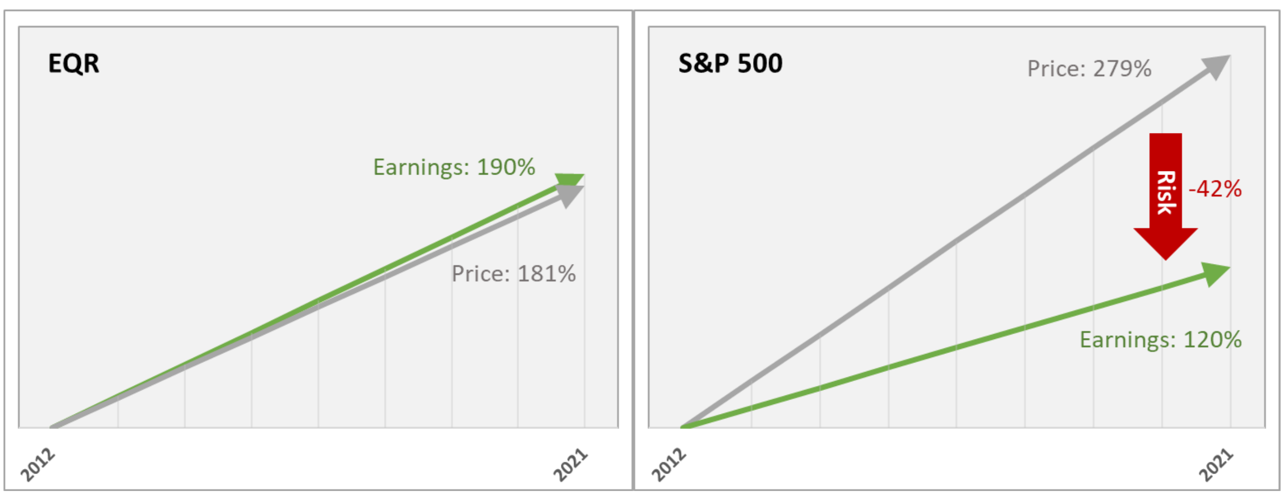
The 2022 Bear Market: Volatility and True Loss

Forty-year inflation highs and Chairman Powell's best Paul Volcker impression gave markets a case of 1970's stagflation déjà vu in the second quarter. Spooked market participants responded by pushing the S&P 500 into bear market territory with just over a 20% decline. ACR strategy results can be found at https://acr-invest.com/strategies/.

Investors who purchased companies with sound cash profits at reasonable prices and pruned their portfolios of excessively priced companies along the way need not worry. They can safely ignore today's price declines as the fundamental value of their portfolio is rising with the accumulation of earnings, and since they avoided overpaying at price extremes. Unfortunately, many investors in recent years purchased companies at inflated prices compounded by further price gains, which are now proving ephemeral.

How do you know which type of investor you are? The investment industry does not give investors the tools to really know, largely because it is very difficult to do. One important way to know whether the prices of the companies you own are reasonable is to understand their earnings and earnings growth. ACR has always done our best to communicate the level and nature of the underlying profits of our companies. On that score, our 2021 year-end commentary showed the earnings and price development of our Equity Quality Return (EQR) strategy companies and the S&P 500 over the past 10 years.

EQR vs. S&P 500: Price and Earnings
2012-2021



Source: ACR and Standard & Poor's

The charts above show the increase in corporate earnings and market price for both the EQR strategy and S&P 500 from 2012 to 2021. Earnings growth is calculated as 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. For additional explanation see end note 1.

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Before proceeding to an update of these charts for the 2022 bear market, we revisit three key takeaways that help explain the figures in them:

1) The change in EQR and S&P 500 earnings is based on (i) the earnings growth of the underlying companies and (ii) differences in the earnings of portfolio companies, in relation to their price, that are removed and added over time.

