A|C|R
alpine capital research

Priorities and Performance

Global financial markets coasted to big gains in the first half of 2017. ACR is long-term bullish on the global economy, but we are wary of higher asset prices. We will continue to take gains as portfolio securities become over-valued, and forgo re-investment until we can secure better prices. In our view, the inescapable conclusion from higher prices is lower returns. Patience we believe will pay.

The market value of many portfolios today could be compromised if yields moved higher, the economy disappoints, or investor sentiment turns. The S&P 500 sells for a 3.6% yield on normalized net earnings.[1] Investors appear to be placidly accepting higher prices and lower yields. After all, interest rates are at rock bottom. What's an investor to do?

Our answer: refuse to give ground. The ACR investment team typically estimates the intrinsic value of quality equities using a rate which implies a 6% yield on cash earning power. An increase in yield to 6% from today's S&P 500 normalized earning power of 3.6% implies a 40% decline in equity values.[2] A similar math applies to most of the individual securities that we are evaluating today. Cash yielding 1% is more appealing than slightly higher yields with the potential for significant losses.

ACR can be accused of being too punitive in the way we think about yields and values, but we cannot be accused of compromising our priorities. ACR's priorities are embodied in our three investor objectives:

1) Protect capital from permanent impairment
2) Generate a satisfactory absolute return over a full economic cycle
3) Beat the market benchmark over a full economic cycle

Capital protection is priority one. Priority two is a satisfactory absolute return which generates real spendable dollars. One can't spend relative returns. A 2% portfolio return hardly generates sufficient spendable dollars just because it beats a 1% benchmark return. Our last priority is to beat the market.

Results for our flagship EQR equity strategy show how we have performed relative to our objectives. EQR has now been through two full economic cycles, defined as a period which includes a significant expansion and contraction in equity market prices.

8000 Maryland Avenue, Suite 700 | St. Louis, MO 63105
t 314.932.7600 | **f** 314.932.1111 | 877.849.7733 | **acr-invest.com**

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Capital Protection

Maximum Drawdown (Month-End)	**April 3, 2000 — June 30, 2017** Since Inception / Two Full Cycles	**January 1, 2008 — June 30, 2017** Most Recent Full Cycle
EQR Net 1% Fee	-29.9%	-28.7%
S&P 500 Total Return	-51.0%	-48.5%

Absolute and Relative Returns over Full Cycles

EQR Total Return Comparison	**April 3, 2000 — June 30, 2017** Since Inception / Two Full Cycles	**January 1, 2008 — June 30, 2017** Most Recent Full Cycle
EQR Net 1% Fee	10.8%	9.3%
Inflation Rate + 6% Hurdle	8.2%	7.7%
S&P 500 Total Return	4.8%	7.7%
Inflation (CPI)	*2.1%*	*1.6%*

Table 1 —Source: ACR Alpine Capital Research, S&P Indices, US Bureau of Labor Statistics

One caveat. Maximum drawdown is not a measure of protection from impairment. It is at best a close proxy. ACR does not seek to protect against market volatility. We seek to protect against a decrease in intrinsic value or overpayment at purchase. Additionally, EQR's maximum drawdown may not seem very good, at least until you consider what happens on the way back up. Mathematically, a 33% decline requires a 50% return to breakeven, whereas a 50% decline requires a 100% return. In practice, EQR was breakeven 6 months after its largest drawdown, while the S&P 500 took over 3 years to breakeven.[3]

The often-lauded virtue of long-term investing can be perverted by the claim that markets always go up over time. The catch is how long "over time" takes. Five to ten years seems like a long time to us. Let us say five years is intermediate-term and ten years is long-term. On this scale equity markets have failed to deliver satisfactory absolute returns in numerous intermediate and long-term periods.

