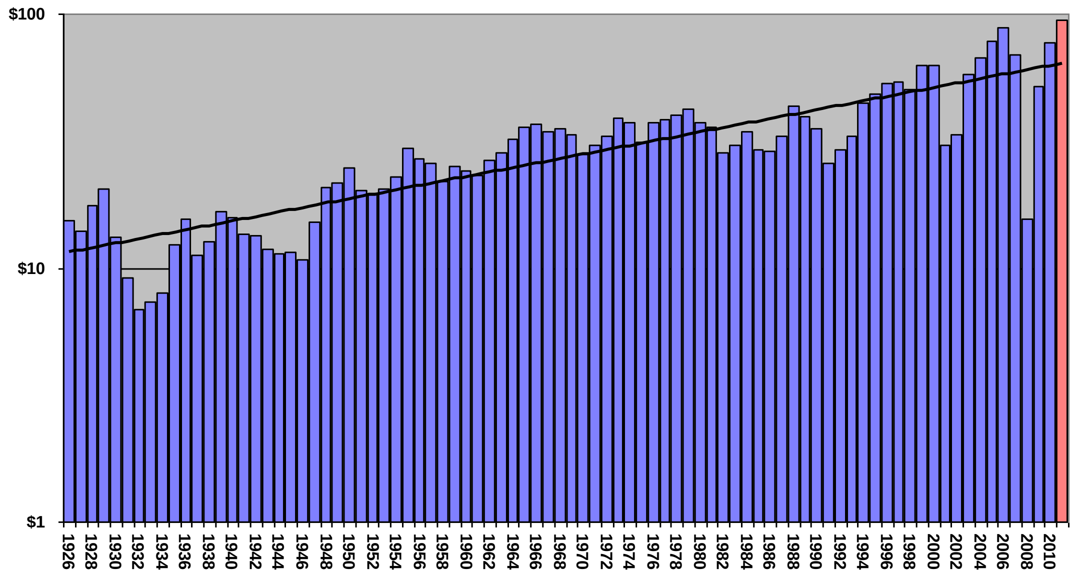
One Foot In, One Foot Out

Corporate profits are strong, but the labor market is stagnant. GDP in developing countries is roaring ahead, while the US and Europe are inching along. Financial institutions are profitable, but governments are on thin ice. Taken together, the economy seems to be in a no man's land of conflicting data points.

The good news: we do not have to figure out any of this to make money. All we have to do is find companies that are making money and pay the right price for them. In our opinion, more money is lost (or not made) because investors become too distracted by big picture issues they could not possibly decipher. The nature of stock investing is to exchange money today for the future profits of a business. Understanding profits is the name of the game.

So what are profits telling us? Big picture corporate profits are well above trend-line. 2010 was a banner year, and 2011 estimates (in red) exceed the all-time high set in 2007.

Corporate Profits: S&P 500 Earnings Per Share in 2010 Dollars



Source: Standard & Poor's

To suggest historical growth rates will proceed from current levels would be more than a touch optimistic. Just picture the trend line jumping to the top of the red bar and proceeding from there. Tough to imagine without the rosiest of rose colored glasses. Yet, many forecasts count on it.

A more plausible forecast in a *healthy* economy would be a slower growth rate, or a decline in earnings, that ends up somewhere closer to the historical trend. Of course, there are many reasons to believe the economy is not exactly healthy.

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Our thesis is government spending has taken the place of profligate consumers. The spending is juicing up corporate profits, companies are producing more with fewer workers, and thus unemployment remains high. If this is the case, the real problems come when government stops spending.

Whatever the culprit, we remain cautious. Stock market prices relative to normalized cash earnings are getting high at 22. The historical average is 16. The most important barometer is our company-by-company valuation analysis. Conservative estimates of corporate profits for the approximately 450 companies we have valued leaves a small list of potential buy candidates. The pickings are not as slim as in 2007, when we could find almost nothing to buy, but they are leading us to a "one foot in, one foot out" portfolio.

Our average portfolio is about 20% cash, and there are more companies closer to sale than purchase. New portfolios are being funded with about 50% cash. Our philosophy of only buying with a significant margin of safety between price and intrinsic value means we will not purchase a company in a new portfolio that is getting close to fair value in a seasoned portfolio.

Newer portfolios are likely to under-perform older portfolios in a market like today's which is fully valued and continuing to rise. Market values this year of many newer accounts are up 2-3%, whereas many older accounts are up 6-7% (see our composite performance presentation at www.acr-invest.com). Newer accounts not only have more cash, but higher quality stocks. In general, we believe larger defensive companies are more attractively valued than riskier cyclical companies today.

Small differences in market movements in the short term are not a concern. We have had them before and will again. Real money is made in the long run. The key to investment success in our opinion is being patient and waiting for the right price. Please note the market does not have to go down for us to employ cash. Opportunity often strikes one company at a time. While we have sold more than we have bought this year, we have added three new companies and have several more in the due diligence pipeline.

Our single-minded focus on corporate profits does not mean we are wearing macroeconomic blinders. Macroeconomic analysis is an important element of our research. It helps us avoid trouble spots, establish normalized profits through the economic cycle, and guides our long term profit estimates.

Economic trouble spots remain. Nevertheless, we remain confident that the long term engine of US economic success is not broken. Debt levels are high, but not so high that they pose a fatal threat to the economy. Our commentary in coming quarters will address these issues in further detail.

Nick Tompras
Chief Investment Officer
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