

Mr. Market, Riding High

2024 turned out to be another excellent year for the economy and financial markets. We are confident about the economic future yet more concerned than ever about US financial asset prices. In addition to a brief recap of 2024, our year-end commentary will consist of three sections summarized below.

Mr. Market and Corporate Profits. US stock prices rose to all-time highs again in 2024. Benjamin Graham’s parable of market behavior, personified in “Mr. Market,” an erratic business partner, is as relevant today as ever. Mr. Market suggests sky-high prices are justified. An analysis of corporate profits, the substance of value, indicates otherwise, despite factoring in future productivity gains from technological innovation.

Secular Booms and Busts. Often unappreciated is how Mr. Market’s unabashed optimism and darkest fears are embedded in the accepted measure of investment results – “total return” (dividend and price return). At valuation extremes, even long-term results as measured by total return can become distorted. Nevertheless, prices eventually reconcile with fundamental values. A series of charts in this section illustrate the point.

Profit Protection. ACR presents company-level results to show how we create value. Today, our flagship Equity Quality Return (EQR) strategy is generating double-digit returns as the market rises. More importantly, we demonstrate how our gains are supported by increases in fundamental value. This contrasts with Mr. Market, whose gains are likely to prove as ephemeral as his mood swings.

Brief Recap of 2024

Led by the largest US tech companies, the S&P 500 once again dazzled last year. US technological superiority is worth celebrating. Even for clients who are not American, advancing the world’s most formidable technologies in a representative democracy is better than doing so under an oppressive autocracy. We are optimistic about the benefits to humanity that could come from technologies such as artificial intelligence, synthetic biology, and quantum computing, not just in developed economies, but in low-income regions as well.

Despite the continued success of US tech leaders last year, as investors we must keep our feet firmly planted. We start with a few simple questions. How did the companies we own do? How did the market treat them? How did the overall corporate sector and market do? Our portfolio of companies did well. Unfortunately, like Rodney Dangerfield, they got no respect. This is to be expected in a speculative market. Below are historical and last year’s results for our flagship strategy Equity Quality Return (EQR) compared to the S&P 500 as measured in total return.

EQR Total Return v S&P 500				
	EQR (Gross)	EQR (Net of Fees)	S&P 500 (Cap Wt)	S&P 500 (Equal Wt)
Since Inception	11.9%	10.8%	7.7%	9.7%
Last Year	13.6%	12.5%	25.0%	13.0%

EQR inception was 4/3/2000. EQR return represented by the EQR-TA composite. Index returns sourced from eVestment. The S&P 500 headline Index is a market-capitalization-weighted index. The equal-weight index weights the 500 constituents equally.

While EQR's results since inception remain solid, the capitalization weighted S&P 500 did much better last year. The contrast between the equal weighted S&P 500, which weights each holding equally rather than by market capitalization, reveals how a narrow group of tech leaders continue to push market prices higher. But how did the companies do?

Fundamental results for EQR and the S&P 500 are a different matter. Total return (dividend and price return) can be broken into three components: the dividend return, earnings return, and P/E change return (the components will not add due to compound mathematics and rounding). The dividend and earnings return represent company-level results, and the P/E change return reflects market opinion. Also note, the earnings return includes (i) earnings per share growth and (ii) changes in portfolio holdings (replacing a higher price investment in relation to earnings with a lower price investment increases the earnings return and vice versa).

EQR v S&P 500 Components of Return Last Year								
	Components of Total Return				Additional Data			
	Total Return	Dividend Return	Earnings Return	P/E Change	Price Return	Beginning P/E	Year End P/E	Average Cash %
EQR	13.6%	2.3%	16.9%	-5.1%	11.0%	10.4x	9.8x	15.0%
S&P 500	25.0%	1.4%	8.5%	13.6%	23.3%	24.8x	28.2x	

See appendix 1 for detailed calculation descriptions. The EQR total return is gross of fees and represented by the EQR-TA composite return. The S&P 500 total return and price returns are sourced from Bloomberg.

One year must be taken with a grain of salt even at the earnings level. While company earnings are far more stable than stock prices, there will still be both good and bad earnings years which are significantly higher or lower than the long-term average.

Nevertheless, we can make three observations about last year. First, the earnings return was better than average for both EQR and the S&P 500. Second, S&P 500 prices continue to rise far faster than earnings leading to multiple expansion. Lastly, EQR prices rose *less* than earnings. The bifurcation of valuations between EQR and the S&P 500 is, in our view, a feature of speculative markets in which prices have become detached from underlying values. Updated total return for all ACR strategies can be found at www.acr-invest.com/strategies.

Mr. Market and Corporate Profits

Benjamin Graham, known as the father of value investing, and Warren Buffett's mentor, introduced "Mr. Market" in *The Intelligent Investor*, first published in 1949.