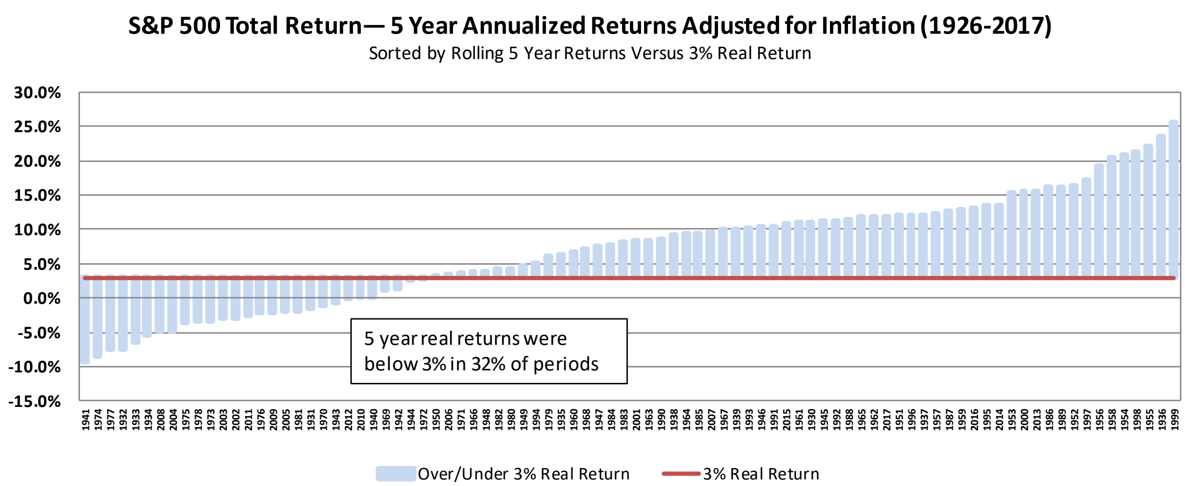

Figure 1 —Source: ACR Alpine Capital Research, S&P Indices

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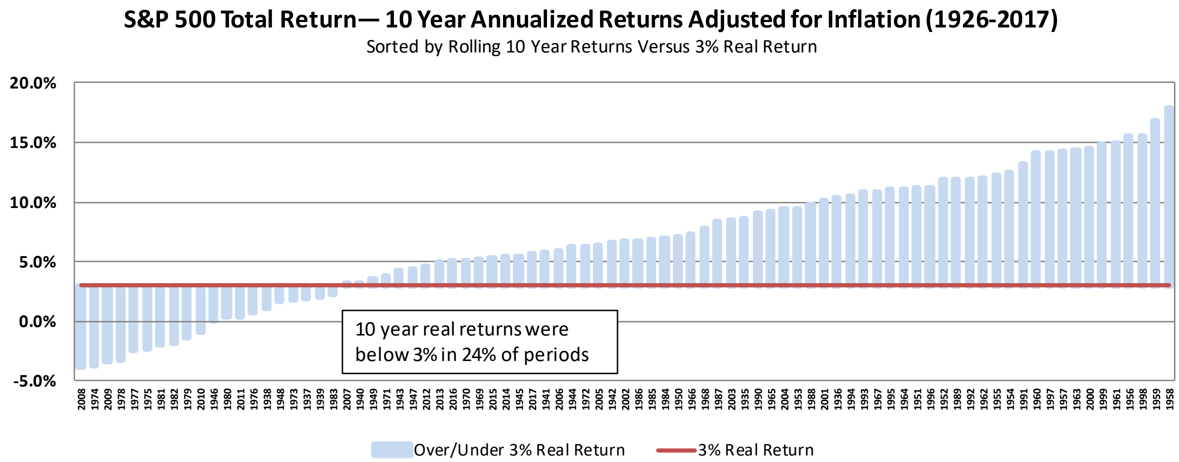

Figure 2 —Source: ACR Alpine Capital Research, S&P Indicies

Based on today's valuations we believe that financial markets are unlikely to deliver satisfactory absolute returns and sufficient real spendable dollars in the intermediate-term and long-term. One area of concern is US small company stocks. Valuations today in the small cap market remind us of valuations in US large caps circa 2000, only worse.

