

The Most Important and Misunderstood Idea in Investing

Portfolio Review

2011 turned out to be a long choppy road to “not so much”, at least on paper. Total return for the year*:

ACR EQR Composite: 4.3%

S&P 500: 2.1%

**Total returns are for the Equity Quality Return Composite and include dividends and capital appreciation net of all fees. Full composite performance and disclosures are updated quarterly on our web site.*

“Paper” refers to the ephemeral nature of these figures – they reflect changes in market value on year-end brokerage statements. A typical week of market volatility could easily triple or wipe them out, yet great importance is attributed to such figures because they happen to fall within the calendar year. The real change of importance is in intrinsic value rather than market value. Intrinsic value is rarely mentioned in the financial press. Even those who can define it usually still focus on market value when evaluating their investments. Intrinsic value is the cash that can be taken out of a company over its business life.

We are slave to what we can measure. Brokerage account market values are available anytime day or night. Intrinsic value, on the other hand, is not published anywhere. It is based on business profits and prospects. Though difficult to measure, intrinsic value is the only sound reference point for determining whether the market value as stated on a brokerage statement is fair, high, or low.

Market value and intrinsic value can vary widely from each other in the short term. Our job as investment managers is to assure that each dollar of market value on client brokerage statements is backed by at least a dollar of intrinsic value. Only a small minority of investment managers lived up to this standard in recent years, as abysmal investment manager and stock market returns from 2000 forward reveals. We will further discuss intrinsic value – the key to protecting capital and making money in stocks – in the next section.

2011 added slightly to the bull market of the previous two years. Unfortunately, the increases of the past three years were preceded by the nastiest bear market since the Great Depression (beware the purveyor of investment services who only shows you the past three years). Total return including both down and up years for ACR and the market are given below*.

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Average</u>
ACR EQR	-14.6%	28.1%	19.2%	4.3%	8.0%
S&P 500 Index	-37.0%	26.5%	15.1%	2.1%	-1.6%

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Despite only minor market value changes in 2011, there was considerable activity both in the global economy and our portfolios. Regarding our portfolios, 16% of our holdings were sold and our average cash balance declined by 12% – from 23% at the beginning of the year to 11% by year end.

Three companies were sold outright as they reached our estimate of intrinsic value and one company was eliminated via acquisition. We also took profits by selling half a position in non-taxable accounts, which we did not sell in taxable accounts to avoid short-term capital gains. Five new companies were added to the portfolio, and several additions were made to existing portfolio companies in August and September.

As always, our activity is driven entirely by the valuations of our current portfolio companies as well as our “on deck” group of over 400 valued companies. The big question is whether or not all of this activity produced anything of value. The best gauge today of whether we are adding value can be found in our intrinsic value estimates, understanding that only time will tell if this year's work will prove as profitable as we believe.

By our estimates, the intrinsic value of our equity portfolios increased by over 10% in 2011, an amount which is yet to be reflected in the “paper” market value shown on client brokerage statements. Bottom-line, a 10%+ gain combined with this year's 3% dividend yield place 2011 under the heading “okay”.

Three of our five new portfolio companies were brought to me by Willem and Tim who have done an outstanding job of adding value to our analytical process this year. Our personnel principle is taken from the late advertising legend David Ogilvy: "If you always hire people who are smaller than you are, we shall become a company of dwarfs. If, on the other hand, you always hire people who are bigger than you are, we shall become a company of giants." Willem and Tim are well on their way to making me smaller.

Willem, Tim and I agreed that one of our portfolio companies was not living up to its responsibility to shareholders. We prefer to have positive relations with management – oftentimes the main reason we buy a company is the quality of its management team. Yet there will also be times when we seriously disagree with management. In these cases we will engage the company privately first. If this does not work we will air our concerns publicly. The letter written to the aforementioned company can be found at www.improvecalamos.com. Kudos to Willem for drafting an excellent letter, which Tim and I lightly edited.