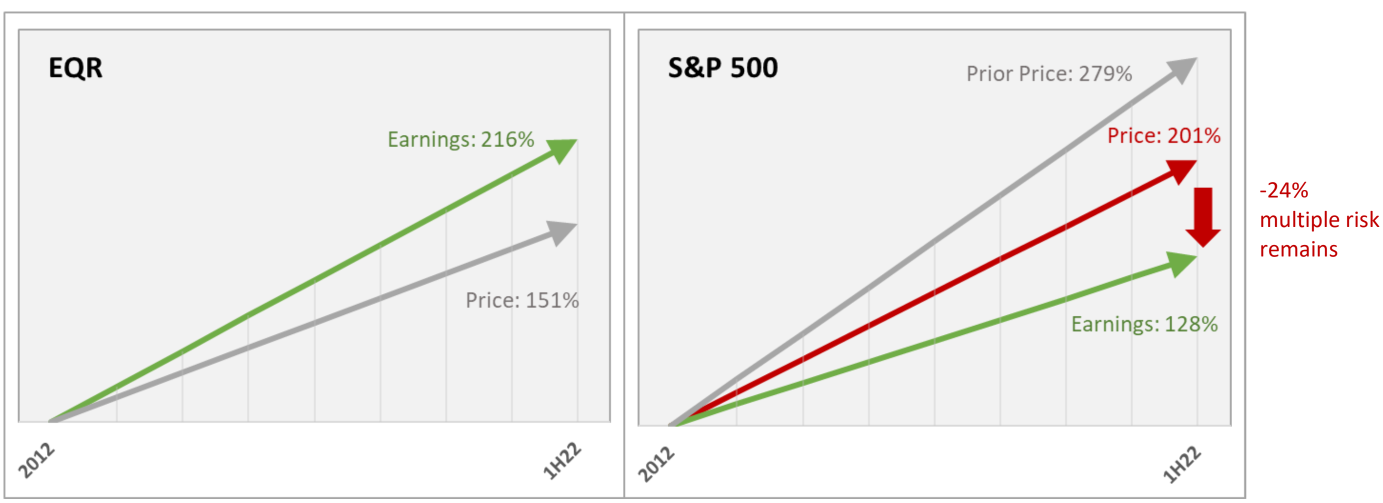
2) EQR earnings are 190% higher largely because we replaced companies (or resized positions) when their prices overshot their earnings with companies whose prices were lower relative to their earnings.

3) ACR thereby "pruned" portfolios of valuation risk while capturing additional earning power and fundamental value.

We believe EQR strategy investors are the type who needn't worry about the bear market because we purchased companies with sound cash profits and pruned our portfolios along the way. Conversely, investors in the S&P 500, especially those who invested during the second half of the last decade, likely purchased companies at inflated prices and may experience disappointing returns.

The bear market of the first half of this year presents an opportunity to update these charts at an interesting moment in time.

EQR vs. S&P 500: Price and Earnings
2012 – 1H22



Source: ACR and Standard & Poor's

The charts above show the increase in corporate earnings and market price for both the EQR strategy and S&P 500 from 2012 to June 30, 2022. Earnings growth is calculated as 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. For additional explanation see end note 1.

Two takeaways will help to explain these updated figures and where we stand today:

1) The price of the EQR strategy during the current bear market has become even less expensive relative to underlying company earnings.

2) The price of the S&P 500 declined significantly more than EQR's price, yet the S&P 500 remains significantly higher in price relative to its earnings.

A more conventional presentation of total return (price plus dividends) for EQR and the S&P 500 since inception and during the bear market of the past six months is presented below:

EQR Since Inception and YTD	EQR (Gross)	EQR (Net)	S&P 500
4/03/2000 – 6/30/2022	11.6%	10.5%	6.3%
YTD 6/30/2022	-9.8%	-10.2%	-20.0%

Past performance does not guarantee future results.
EQR (Net) is net of 1% fee.
See EQR performance presentation for disclosures and full results at https://acr-invest.com/eqr-advised-sma-composite/.