US Large Cap and Small Cap Overvaluation				
			Subsequent Annualized Total Return	
Year	**Equity Index**	**Current PE**	**5 Years**	**10 Years**
Dec 31, 1999	S&P 500 (US Large Caps)	30x	-3.8 %	-0.9 %
Jun 30, 2017	S&P 600 (US Small Caps)	52x	?	?

Table 2 —Source: ACR Alpine Capital Research, S&P Indices, S&P CapIQ

ACR prioritizes absolute returns which produce spendable dollars over a full cycle. A by-product of our absolute return hurdle approach has been greater stability in intermediate-term returns as well. The table below shows EQR has historically generated a minimum return of 6% gross in practically every rolling five-year period since inception. The only time we failed to do so was 4Q-2008 and 1Q-2009, a period in which we bought like mad and strongly advised against selling to harvest returns.

Percent of Time 5-Year Annualized Return was Greater than 6%		
	EQR	**S&P 500**
2000 (April) - 2017 (June)	93%	49%

Table 3 —Source: ACR Alpine Capital Research, S&P Indices

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The S&P 500 failed to generate a return higher than 6% in over half of the five-year periods since EQR's inception in April of 2000.[4] US equity markets since the late 1990s have sold for prices higher relative to earnings than they have historically. Some offer this as evidence for optimism. High prices are here to stay! Unfortunately, higher valuations have not protected investors against bad results. The higher valuations of the past twenty years have been accompanied by large market swings and extended periods of disappointing returns.

The caveat for ACR is that our ability to protect against prolonged periods of disappointing absolute returns is likely to result in periods of relative return underperformance.