ACR has never formulated an “outlook” for the year. This is not strictly out of mental lethargy. The firm's founder discovered years ago there was something like a 50/50 chance of his outlook being right. So rather than wasting time on things we are just as likely to get wrong, we spend our mental energy on things we know reasonably well. That list is relatively small, consisting primarily of business quality and stock value.

The overall US stock market appears reasonably high selling at a price 21x higher than our estimate of normalized cash earnings. Anything above 20x for the overall market is in our opinion pricey. However, the valuation of the overall market does not necessarily concern us. While it represents the universe from

which we select our holdings, we do not invest in the stock market. We invest in a small group of businesses which oftentimes have very different characteristics than the stock market. On that score our portfolio companies are selling at a price 12x higher than our estimate of normalized cash earnings, which we estimate is approximately 30% from their intrinsic value.

Regarding quality, our portfolio companies have a very reliable earning power, a characteristic evidenced by their strong corporate operating performance during the 2008-09 recession relative to the economy generally. Equally important, our companies are conservatively financed. Interest coverage is 10.3x for our portfolio companies versus 5.6x for the average company in the S&P 500 (interest coverage is the amount by which earnings before interest and taxes is higher than interest payments on debt).

In short our “outlook” consists of only two brief but hopefully reliable assertions: the valuation of our portfolio bodes well for future returns, and the quality of our portfolio will sustain us through potential turmoil. When these positive future returns will materialize and how 2012 will turn out is unknown to us. While this may be unsatisfying to those who pine to know the future direction of the market, better to be unsatisfied than filled with unfounded expectations.

Investment, Speculation and Intrinsic Value

Intrinsic value for stocks is best understood in the context of the distinction between investment and speculation. One of the best definitions on the subject dates back to the late great investor and author Benjamin Graham. Graham wrote circa 1934 during the darkest hours of the Great Depression: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Given the safety of principal standard and stock price volatility, one might conclude that all stocks must be speculative. In our opinion, this is not the case. The logic of how stocks can be a sound investment as distinct from a speculation rests on three key requirements.

- (i) A quality company. A quality company by definition has a reliable intrinsic value. The value of the enterprise must not only be sound, it must also be conservatively financed. A conservatively financed company can service its debt regardless of economic conditions. A quality company does not necessarily imply a quality business. What is the difference? A company may have liquid assets which are worth significantly more than its price. Even if the company's business is weak, it may qualify as a quality investment as long as these assets can be monetized.
- (ii) A quality price. Intrinsic value is not a precise figure, but more a range of potential values. Therefore, a significant margin of safety is required between market price and intrinsic value. Price itself is an element of quality. A mediocre company can be a sound investment if it is selling at a very large discount to a knowledgeable estimate of its intrinsic value. Conversely, the highest quality company can be a speculation when price is significantly higher than value.

- (iii) Sufficient diversification. Even the very best investors make mistakes. Sufficient diversification is achieved when the overall portfolio return is protected from unexpected adverse results in individual holdings, industries, or other common risk factors.

A final dimension is time horizon. Clearly the safety of principal standard in Graham's definition does not apply to short term changes in market value. Stock prices are volatile in the short term. Rather, the safety of principal standard applies to the long term value of a quality company purchased with a significant margin between price and value.

Making Money: Dividends, Intrinsic Gains, and Market Gains

Focusing on intrinsic value and paying the right price makes sense, but how does it make money? Money in a stock is made two ways: dividends and price appreciation. One of the reasons investors erroneously focus on market value is that price appreciation – the increase in market value – is potentially a much quicker way to make more money. In the short term, price or market gains are volatile and determined by buyers and sellers. The more buyers there are at higher prices, the more prices go up and vice versa.

Unfortunately, predicting the behavior of crowds is impossible (at least for us). Predicting intrinsic gains in a quality business, however, is possible – and intrinsic and market gains are joined at the hip in the long term. To see this consider a stock that pays a 3% dividend and grows its revenues and profits at 7% per year. At the end of ten years the business will have doubled in size. This is the intrinsic gain. The market gain will mirror the intrinsic gain – a business that doubles its earning power is worth double as much (holding all else equal).