Almost all stocks including EQR strategy holdings will decline during bear markets. The key is to distinguish between stock price volatility and true loss. ACR defines true loss as an unanticipated material degradation in earning power, or the (unwitting) overpayment for earnings or fundamental value. Even though EQR declined by 10% in the first six months and may decline more in the future, the development of the earnings of our companies relative to their prices demonstrates that ACR's clients are very likely to be experiencing volatility rather than true loss.

The upshot is that this year's price declines have allowed us to put a great deal of cash to work, and we are now nearly fully invested. The quarter-end price/value[2] of EQR was a historically favorable 0.71. Only in 2008-09 and March 2020 was the price/value lower than 0.70.

The bear market has seen many high-flyers come back to earth, as the table on the following page shows. While we are sifting through the rubble, we have not identified any companies of interest from this group. The merits of a valuation are not based on how far a stock declines from its peak, but whether we can reliably estimate the company's future earnings, and what the price is *today* for those earnings. Fortunately, in the quarter we added two new EQR holdings, which were significantly off their highs and even more attractive, in our view, than the companies on this list.

Company	Ticker	Current Price	3-Year High Price	3-Year High Date	Decline from High	Market Value $
Peloton Interactive, Inc.	NasdaqGS:PTON	9.6	171.1	Jan-21	-94%	3,222
Nikola Corporation	NasdaqGS:NKLA	5.8	94.0	Jun-20	-94%	2,430
Carvana Co.	NYSE:CVNA	25.2	376.8	Aug-21	-93%	2,665
QuantumScape Corporation	NYSE:QS	10.8	132.7	Dec-20	-92%	4,666
Clover Health Investments, Corp.	NasdaqGS:CLOV	2.6	28.9	Jun-21	-91%	1,226
Redfin Corporation	NasdaqGS:RDFN	9.1	98.4	Feb-21	-91%	980
Lemonade, Inc.	NYSE:LMND	19.4	188.3	Jan-21	-90%	1,198
Robinhood Markets, Inc.	NasdaqGS:HOOD	8.9	85.0	Aug-21	-90%	7,751
Snap Inc.	NYSE:SNAP	10.0	83.3	Sep-21	-88%	16,407
Opendoor Technologies Inc.	NasdaqGS:OPEN	4.9	39.2	Feb-21	-87%	3,086
Wayfair Inc.	NYSE:W	49.3	369.0	Jan-21	-87%	5,193
Teladoc Health, Inc.	NYSE:TDOC	42.1	308.0	Feb-21	-86%	6,783
Beyond Meat, Inc.	NasdaqGS:BYND	33.4	239.7	Jul-19	-86%	2,125
Coinbase Global, Inc.	NasdaqGS:COIN	67.1	429.5	Apr-21	-84%	14,891
Allbirds, Inc.	NasdaqGS:BIRD	5.1	32.4	Nov-21	-84%	763
Zillow Group, Inc.	NasdaqGS:Z	35.7	212.4	Feb-21	-83%	8,801
Roku, Inc.	NasdaqGS:ROKU	86.7	490.8	Jul-21	-82%	11,790
Rivian Automotive, Inc.	NasdaqGS:RIVN	32.2	179.5	Nov-21	-82%	28,974
DraftKings Inc.	NasdaqGS:DKNG	13.4	74.4	Mar-21	-82%	5,596
Zoom Video Communications, Inc.	NasdaqGS:ZM	106.1	588.8	Oct-20	-82%	31,658
Twilio Inc.	NYSE:TWLO	86.6	457.3	Feb-21	-81%	15,730
Lyft, Inc.	NasdaqGS:LYFT	13.3	68.3	Mar-21	-81%	4,632
DocuSign, Inc.	NasdaqGS:DOCU	63.4	314.8	Aug-21	-80%	12,676
Warby Parker Inc.	NYSE:WRBY	12.3	60.3	Nov-21	-80%	1,408
AMC Entertainment Holdings, Inc.	NYSE:AMC	14.9	72.6	Jun-21	-79%	7,706
Palantir Technologies Inc.	NYSE:PLTR	9.7	45.0	Jan-21	-78%	19,811
PayPal Holdings, Inc.	NasdaqGS:PYPL	81.7	310.2	Jul-21	-74%	94,554
DoorDash, Inc.	NYSE:DASH	71.8	257.2	Nov-21	-72%	28,523
GameStop Corp.	NYSE:GME	34.0	120.8	Jan-21	-72%	10,295