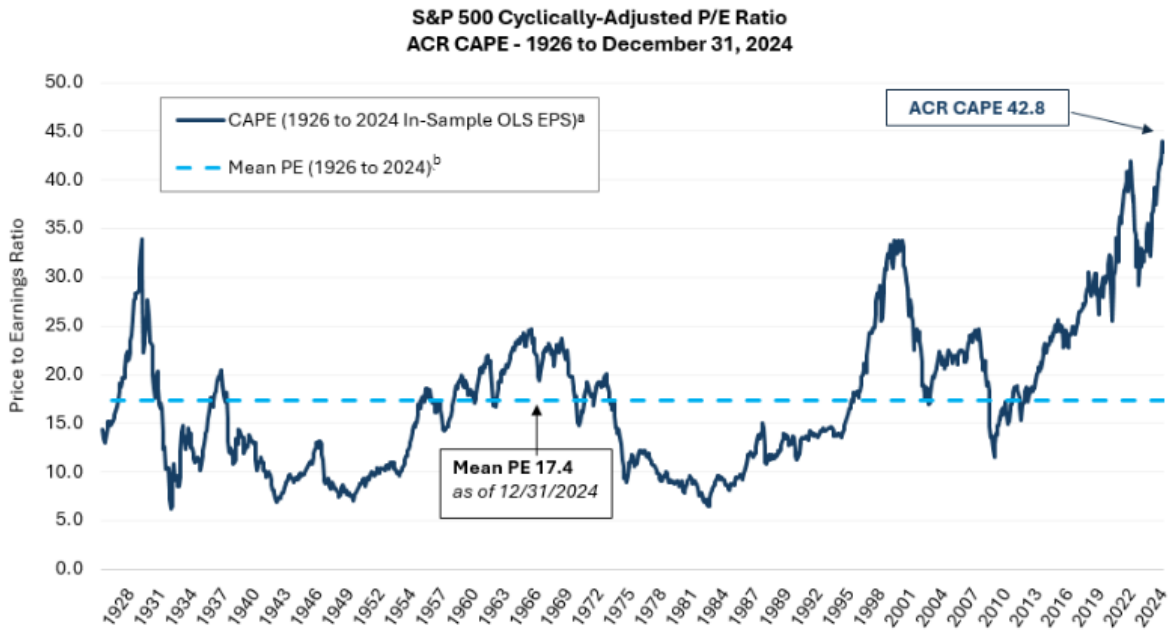
Imagine that in some private business you own a small share that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a \$1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

Graham's story teaches us how to think about the stock market. The market is like a fickle partner susceptible to extremes of overexcitement and pessimism. Intelligent investors know this and take advantage of the stock market rather than allowing the stock market to take advantage of them.

The difficulty is that Mr. Market sets the price. If Mr. Market decides to place unreasonably high or low prices on certain stocks, prices will remain unreasonably high or low. Intelligent investors must remain patient. They stick to their calculations of a company's value based on its "operations and financial position." Speculators, on the other hand, try to read Mr. Market's mind and sell when he is about to swing from optimism to pessimism, or vice versa. We do not take this approach at ACR because Mr. Market's behavior is unpredictable.

The ACR investment team estimates company values one at a time. Yet since we are charged with beating the market in the long term, we also spend time understanding overall market valuations. The US market is our focus below due to robust historical data and simplicity. Our discussion begins with the ACR S&P 500 cyclically adjusted P/E chart showing prices are at an all-time high relative to earnings. We then introduce the two main reasons why higher P/Es could be justified: lower return requirements and higher growth rates. Finally, we expose the circular logic underpinning the lower return requirement thesis and delve into why growth is unlikely to be high enough to justify today's prices.



Note: a) ACR CAPE based on Real S&P 500 Price Per Share (PPS) divided by Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to September 30, 2024. Price as of December 31, 2024; EPS as of September 30, 2024. b) Arithmetic mean. Sources: S&P Dow Jones Indices; Robert Shiller; BLS- CPI Data; ACR Alpine Capital Research.

At 42.8 the ACR S&P P/E is at its all-time high, but we never want to fixate on a single figure. The well-known Shiller cyclically adjusted P/E is 37.9, and the newer Shiller total return adjusted P/E is 40.8. The P/E without cyclical adjustment is 28.2, and the P/E without cyclical adjustment and before chronic special and unusual charges is 25.3. The prudent choice would be to throw out the last two figures. For the sake of argument, we leave them in and consider a wider range, from 42.8 to 25.3.

A multiple contraction to the historical average of 17.4 from 42.8 and 25.3 would result in 59% and 31% price declines, respectively. Looking at these multiples from the perspective of annual returns, P/Es of 42.8 and 25.3 are equivalent to a 2.3% and 4.0% earnings yield (E/P), respectively. A difference of 1.7% appears less onerous but would still have a considerable impact on financial security. A 2.3% and 4.0% spending rate (spending / assets) equates to \$23,000 versus \$40,000 per year on \$1 million in assets. This is why both excellent return estimates and realizations are so important. The long-term average P/E of 17.4 is equivalent to a 5.8% earnings yield, or \$58,000 per year on \$1 million.

P/Es are significantly higher (earnings yields lower) than historical averages under any earnings adjustment method. One school of thinking suggests higher multiples are warranted because investors require lower future returns. Why do they require lower returns? There are many reasons. Corporate profits are more secure. Interest rates are lower. Savings exceed investment. Regardless of the reasoning, the logic is circular. Low returns imply high P/Es, and high P/Es imply low returns.

Our disagreement with this school of thought is the implication that multiples will never contract. The point, however, for ACR is moot. Our foremost objective is to protect capital. Therefore, seeking to mitigate the *risk* of multiple contraction is required, whether it happens or not. Mr. Market’s unreliability suggests this risk is high for the S&P 500. We illustrate how we seek to preserve capital from multiple contraction in our final section called Profit Protection.