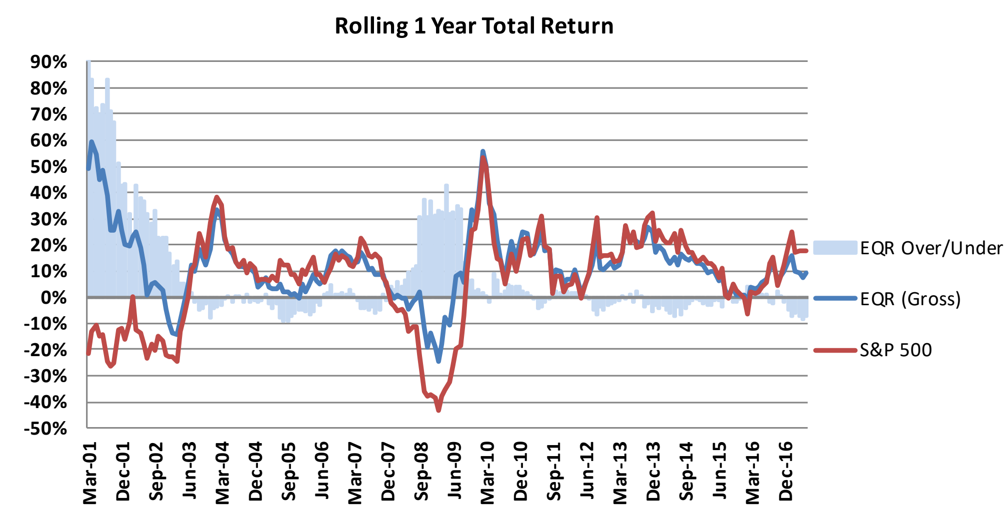

Figure 3 —Source: ACR Alpine Capital Research, S&P Indicies

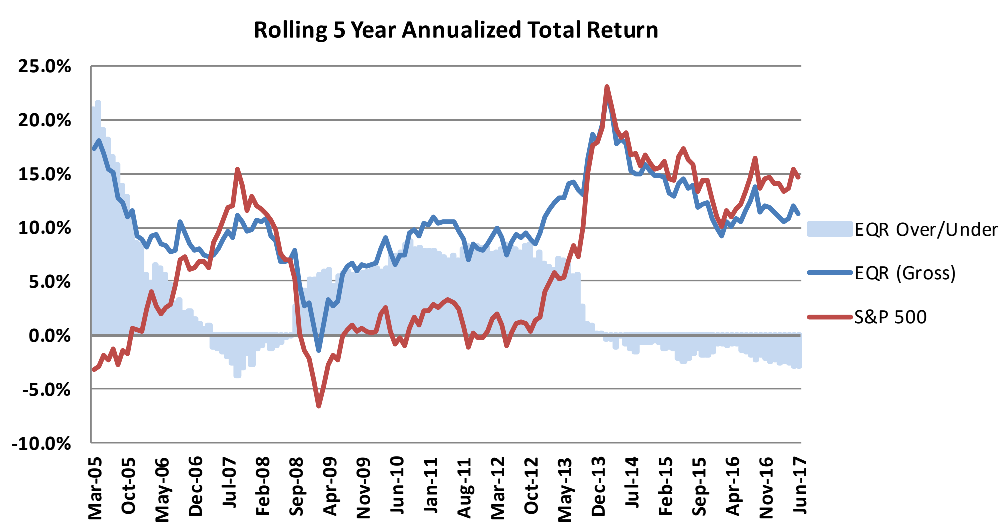

Figure 4 —Source: ACR Alpine Capital Research, S&P Indicies

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The good thing about EQR's periods of underperformance relative to the market is that they have occurred when general market returns were high. Regardless, beating the market benchmark over a full cycle is an objective we fully expect to achieve. The following chart shows EQR's rolling returns over ten years, a period which approximates a full market cycle.

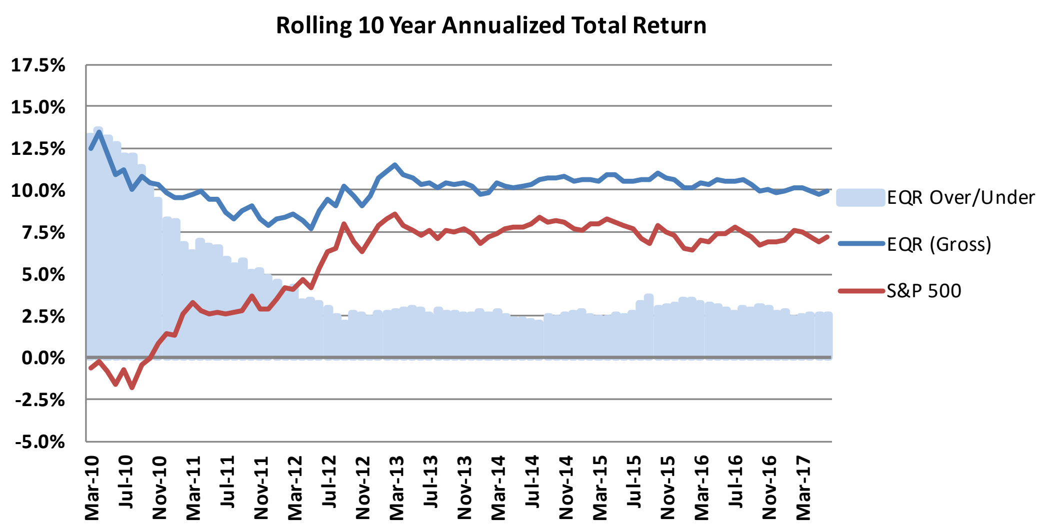

Figure 5 —Source: ACR Alpine Capital Research, S&P Indicies

The irony is that from today's market valuations we expect it will be much easier to achieve our third objective of relative return outperformance in the years ahead. The more challenging task will be to deliver absolute returns and real spendable dollars. We believe that ACR is positioned once again today to take advantage of market conditions to do so.

Nick Tompras
July 2017

References

[1, 2, 3, 4] Sources: ACR Alpine Capital Research, S&P Indices

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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