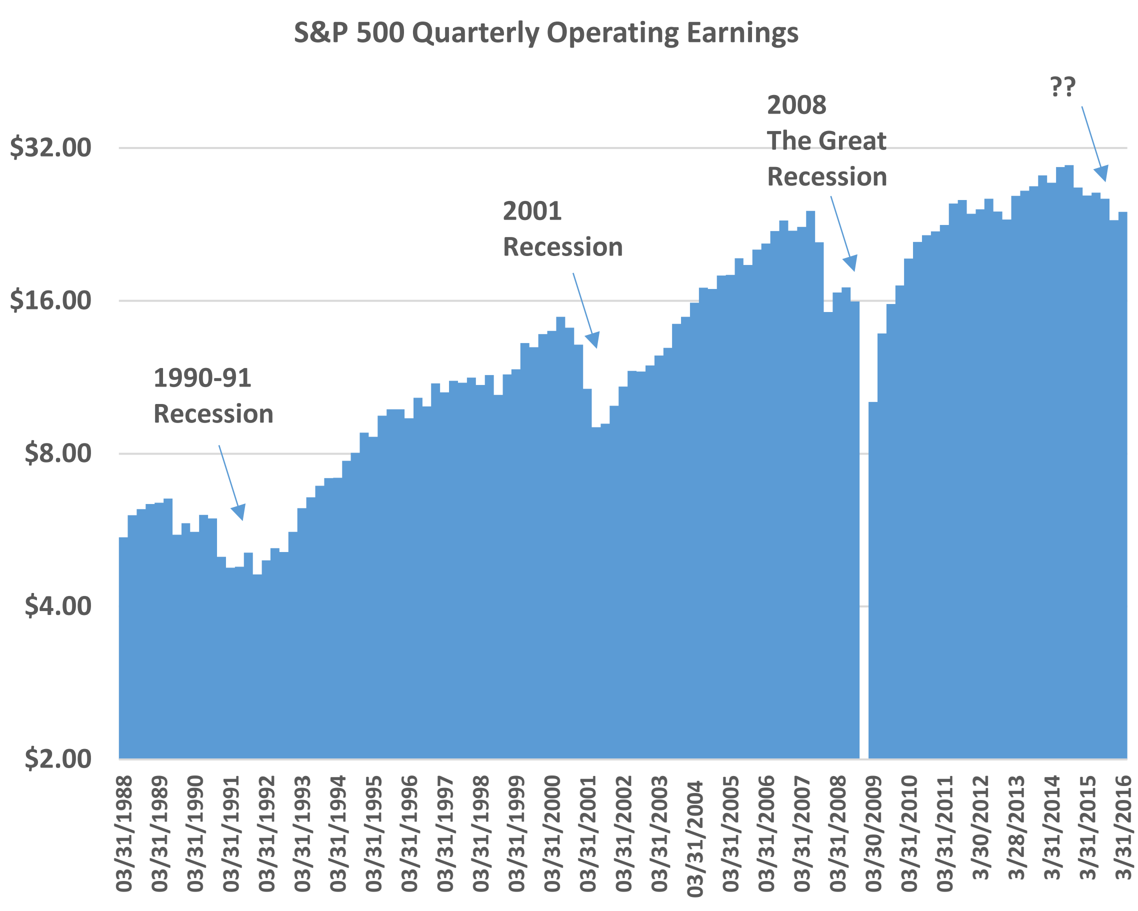
Keeping Time

Brexigeddon was the main story in the second quarter, and it seemed to come and go in a flash of the market pan. Brexit is an historic event. It could have significant implications for individual nations and companies, serve as a stepping stone toward breakup of the Eurozone, and spark the next global recession. And it could be much ado about nothing. Global corporate profits are unlikely to be measurably different in ten years either way, which is what matters most for the future value of the equity markets. Most importantly, we do not believe the overall profits generated by the underlying companies in our portfolios will be significantly impacted by Brexit in the long term.