Also count us as skeptics that higher future growth rates support permanently higher P/Es at today’s levels. Our rationale rests on two essential observations for understanding corporate earnings growth.

- (i) GDP (Gross Domestic Product) per capita growth has been very consistent in the long-term at around 1.5-2.0% per year real (inflation adjusted).
- (ii) Corporate profit growth is “joined at the hip” with GDP growth. GDP is equivalent to GDI (Gross Domestic Income) whose three main components are wages, profits, and taxes. The shares of each will fluctuate over time, but not enough to radically decouple from GDP.

Two charts supporting these points, which will be familiar to our readers, are in the appendix.² Though we believe the logic and data linking GDP and profit growth are sound, a few technical considerations should be mentioned. Differences between GDP per capita and S&P 500 EPS growth are to be expected. GDP includes all domestic profits from both publicly traded and private firms, whereas the S&P 500 represents only the largest US publicly listed companies including their foreign profits. Additionally, per capita growth, capital productivity, and systemic leverage can all impact long term growth differently.

Our two most salient points remain: (i) the trajectory of S&P 500 EPS and GDP per capita growth are closely aligned, and (ii) the S&P 500 is our focus since it’s our benchmark. On that note, the following table shows S&P Real EPS growth over several historical periods.

Beginning Period to 2024				
	1926	1950	1975	2000
S&P 500 Real EPS Growth	2.3%	2.2%	3.0%	3.2%

Note: S&P 500 annualized real (inflation-adjusted) EPS growth from the noted year through 2024. Source: S&P, Robert Shiller BLS, ACR.

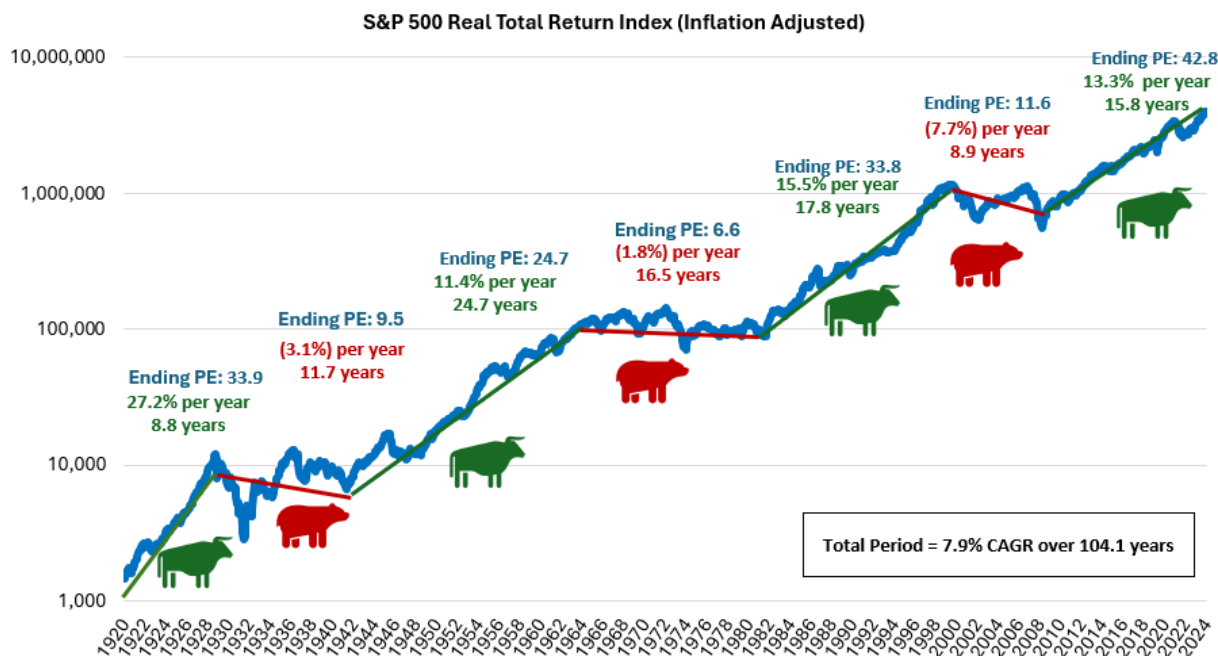
S&P Real EPS Growth is about a half percent higher over the full period than US GDP per capita growth. As cited above, this could be for many reasons. Perhaps more noteworthy, S&P 500 Real EPS growth has been higher in more recent years, raising the long-term average annual growth rate from 2.3% to 3.2%. The most significant reason for rising EPS growth has been higher profit margins. Higher profits have been realized at the expense of a lower share going to wages and taxes, which is unsustainable in the long term. Still, expanding margins could produce 3% growth over a twenty-year valuation horizon. A chart of long-term profit margins in the appendix supports rising margins but is more indeterminant in

the long-term.³ All else equal, a 1% higher growth rate would increase the historical P/E from 17.4 to 21.3. A 21.3 P/E is 16% below the optimistic non-cyclically adjusted pre special charge P/E of 25.3, yet still 50% below our estimated S&P 500 cyclically adjusted P/E of 42.8.