Source: CapIQ, current price as of July 25, 2022; 3-year high price based on intraday high

By our reckoning, markets reached peak distortion sometime in the fourth quarter of 2020 or early 2021. A great speculation, on par with the boom of the late 1990s, slowly built during the latter half of the last decade, culminating in a frenzy of overvaluation during the pandemic. Whether we are in the fourth or ninth inning of the bust likely depends on the company in question. Regardless, we continue to believe that very large distortions remain between a well-selected group of value companies and the overall market. Whether the value reset implied by these distortions will occur during the current bear market or whether they will play out over several years of ups and downs, only time will tell.

Nick Tompras
July 2022

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

Please see page 6 for important disclosures.

End Notes

1. The EQR Total Accounts Composite total return (including cash) was 236% from Dec. 31, 2011 to Dec. 31, 2021 pure gross of fees. The dividend return was 20% based on the EQR strategy period divided yield multiplied by the equity allocation. The portfolio total return and estimated dividend return establish a price return of 181%. 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 8.8% (P/E of 11.3) as of Dec. 31, 2021. The price growth of 181% and EY increase of 3% results in calculated earnings growth of 190%. 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 13.8% (P/E of 7.2) as of Dec. 31, 2021. This results in earnings growth of 391%. 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 279% from Dec. 31, 2011 to Dec. 31, 2021 (total return was 363%). 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 4.0% (P/E of 24.9) as of Dec. 31, 2021 (4Q21 earnings are based on the current estimate provided by S&P Dow Jones Indices). The price growth of 279% and EY decrease of 42% results in 120% earnings growth. As reported earnings result in the most favorable earnings growth rate for the S&P 500. Operating earnings resulted in 109% earnings growth and normalized earnings using ACR's cyclical adjustment method resulted in 52% 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 Dec. 31, 2021. 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 portfolios 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. we believe are under-valued – has resulted in the capture of significant earnings growth.

   The EQR Total Accounts Composite total return (including cash) was 203% from Dec. 31, 2011 to June 30, 2022 pure gross of fees. The dividend return was 21% based on the EQR strategy period divided yield multiplied by the equity allocation. The portfolio total return and estimated dividend return establish a price return of 151%. 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 10.8% (P/E of 9.3) as of June 30, 2022. The price growth of 181% and EY increase of 2% results in calculated earnings growth of 216%. EQR company cash earning power estimates were chosen because we believe that they are more accurate and conservative than other earnings measures. 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 201% from Dec. 31, 2011 to June 30, 2021 (total return was 270%). 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 5.2% (P/E of 19.1) as of June 30, 2022 (03/31/2022 TTM earnings provided by S&P Dow Jones Indices). The price growth of 201% and EY decrease of 24% results in 128% earnings growth. As reported earnings result in the most favorable earnings growth rate for the S&P 500. The analysis for both the EQR strategy and S&P 500 includes changes in the underlying companies owned from Dec. 31, 2011 and June 30, 2022. 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 portfolios 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.

2. *The Price/Value is ACR's estimate of undervaluation based on market prices and Fundamental Value. Fundamental Value is ACR's estimate of what a company is worth based upon our estimate of its future cash flows and their riskiness. Ultimately, Fundamental Value represents the portfolio manager's subjective estimate of business value.*

Please see page 6 for important disclosures.

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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. 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 web site at www.acr-invest.com/strategies/eqr-advised-sma-composite.

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. See EQR's full composite presentation at www.acr-invest.com/strategies/eqr-advised-sma-composite.