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Patient Investing

The stock market moves in leaps and bounds. This past year was no exception. From the market bottom in October 2002, the NASDAQ Composite Index is up 47%, the Russell 2000 Index of small companies is up 46%, and the S&P 500 Index of large companies is up 19%.

Company quality was a factor. Junk rose to the top, literally. Below is a table of stock returns segregated by credit quality – AAA represents the highest quality, CCC the lowest.

	AAA	AA	A	BBB	BB	B	CCC
Companies	13	63	322	515	384	238	20
Stock return past year	7.8%	21.2%	26.0%	34.8%	51.3%	150.7%	213.9%

Alpine sticks with quality. The majority of our holdings are AAA to A, with a few BBB's. Not surprisingly, our returns were at the quality end of the spectrum this past year. The following is an explanation of why we are comfortable, at least temporarily, playing the role of tortoise rather than hare.

Firstly, quality is paramount. One could get by owning lower quality companies. Then again, one could fall off a financial precipice owning lower quality companies, should the economic equivalent of a 50 or 100 year flood hit. When it comes to your money and ours, we don't live on the edge.

Secondly, additional risk is likely to provide only a modest addition to return. Investing in BB/B versus AA/A securities has typically added a few percentage points of return *in the long run* – meaningful, but not worth the chance of financial disaster. On the other hand, speculating on B and CCC companies could prove far more profitable *in the short run*, as indicated by the spectacular returns in the table above. Indeed, speculators often bet on high-quality companies during difficult economic times to profit from a 'flight to quality'. Then they bet on low-quality or smaller companies when the economy is improving. Sounds reasonable enough. There is just one problem. This is like saying one can jump in before the big run-up and jump out before the bubble bursts. Easier said than done. While big returns may be at stake, we believe the odds of long run success with speculative strategies are only slightly better than those you will find in Las Vegas.

Thirdly, we believe our quality portfolio will fare well in the long run compared to lower quality and small company portfolios – not only from today, but from last year. Today, it costs $32 to buy $1 of earnings in the Russell 2000 Index of small companies. By contrast, it costs $13 to buy $1 of earnings in the average Alpine-selected portfolio.* The Russell 2000 would have to decline 60% to be equivalent in value to our portfolio. *Even from last year, when it cost only $22 to buy $1 of earnings in the Russell 2000, the index would have to decline 40% to be equivalent to our portfolio*. The NASDAQ is even more over-valued, while the S&P 500 is a little less. In short, significant valuation discrepancies like these

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provide us with the kind of odds we like. More importantly, investors in over-valued indexes are likely to experience one or more of the following: significant short-term losses, negative intermediate-term returns, or low long-run returns. The valuations in the Alpine portfolio may not offer protection against short-term price swings, but our portfolio is far better positioned to provide protection against unsatisfactory intermediate and long-run returns.

Please note, the reason we are pessimistic about overall stock prices has nothing to do with economic conditions. The economy is clearly on the mend. Rather, we believe stock prices will continue to face a strong headwind because of the enormous bubble created from 1995-99.

In the end, the only way to avoid speculative losses is to avoid speculative prices. Discipline is essential. There are a few pockets of reasonably valued companies in today's market, but unfortunately, we are not finding enough of them. Inactivity, in this case holding cash, is sometimes the most intelligent thing to do. It is no fun sitting on cash, especially when rates are at historical lows. But if discipline were easy, it wouldn't be discipline.

Another reason we are comfortable holding cash is that we view the opportunity set of attractive investments over time, rather than at a single point in time. Given the frequent and wide-ranging fluctuations in company, industry, and general market conditions, we are confident that we will have the opportunity to invest in sound businesses at reasonable prices soon. In the meantime, patience is a virtue.

Nick Tompras

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* For the technically minded, the above conclusions about relative valuations require the assumption that $1 in earnings in the Alpine-selected portfolio is equivalent in value to $1 of earnings in the indexes mentioned. I believe the Alpine portfolio should sell at a premium, given its above-average quality and return-on-capital. But maybe I'm prejudiced, so we'll leave it at equal. Also note, earnings are adjusted for normalized economic conditions, stock compensation expense, inflated reported pension income, and normalized special charges.

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