A final argument is that new technologies and leading tech companies will drive a new era of higher productivity. Regarding new technologies, our long-term analysis of GDP per capita measures productivity and covers the introduction of electricity, the automobile, computing, the Internet, and much more. We *need* new technologies to drive continued growth. Thankfully, it appears we have them. Regarding leading tech companies, our 2023 year-end commentary elaborates on the nature of competition (Valuation Time Warp). Dynamic free enterprise economies go through processes of creative destruction. For every Nvidia, there is an Intel. There will always be winners and losers. On that note, we offer parting thoughts for this section. Picking winners is not about picking the best or fastest growing company. It is about picking the best company for the money.

Secular Booms and Busts

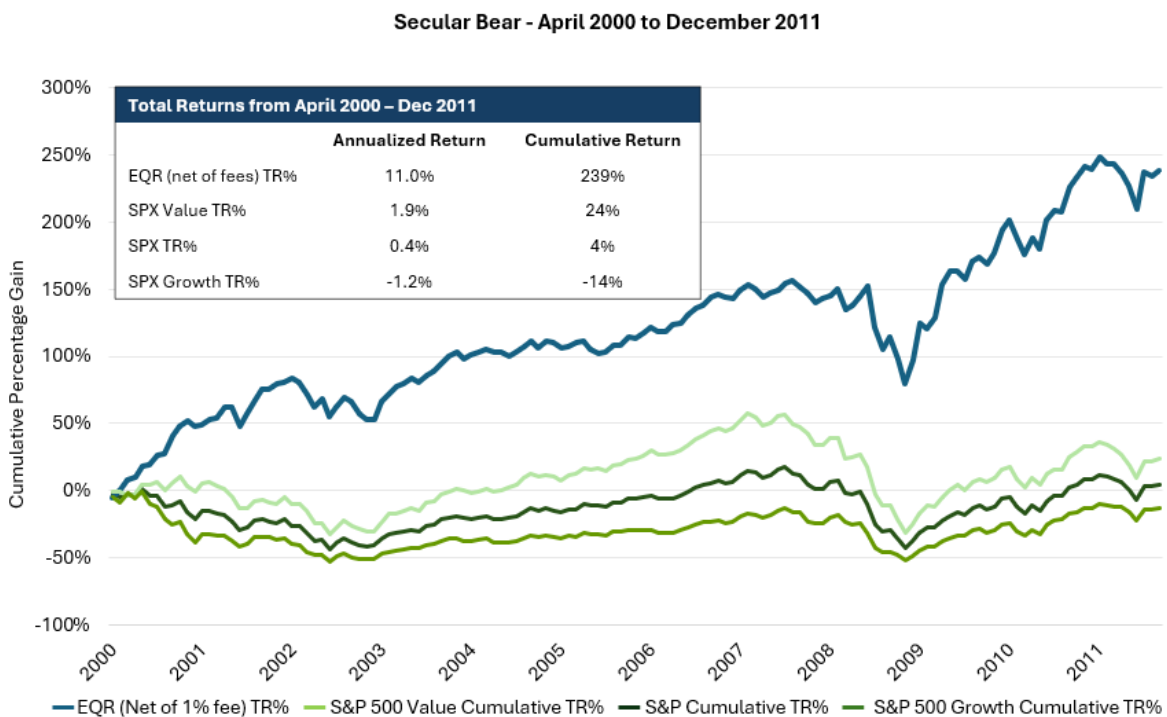
Our 3rd quarter commentary this year introduced an analysis of the US stock market since 1920 that breaks its history into seven secular markets – 4 bulls and 3 bears. The returns are inflation adjusted since this is the only way to properly compare the Great Depression and Great Inflation bear markets.



Note: Bull/bear period identification and analysis by ACR. Real S&P 500 total return index sourced from Robert Shiller dataset December 2024. PE data is ACR CAPE based on Real S&P 500 Price Per Share (PPS) divided by Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to September 30, 2024. Price as of December 31, 2024; EPS as September 30, 2024. Sources: S&P Dow Jones Indices; Robert Shiller; BLS- CPI Data; ACR Alpine Capital Research.

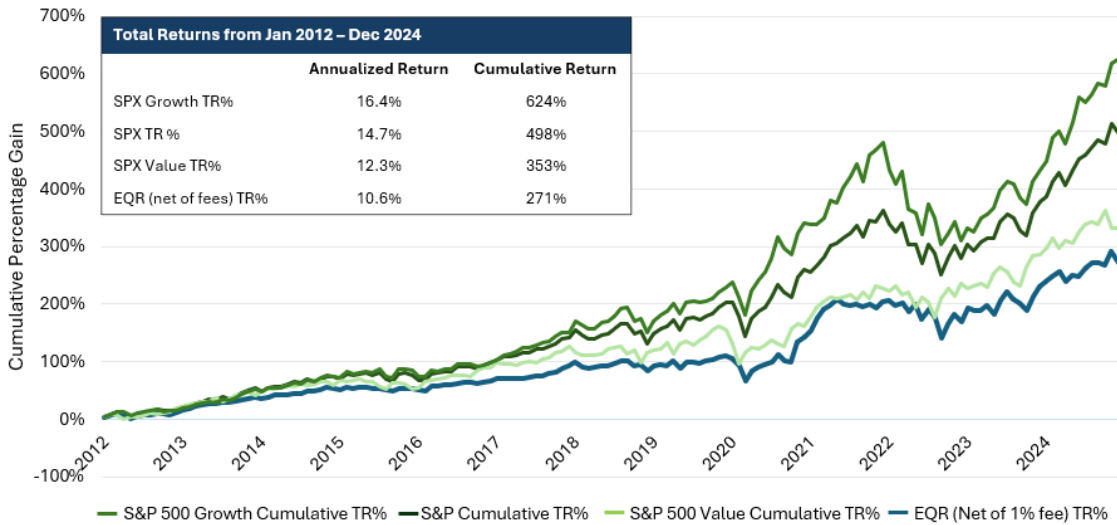
S&P 500 *long-term* performance is radically different depending on whether you started in a secular bull or bear. Greater than one-third of the years occurred during secular bear markets averaging a real annualized return (inflation-adjusted) of -3.7% per year. Conversely, the secular bull years averaged a phenomenal real annualized return (inflation-adjusted) of 14.8% per year. The P/E ratios on the chart show that the secular bulls and bears are nothing more than extremes in prices compared to profit. The path to investment success, it follows, is to focus on profits and not overpay for them.