The more important unfolding story for investors stateside has received scant attention: US companies are in an earnings recession which is empirically consistent with the last three general recessions. The chart below shows what appears to be a recession in 2015 when in fact GDP expanded and unemployment remained below 5%.



Source: S&P Dow Jones Indices

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The primary culprits of the earnings recession are the energy/commodities bust and the strong dollar (which penalizes the 44% in foreign revenues earned by S&P companies when translated back to US Dollars). But there are always excuses. The facts are revenues and margins are down. ACR does not attempt to forecast the beginning or ending of recessions – it's too tough. The closest we can come is to say we are most likely nearer to the peak than the trough of the economic cycle, which is a condition that can persist for years. Most importantly, our cash earnings forecasts and valuations are contingent on earning power estimates which explicitly account for the inevitable recession. Preparation is everything.

They say timing is everything, too. Certainly this is true in investing. Knowing when to buy, hold and sell is the name of the game. However, the key to knowing "when" does not include guessing when the next recession or bear market will strike. Rather it is to first be clear about what you are buying and its cost. Intrinsic value is what you buy. Price is what it costs. Intrinsic value is earned over many years in the future as companies generate cash profits for their owners. It thus stands to reason that a stock investor should *buy* when price is lower than intrinsic value, *hold* while that value is earned over the years via cash profits, and *sell* only if and when price rises above intrinsic value. Were it only that simple.

Stock prices distract investors much like kids fixated on iPhones. Rather than focusing on healthy measures of value and investment success, such as the cash profits earned each year by the companies they own, investors become unwitting speculators slavishly following stock price gyrations and assessing results based on recent ups and downs. Not only do they ignore value, but they confuse price with value. The typical stock market participant is like the man who knows the price of everything and the value of nothing.

To make matters worse, stock price volatility is irresistible to the speculator just as the casino is to the gambler. The purpose of the stock market is to serve as a venue for American business to raise money from investors in exchange for a satisfactory return on investment. Yet most stock market participants spend their time betting when stocks will rise or fall, paying attention to the fundamentals only insofar as they impact short term price movements. When individual stock prices normally rise and fall over 30% or more in a single year (the S&P 500 10 year company level standard deviation is 31%), the temptation of a quick buck is just too great for some to resist. Therein lies the difference between investor and speculator. An investor expects a stock's price to rise for just two reasons: the company is growing its intrinsic value, or the price is a lot lower than intrinsic value. In both cases price is a function of value, not the other way around. Speculators expect price action sooner than later, whereas investors patiently await for price to respond to intrinsic value, while clipping a nice intrinsic "coupon" in the form of earnings and/or dividends along the way.

The industry convention for measuring investment results – total return – also contributes to investors becoming unwitting speculators. Total return is defined as dividends plus the change in price, expressed as a percentage of the original purchase price. Performance reports include annual total returns, and investors regularly chatter about what their return was last year or in the past few years. Due to price volatility, however, a year or two is usually a meaningless time frame, and can throw off returns over

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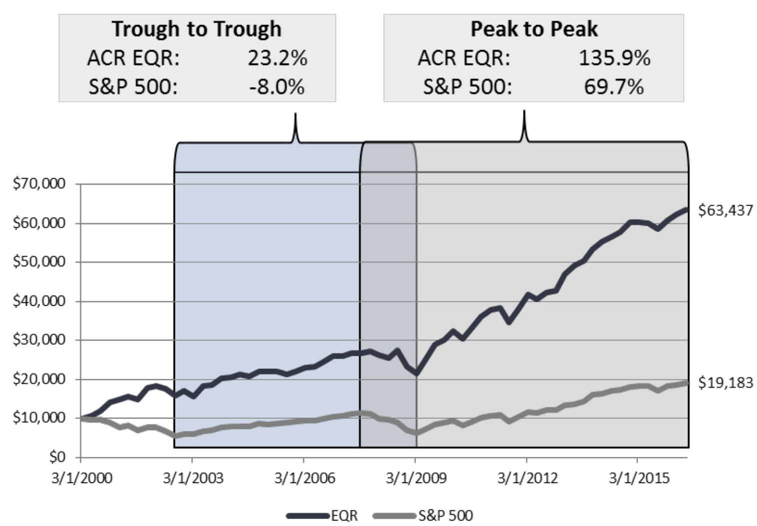
longer periods as well. Measuring returns over periods of economic significance can be a more effective method for assessing investment performance compared to yearly or trailing returns.

