

## Capital Protection and Volatility

Equity and debt markets rebounded in the 2<sup>nd</sup> quarter as tariff panic receded. The largest selloffs typically present the best opportunities. Yet smaller waves of volatility — such as the Christmas holiday declines of 2018, the rising rate bear market of 2022, and the recent Trump tariff tirade — still present favorable conditions for a purchase or two. We are investors rather than traders. This means we make no attempt to call tops and bottoms. Rather, market declines allow us to acquire shares of businesses that have temporarily gone on sale. Conversely, after rapid price increases, we may trim holdings which have become too large in the portfolio at higher valuation levels.

Our activities naturally impact cash balances. The average cash position in our flagship EQR strategy went from 18% in November of last year to 9% in April and is now back at 12%. When volatility presents opportunity, we never think about overall market valuations. Instead, we focus on the price-to-value of the individual companies we own, or could own, and act accordingly. Cash is helpful for taking advantage of opportunities during market declines and can reduce volatility, yet adjusting cash balances is not how we think about protecting capital. Rather, cash is a byproduct of focusing on the three essential elements of capital protection and appreciation: quality, value, and diversification.

The way to achieve our foremost objective of protecting capital is to own quality companies, purchase them at reasonable valuations, and maintain a suitable level of diversification. Quality defines both the *company* and *investment*. The quality of a *company* is defined by the durability of the cash flows which produce its fundamental value. The enterprise must be well positioned, based on its products, markets, and competitive standing, to generate durable cash flows. The company must also have a modest or low level of debt if we are investing in its common equity. The quality of an *investment* is defined by the attractiveness of the price paid in relation to fundamental value.

We are relentless on these points in our equity investments: durable cash flows, modest levels of debt, and the right price. The ACR investment team forgoes many investments due to this discipline. This can reduce returns, not only during good times, but all the time. Attempting to protect from a depression, and not having one, means we never receive the benefit of this “insurance.” But that is okay with us. We care more about holding on to what we have than making a few extra bucks on top of a satisfactory return.

Proper diversification, the third essential element of capital protection and appreciation, represents quality at the portfolio level. Proper diversification is achieved when the overall portfolio return is protected from unexpected adverse results in individual holdings, industries, countries, or other risk factors. The right amount of diversification means enough to make up for mistakes and negative surprises, but not so much that we “deworsify” into lower quality or overvalued investments. In other words, a certain amount of concentration can be risk-reducing. Successfully executed, concentration has three benefits: (a) returns are enhanced by selecting investments with the highest probability of success, (b)

risk is reduced by avoiding mediocre and poor commitments, and (c) knowledge is improved by concentrating the analytical effort.

Protecting capital does not necessarily help investors avoid volatility. Volatility is not risk. It may (or may not be) a byproduct of risk. Volatility can be an element of risk at the investor level (more on that in a moment). Risk at the investment level is the likelihood and potential magnitude of a permanent decline in the earning power of an enterprise, or the payment of a market price at purchase which is higher than fundamental value. Realized risk reduces fundamental principal value and investment return. Our goal is to protect against realized risk, not to mitigate volatility.

Fundamental principal value has two components. The first is the original (or any subsequent) cash contributed to an account or fund. The second is the ex-post level of cash income earned by our portfolio companies, which is either reinvested at the company level or paid out as a dividend. Put another way, unspent cash income becomes principal value after it is earned and reinvested. Fundamental principal value is different from market value. Fundamental principal value is determined by cash contributions and company earnings. Market value is determined by market participants agreeing on a price when buying and selling. Ben Graham used to say that the market is a “voting machine” in the short run and a “weighing machine” in the long run. The voting machine is the buying and selling that establishes market value. Fundamental value, on the other hand, is “weighed” each year as companies produce cash earnings. These two values at times can become detached, which is one of the reasons we share fundamental value metrics with you.

We believe that many investors are unwittingly focused more on avoiding volatility than protecting capital. Who doesn't want to avoid downside volatility? The framework and methods are what matter. All investors should adjust their exposure to equity volatility based on two factors. The first is their spending needs. Volatility is a risk at the investor level if investor cash needs are not properly matched with investment cash flows. Equities must be balanced with quality fixed investments to produce enough cash income, realized gains, and liquidity to meet the investor's cash needs. The second is their tolerance for volatility. Investors who cannot stomach larger temporary equity price declines can calibrate their equity-to-fixed income allocation to stay within a desired volatility comfort zone, recognizing the tradeoff is likely to be a lower long-term return.

Whether these proper steps to address volatility are taken or not, investors often choose other methods to avoid volatility that we consider counterproductive. Overemphasizing low volatility equity investments is one. First, on principle, investors will want to select the most attractively valued quality investments from the largest universe possible. Limiting one's selection universe to low-volatility equity investments is therefore suboptimal. A related and greater danger is paying an unwarranted premium for low volatility which turns out to be value destructive when the premium shrinks or disappears. Today, the temptation to execute this type of strategy is higher than ever with the proliferation of ETFs (Exchange Traded Funds) designed with such characteristics in mind.

A close cousin of the low volatility strategy is to own “defensive” stocks rather than cyclical companies when one thinks the risk of recession is high. This reminds us of the old economist’s joke that the market has predicted nine of the last five recessions. Count us as skeptics that investors can successfully anticipate recessions, jump into defensive holdings at the right time, avoid the associated economic and market volatility, buy cheaper (and usually riskier) holdings at the bottom, and ride these holdings back up until it’s time to play defense again. Yet media pundits, portfolio managers, and wealth managers chatter incessantly about short-term economic data and how a portfolio should be “positioned” for the economic and market environment they are guessing may unfold.

In our view, attempting to anticipate the next recession is speculation, not investment. Sometimes it may work, other times it may not. In the meantime, as the dice are thrown, commissions and taxes drain value, and the portfolio is not optimized to own the most attractive investments for the long run. Important to note, this does not mean investors should fail to adjust valuations and holdings based on prevailing economic conditions. Understanding how companies and industries are impacted by economic cycles and estimating future cash profits accordingly is essential to investment success. That is different from attempting to sell or reposition a portfolio in anticipation of a market decline. ACR avoided financials and housing stocks prior to the GFC (Great Financial Crisis) because we understood the fragile state of these sectors, not because we knew precisely when the bubble would burst.

The economy appears sound today, but conditions can change on a dime. Indeed, when economic conditions appear most benign, the economy and markets can be most at risk. As always, the ACR investment team will continue to be on alert for trouble spots as well as opportunities as economic events unfold.

*Nick Tompras*  
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