Not overpaying, while critically important, does not help us call tops and bottoms. Predicting what Mr. Market will do next is difficult at best. Therefore, we stick to owning reasonably valued companies. Our approach has resulted in pedestrian returns that fall behind the market during secular bulls, especially in the latter stages of a speculative boom. Yet, we expect to make up this shortfall, and then some, during the secular bears. Our historical returns reveal this pattern.



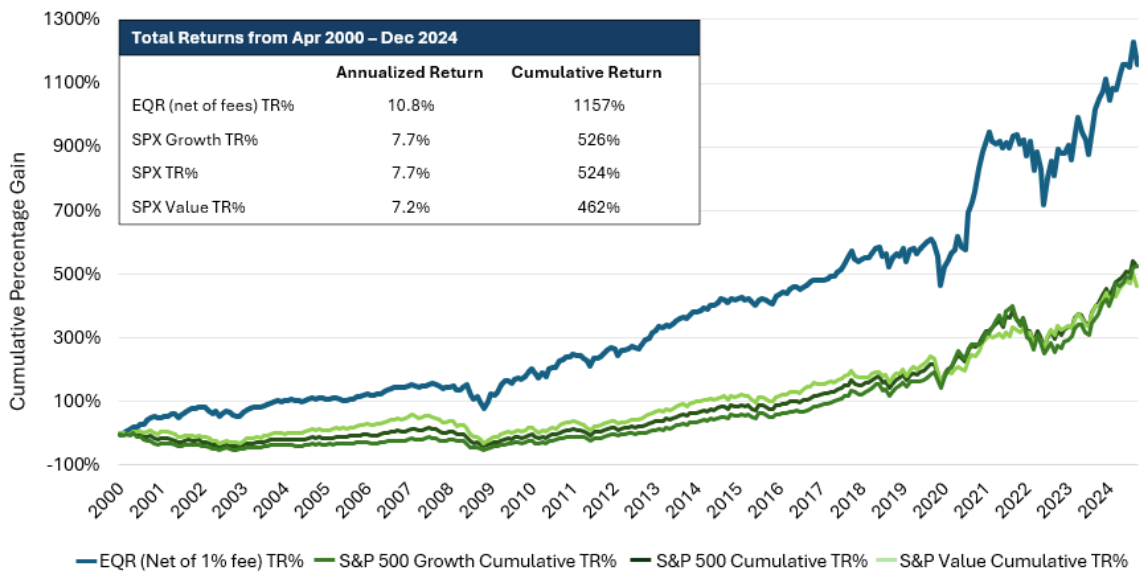
S&P 500, S&P 500 Value, and S&P 500 Growth total return index data sourced from Bloomberg. EQR (Net 1% fee) sourced from ACR Alpine Capital Research.

Secular Bull - Jan 2012 to December 2024



S&P 500, S&P 500 Value, and S&P 500 Growth total return index data sourced from Bloomberg. EQR (Net 1% fee) sourced from ACR Alpine Capital Research.