EQR Advised / SMA (Net 1.00%)*					
		Cumulative Return		Annualized Return	
Years	Period	EQR*	S&P 500	EQR*	S&P 500
2000-2002	Stock Bubble Crash / Recession	65.1%	-39.0%	20.0%	-16.5%
2003-2007	Recovery / Housing Bubble	49.6%	82.9%	8.4%	12.8%
2008	Financial Crisis	-13.9%	-37.0%	-13.9%	-37.0%
2009-Present	Recovery / Fed Bubble	151.6%	173.1%	13.1%	14.3%
Total Period 2000-Present (6/30/16)		**440.0%**	**91.9%**	**10.9%**	**4.1%**

**EQR Net 1.00% is the total return (dividends and capital appreciation) of the Equity Quality Return Advised SMA Composite calculated net of a 1.00% hypothetical annual fee. The EQR Net 1.00% return calculation is supplementary information based on ACR's asset management fee for advised accounts. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site at www.acr-invest.com. Period begins April 3, 2000; period ends June 30, 2016. Past performance is not indicative of future results.*

Stock price movements tend to follow broad intermediate term trends based on economic and market conditions. Importantly, they can turn on a dime when those conditions change, and complete reversals of fortune can take place for groups of stocks and investment managers. Investment managers who looked brilliant in a more speculative market can look foolish when the market turns, giving up the return advantage earned in the rising market and then some. For this reason it is imperative that investors measure returns over a full market cycle, which includes periods of both rising and declining prices. The chart below shows two such periods.



Full cycle
No arbitrary calendar end-point bias

Trough to trough (6.75 years):
September 2002 – March 2009

Peak to peak (9 years):
September 2007 – June 2016

All returns and dollar values are cumulative and based on quarterly returns

Total Return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income. ACR EQR returns are shown pure gross of fees. Past performance is not indicative of future results.

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The market since 2015 has been relatively flat. Whether this will mark the beginning of a new economic period in the above table remains to be seen. In the meantime investors can keep track of their progress by paying attention to what matters – the annual cash profits generated by their companies. The earnings yield is an excellent metric for this purpose. The earnings yield represents the estimated earnings that could be paid out in a dividend each year while earnings growth keeps pace with general inflation, all as a percentage of the current price (Adjusted Earnings / Price). Based on the ACR investment team's estimates of normalized cash earning power, the current earnings yield of the EQR portfolio is 8.2%. A true estimate of return would include the addition of inflation and the potential return from buying stocks below their intrinsic value, but we believe the earnings yield itself is a sound and conservative barometer of annual fundamental results for the EQR portfolio. The patient investor knows to check fundamental figures like the earnings yield to assess short term results, quite unlike the speculator who fixates on ephemeral price fluctuations stemming from events such as Brexit.

Nick Tompras
July 2016

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

Past performance is not indicative of future returns. Data in this Commentary represents past performance and investors should understand that investment returns and principal values fluctuate, so that when you redeem your investment it may be worth more or less than its original cost. Performance has been calculated on a total return basis, which combines principal and dividend income changes for the periods shown. Principal changes are based on the difference between the beginning and closing values for the period and assume reinvestment of all dividends and distributions paid. Adviser's fees are disclosed in the Firm Disclosure Brochure, ADV Part 2A. All applicable expenses such as advisory fees have been included in calculating performance. 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. The volatility of the Indexes portrayed may be materially different than the composite presented. Investors cannot invest directly in an index.

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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. 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 Index Benchmark is the S&P 500 Total Return (TR) Index. The S&P 500 TR Index best represents the quality of the composite holdings. The S&P 500 TR Index is a broad-based stock index including reinvestment of dividends and is widely regarded 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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