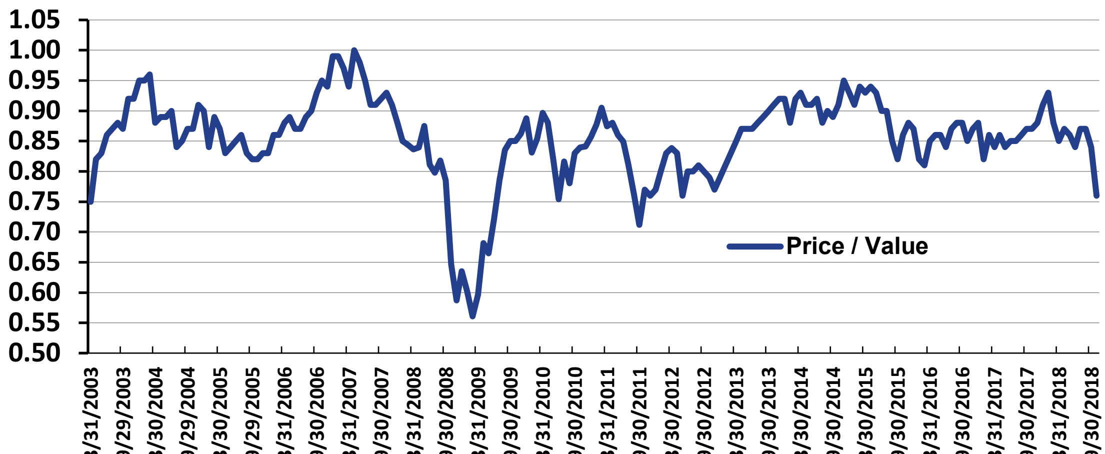
Volatility and True Results

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.

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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 ÷ 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.

Rather than focusing on short-term volatility, we maintain an almanac of financial statistics on our portfolio holdings and boil them down to a handful of key summary statistics. A series of equations will help illustrate our framework for thinking about true fundamental returns. Metrics will be different for equities and credit investments and will vary somewhat based on strategy structure and each portfolio manager's unique statistical matrix. Equations and data for the EQR strategy are below:

Equity Valuation Return - Fundamental Cash Drag = Portfolio Valuation Return > Market Return

Equity Valuation Return = Required Return[1] + Excess Return from Price/Value over Ten Years
12.6% = 9.5% + 2.8% (Excess Return = 2.8% = (1.00 ÷ 0.76) ^ (1/10) - 1)

Fundamental Cash Drag[2] = (Dividend Yield + Real EPS Growth + Inflation - Cash Return) x Cash Allocation
1.5% = (2% + 2% + 3% - 2%) x 30%

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Equity Valuation Return - Fundamental Cash Drag = Portfolio Valuation Return
12.6% - 1.5% = 11.1%

Market Return = Cyclically Adjusted Earnings Yield[3] + Inflation - P/E Change over Ten Years
3% = 3% + 3% - 3%

Portfolio Valuation Return > Market Return
11.1% > 3%

While we are reluctant to share this data because we fear it will be misconstrued, we share it anyway because we believe summarizing valuation metrics is important for effective investor communication. Our concern about data misconstruction is founded on the belief that forecasting equity returns over a specific time horizon is impossible, whereas estimating long-term returns in a rough directional sense is possible. A ten-year horizon is used not because we expect returns to be exactly as indicated ten years from today, but because it is long enough for corporate cash flows to develop into intrinsic value, and therefore to be directionally on target.

The primary takeaway from the data above is that the difference between EQR strategy valuations and market valuations today 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

[1] The Required Return is the rate of return required for the inherent risk of an investment. The higher (lower) the risk, the higher (lower) the required return. The required return also serves as the rate which equates future cash flows with present intrinsic value in ACR's discounted cash flow valuations. The portfolio required return is the weighted average required return of each portfolio investment.

[2] The Fundamental Cash Drag is the estimated fundamental return that an investor forgoes by holding cash. The fundamental return consists of dividends and per share corporate earnings growth. This is distinct from the market return which includes dividends and market price appreciation. The current dividend yield is used since ACR only expects cash drag during periods of historically low dividend and earnings yields.

[3] 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.

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

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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.

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