Full Cycle - April 2000 to December 2024



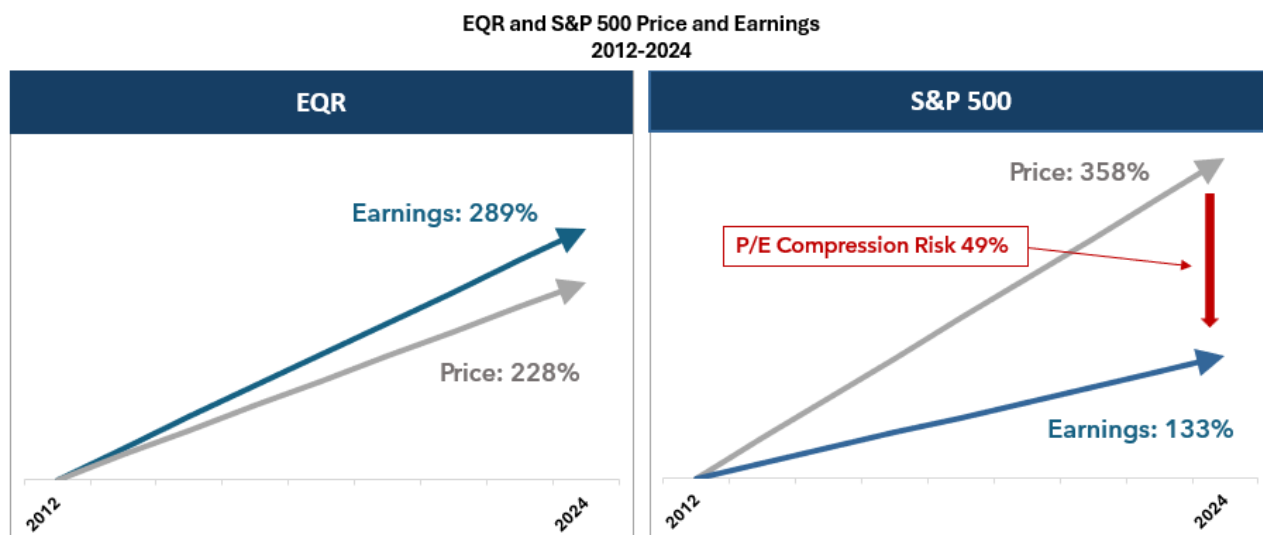
S&P 500, S&P 500 Value, and S&P 500 Growth total return index data sourced from Bloomberg. EQR (Net 1% fee) sourced from ACR Alpine Capital Research.

The widely varying outcomes for our EQR strategy compared to the indexes during secular bear, bull, and full cycle periods are striking, but unsurprising. Our strategy, which consists of a limited number of holdings with very different valuation characteristics from the market, can result in very different

performance from the market. This is an unusual element of our strategy compared to most equity market managers.

Profit Protection

Our final section shows the contrast between fundamental portfolio results (“Earnings”) and Mr. Market’s opinion (“Price”) during the current secular bull market. Like the fundamental performance presented in our 2024 recap above, “Earnings” includes (i) earnings per share growth and (ii) changes in portfolio holdings. Dividends are excluded from this presentation since Earnings and Price should track each other.



See appendix 4 for full disclosure. Source: ACR and S&P 500 index data. The charts above show the increase in estimated corporate earnings and market price for both the EQR strategy and S&P 500 from 12/31/2011 to 12/31/2024.

EQR earnings are 289% higher largely because we replaced companies when their prices overshot their values with companies whose prices were lower relative to their value and earnings. ACR thereby “pruned” our portfolios of valuation risk while capturing added earning power and value.

The current secular bull market relative to EQR began in 2012. The US had emerged from the Great Financial Crisis (GFC) but Europe was still showing signs of strain. The final bell signaling the end of the GFC globally was on July 26, 2012. Mario Draghi, President of the European Central Bank, pledged “to do whatever it takes” to stabilize the Euro and the alarmingly wide credit spreads in Italy and Spain. Stock prices rebounded appreciably in the US from 2009-2011, but 2012-13 was when equity markets really took off again. Since then, market prices barely looked back on their way to stunning valuation levels not

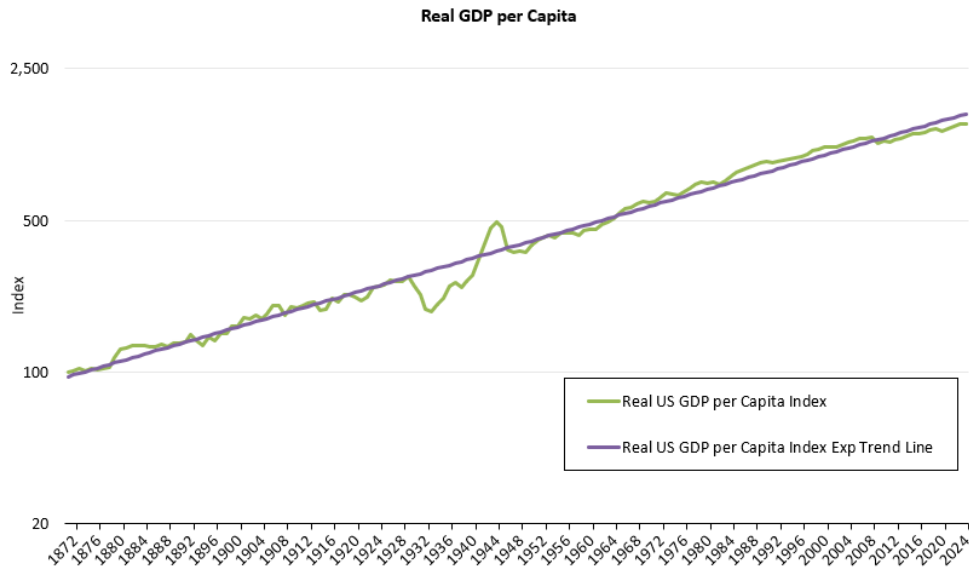
seen since the historic Internet bubble of 2000. This situation implies the risk of a substantial decline in the S&P P/E, a risk the EQR strategy is designed to protect against in the long-term.

While recessions will come and go, we remain bullish on the long-term prospects for US and global economic growth. GDP has been rising ever since the industrial era dawned in the 18th century. While nothing lasts forever, new seeds of technological innovation in support of continued growth appear ready to sprout. A positive long-term view of the economy does not, however, change our view of asset prices. We believe a secular bear market at some point is likely. Secular bulls and bears as we have shown are valuation driven. Asset prices relative to income matters. On that score, ACR will remain disciplined, paying only reasonable prices for sound businesses, regardless of how long the secular bull lasts.

