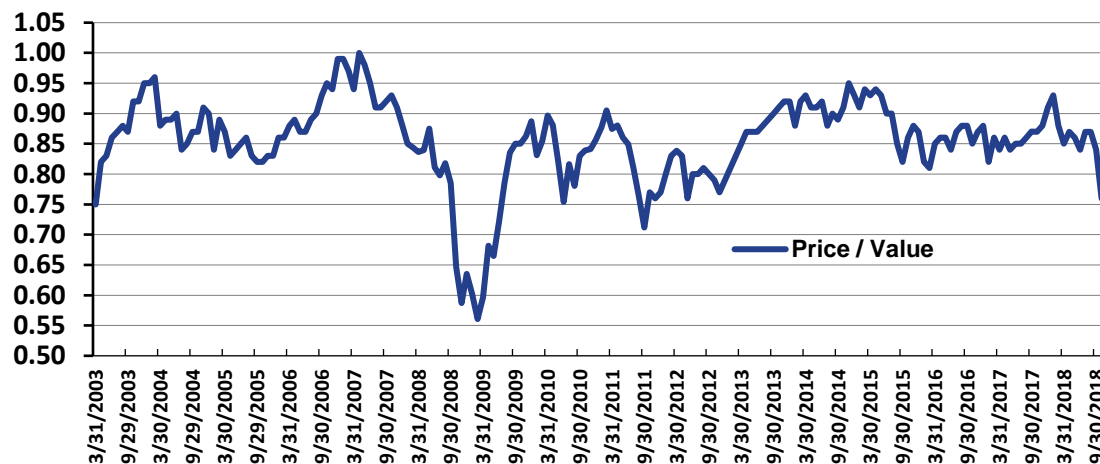


## Volatility and True Results

The US equity market continued its steady ascent in the third quarter after a brief spate of volatility earlier in the year. Volatility then reared its lovely head again in the early weeks of the fourth quarter. Did we say *lovely*? Indeed, we did. Long-standing ACR investors know that volatility rears a lovely rather than ugly head in our eyes because volatility creates opportunity.

**Prices are so high that far larger declines are, in our view, necessary to create a broad equity market opportunity. However, fissures have developed underneath the surface, which are creating more opportunity in individual equities than we would have thought at this juncture.** The same cannot be said for the credit markets. Credit spreads have widened only slightly, and few attractive individual credit opportunities have appeared. Since credit markets have historically led equity markets in downturns, will this turn out to be an equity market head fake? Only time will tell. Regardless, investment opportunities as indicated by our price-to-value framework in the EQR strategy are demonstrated in the chart below.

**EQR Strategy Historical Price-to-Value**  
Ratio of Market Price to Intrinsic Value  
3/31/03 to 10/26/18



Source: ACR Analysis

A price/value ratio of 0.76 today means that the *market values* of the companies we own in the EQR strategy are 76% of our estimate of their *intrinsic value* (intrinsic value and fundamental value may be used interchangeably). *Market value* is determined by stock price – it is equal to the value of company’s outstanding shares multiplied by its prevailing price. *Intrinsic value*, on the other hand, is what we think a company is worth based upon our estimate of its future cash flows and their riskiness.

Valuations contain three mathematically interdependent variables – (i) intrinsic value, (ii) future cash flows, and (iii) required return. Intrinsic value is equivalent to future cash flows divided by the required

return, where the required return reflects the inherent risk of the investment. The weighted average EQR strategy required return today is 9.5%. If we have estimated the future cash flows of our portfolio companies correctly, we will earn 9.5% plus the difference between market price and intrinsic value as that gap closes over time. Today that difference is 31%, which is simply the increase to full value from a price/value ratio of 0.76. ( $1.00 \div 0.76 - 1 = 31\%$ ).

In our first quarter commentary, we demonstrated our record of estimating intrinsic value by comparing the forecasted EQR return, which is based on our required return and price/value ratio estimates, to the actual EQR annualized total return in the subsequent ten years. While we are proud of our past record on that score, investors are right to ask, “But what will you do for me in the future?” This ultimate investor question unfortunately can only be answered with another question: “What is the quality of our valuation work today?”

**ACR believes that quality valuation work requires an exclusive focus on intrinsic value which in turn requires dedication to two main activities: (1) the thorough assessment of risk to establish a sensible required return, and (2) the effective estimation of future cash flows. ACR never attempts to forecast market prices or guarantee against market price volatility. Our objective is to protect the intrinsic value of the capital entrusted to us against permanent impairment.**

Since ACR is known for downside protection, investors dissect our daily, monthly, and quarterly volatility during market declines to determine our protective success. While such analysis may hint at our ability to truly protect capital, a longer downturn during which capital is truly impaired is the only real data point for properly establishing our protective success. Over the past 18 years there have been two such data points. The bear markets of the early 2000s and the 2008 global financial crisis each lasted less than two years, but both had a devastating impact on market returns in surrounding decade-long periods. During those crucial times, ACR protected our investors’ capital, and we believe we will do so again.

Our basis for believing we can provide a satisfactory return in the future rests on a couple of key statistics we are fond of sharing. The current cyclically adjusted P/E for our flagship EQR strategy is 11.6 and for the S&P 500 is 33.5<sup>1</sup>. If these figures are directionally on target, the price of the EQR strategy would have much less far to fall than the S&P 500 and represents a much higher yield on each dollar invested. These data points bode well for future results.

The valuation difference between EQR and the market is about as wide as we have ever seen. The discrepancy has not been this great since our founding nearly nineteen years ago in November 1999. The difference is that then we were able to find enough companies at favorable prices to be fully invested. In recent years we have struggled to put cash to work and are today sitting on an all-time high cash balance. The good news is while we may not become fully invested over the short-term, we are seeing enough opportunity to work our cash balances down significantly in the final quarter of this year.

*Nick Tompras  
October 2018*

<sup>1</sup> The Cyclically Adjusted Earnings Yield equals the S&P 500 Cyclically Adjusted Earnings Per Share divided by the S&P 500 Current Price Per Share. The S&P 500 Cyclically Adjusted Earnings Per Share is calculated based on the Ordinary Least Squares Trendline of Real S&P 500 Earnings Per Share from 1926-Present. The cyclically adjusted PE for our Flagship EQR strategy is based on current price divided by ACR's internal bottom-up estimate of normalized earnings at each portfolio company, weighted for the positions size in the portfolio.

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

## **Amended and Restated November 2024**

### **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](http://www.adviserinfo.sec.gov). Registration with the SEC does not imply any particular level of skill or training.

All statistics highlighted in this research note are sourced from ACR's analysis unless otherwise noted.

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.

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.

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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](http://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.