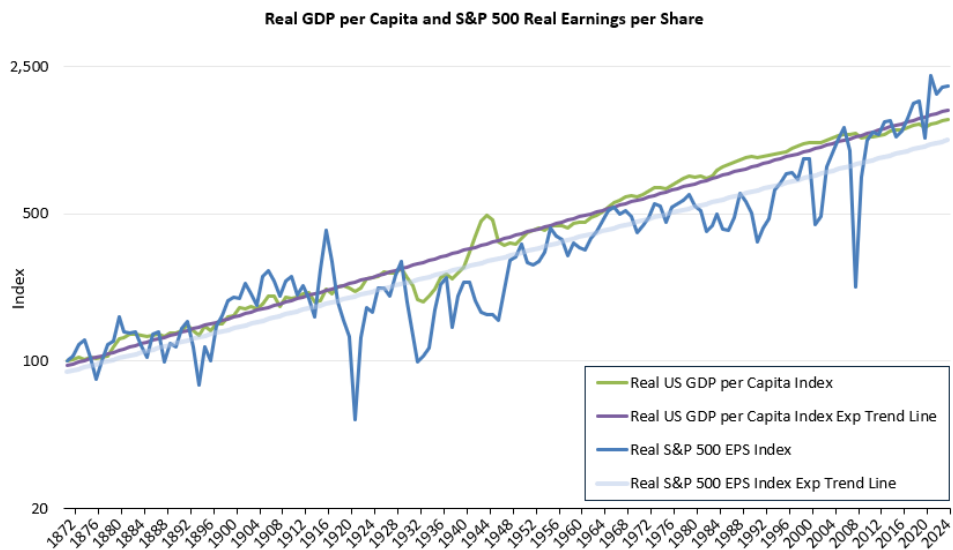
Nick Tompras
January 2025

APPENDIX

1. This table decomposes the return of the EQR strategy and S&P 500 index into total return, dividend contribution, and price appreciation, with price appreciation made up of earnings growth and change in earnings multiple. The EQR total return is gross of fees and represented by the EQR-TA composite return. The dividend return for EQR is represented by the average monthly dividend yield on the portfolio. Price return is calculated by geometrically solving for the difference between total return and dividend return. EQR portfolio P/E ratios are based on ACR's bespoke normalized PE estimates for the EQR strategy. Earnings growth is calculated by geometrically solving the difference between price return and PE growth over the period. The S&P 500 total return and price returns are sourced from Bloomberg. The S&P 500 dividend return is calculated by geometrically solving for the difference between total return and dividend return. The S&P 500 PE ratios are calculated based on S&P 500 as reported EPS (estimated for YE2024).
2. Real GDP per Capita and S&P Real EPS growth.

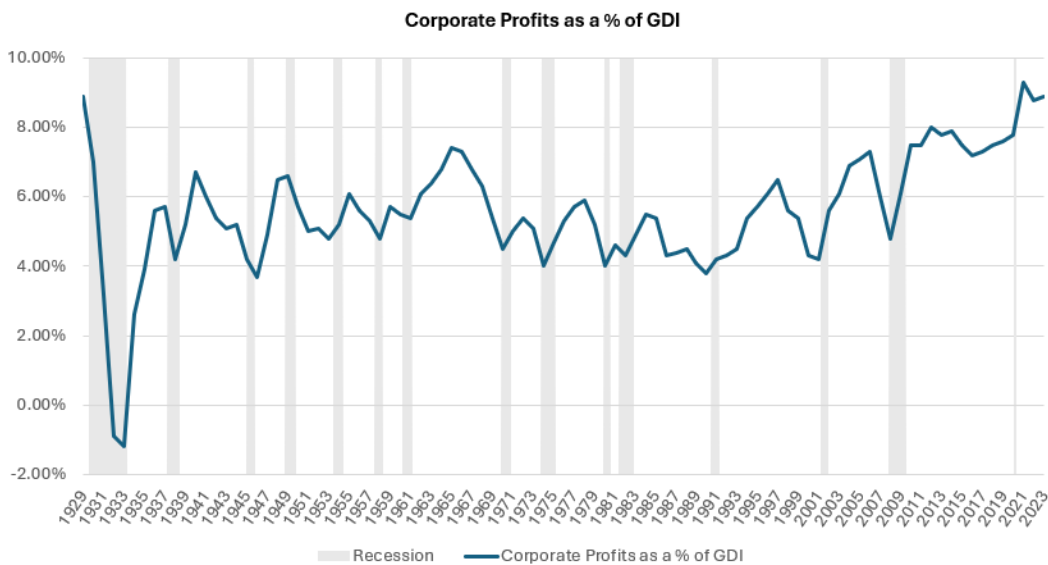


Note: US GDP per Capita through year end 2024. GDP data sourced from The Conference Board and ACR Alpine Capital Research; Population data sourced from Our World in Data, Worldbank, and FRED.



Note: US GDP per Capita through year end 2024. S&P 500 EPS for 2024 is as reported through September 2024. GDP data sourced from The Conference Board and ACR Alpine Capital Research; Population data sourced from Our World in Data, Worldbank, and FRED. S&P 500 EPS data sourced from Robert Shiller.

3. Corporate Profits as a % of Gross Domestic Income (GDI)



Source: Corporate Profits with inventory valuation and capital consumption adjustments data, and recession data, are sourced from FRED, years 1929-2023. This chart shows (1) the share of Gross Domestic Income (GDI) accounted for by

corporate profits (public and private), with inventory valuation and capital consumption adjustments, from 1929 to 2023. The inventory valuation adjustment reflects inventory price changes, and the capital consumption adjustment reflects the economic depreciation of capital assets. These adjustments provide a clearer measure of corporate profits over time, offering insight into the portion of economic income generated by corporate profitability. (2) The shaded areas in the chart represent periods of economic recessions, as defined by the National Bureau of Economic Research (NBER).

4. The referenced chart shows the increase in estimated corporate earnings and market price for both the EQR strategy and S&P 500 from 12/31/2011 to 12/31/2024. Earnings growth is calculated by comparing the earnings yield (earnings / price or "EY") multiplied by the portfolio price at the beginning and ending periods. Price growth for the EQR strategy is calculated by disaggregating the price and dividend return from the portfolio total return.

The EQR Total Accounts Composite total return (including cash) was 322% from Dec. 31, 2011 to December 31, 2024 pure gross of fees. The dividend return was 29% based on the EQR strategy period dividend yield multiplied by the equity allocation. The portfolio total return and estimated dividend return establish a price return of 228%. The EQR strategy EY based on our company-level earning power estimates was 8.6% (P/E of 11.7) as of Dec. 31, 2011 and 10.2% (P/E of 9.8) as of December 31, 2024. The price growth of 228% and EY increase of 1.6% percentage points results in calculated earnings growth of 289%. EQR company cash earning power estimates were chosen because we believe that they are more accurate and conservative than other earnings measures. Based on as-reported earnings (diluted EPS excl. extra items from S&P Cap IQ), the EQR strategy EY was 7.9% (P/E of 12.6) as of Dec. 31, 2011 and 2.0% (P/E of 49.1) as of December 31, 2024. This results in earnings growth of 19%. As reported and operating earnings of concentrated portfolios like the EQR strategy often contain distortions that render them less accurate and informative. We believe the EQR cash earning power estimate removes these distortions and is the best representation of earnings for the EQR strategy and this analysis. The S&P 500 Index price return was 368% from Dec. 31, 2011 to December 31, 2024 (total return was 498%). The S&P 500 EY based on trailing 4Q as reported earnings was 6.9% (P/E of 14.5) as of Dec. 31, 2011 and 3.6% (P/E of 28.2) as of December 31, 2024 (TTM 12/31/24 earnings provided by S&P Dow Jones Indices). The price growth of 368% and EY decrease of -3.4% points results in 140% earnings growth. When we first began publishing this study, as reported earnings resulted in the most favorable earnings growth rate for the S&P 500 so it was chosen for conservatism. For comparison, operating earnings resulted in 142% earnings growth and normalized earnings using ACR's cyclical adjustment method resulted in 81.6% earnings growth.

The analysis for both the EQR strategy and S&P 500 includes changes in the underlying companies owned from Dec. 31, 2011 and December 31, 2024. Earnings growth is impacted by both the earnings growth of portfolio companies and changes in portfolio composition. For the EQR portfolio, the analysis shows how changes in portfolio composition – as we "prune" the portfolio of companies we believe are over-valued and replace them with companies we believe are under-valued – has resulted in the capture of significant earnings growth.

IMPORTANT DISCLOSURES

ACR Alpine Capital Research LLC is an SEC-registered investment adviser. For more information, please refer to Form ADV on file with the SEC at www.adviserinfo.sec.gov. Registration with the SEC does not imply any particular level of skill or training.

Unless otherwise noted, all statistics highlighted in this research note are sourced from ACR's analysis.

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, charges, and expenses carefully before you invest.

This information should not be used as a general guide to investing or as a source of any specific investment recommendations and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer to sell or a solicitation to invest.

This information is intended solely to report on investment strategies implemented by Alpine Capital Research ("ACR"). Opinions and estimates offered constitute our judgment as of the date set forth above and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. There are risks associated with purchasing and selling securities and options thereon, including the risk that you could lose money. All material presented is compiled from sources believed to be reliable, but no guarantee is given as to its accuracy.

The investment outlook represents ACR's views on the economic factors that may affect the global capital markets. There can be no guarantee that these factors will necessarily occur as ACR anticipates, nor that if they do, they will lead to positive performance returns. There can be no assurance that any objective will be achieved.

The Equity Quality Return (EQR) Total Accounts 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 preserving 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. Pure Gross returns are gross of all fees and do not reflect the deduction of transaction costs in wrap portfolios. Pure Gross returns are supplemental information. Net of ACR Fee returns are Pure Gross returns reduced by 1.0% per annum, which is the standard management fee for the Equity Quality Return strategy. Please refer to our full composite performance presentation with disclosures published under the Strategies section of our website at <https://acr-invest.com/eqr-advised-sma-composite/>

The S&P 500 TR Index is a broad-based stock index that includes dividend reinvestment and has been presented as an indication of domestic stock market performance. It is unmanaged and cannot be purchased by investors. See EQR's full composite presentation at www.acr-invest.com/strategies/eqr-advised-sma-composite