Income oriented investors today are logically focusing on dividend income with short-term interest rates near 0% and long-term interest rates near 3%. ACR has always focused on total return – the return from both dividends and intrinsic/market gains. In our opinion, the cost of limiting the opportunity set to high dividend yielding stocks is far greater than the benefit of a little extra dividend income.

That said, we love dividends. Companies that give back lots of cash to shareholders each year not only line shareholder pockets; they keep management more honest as capital allocators. Finance 101 rightly teaches that a company should pay dividends rather than retain profits, unless the return on its business will be higher than the return shareholders can earn elsewhere (holding risk constant). Management with less cash to spend each year is more likely to be pickier about how it invests what remains.

Many corporate managers do just the opposite. They would rather grow the top line and increase the corporate empire by making pricey acquisitions and diluting shares outstanding. The reason is incentives. Corporate managers of \$50 billion in revenue companies generally make a lot more money than managers of \$5 billion companies, regardless of how much their shareholders have made.

The EQR portfolio today pays a dividend of 2.9%, 30% more than the 2.1% paid by the average S&P 500 company. In the long term we believe our companies will produce intrinsic/market gains of 7-8% for a

total return of over 10%. This includes a 3% inflation plug. If inflation is lower we expect a lower return and vice versa. Of course these are not guarantees, but estimates based on our analysis of intrinsic value. Another way of thinking about dividends and gains is to calculate the cash earnings yield. The cash earnings yield is an estimate of the sustainable dividend yield assuming a company paid out all of its profits in dividends. The estimated cash earnings yield for our portfolios today is over 8%. Add 3% inflation and the total estimated return is again over 10%.

It follows then that we find a 10% or greater total return in sound companies with a 3% dividend yield more attractive than a 7-8% total return portfolio even if its dividend yield were 5%. We love dividends, but not at the expense of total return.

Parting Thoughts on Risk and the Road Ahead

Understanding businesses and their intrinsic values are the keys to investment success. Yet the average investor will still check their market value daily on the Internet or rip open their monthly statement to see how they did. Unless they or their investment manager knows their intrinsic values, they are like passengers on a boat counting waves without any idea where they are drifting.

One could argue that we are the boat adrift on a sea of macroeconomic tides which could someday capsize the companies we own. The macro economy has taken on greater importance and interest for us in recent years, and we are more confident today in our analysis with economist Steve Fazzari informing our viewpoints. Unlike Alan Greenspan and Ben Bernanke, Steve understood the economy's fragility in 2007 and foresaw its weakness today.

Steve's conclusions have been an important reason behind our more conservative normalized earning power estimates in recent years, and he has been a great help in interpreting the myriad of macroeconomic perspectives which are recasting national economic policies.

Conversely, the more we know, the more we realize that we don't know. Rational economic models with mathematical proofs can be complex enough. Sprinkle in a little human behavior and you have an almost impossible puzzle for the ages. Macroeconomic analysis in our investment decision-making process will continue to be limited to specific factors in our company-level valuations. Too many investment managers in our view make major investment decisions on economic theories which are speculative at best.

Our underlying macroeconomic premise remains that the global economy will function, if imperfectly. Consider the alternative, which we call the Mad Max Paradox. For those unfamiliar with the Mad Max movies, they are set in a stark post-apocalyptic world in which tribes of barbarians live in makeshift forts made from relics of the industrial past. The Mad Max Paradox is the proposition that a true global economic implosion would be so bad one cannot prepare for it. We subscribe to the Mad Max Paradox, and believe the odds of it happening are less than miniscule.

A more plausible potentiality is what we call the Big Reset, though still far-fetched since it has never happened in the post Industrial Revolution era. The Big Reset consists of an epic and permanent

contraction on the order of 1/4 to 1/3 of the economy. Permanent means the economy contracts and then resumes normal output levels from the low. We have long said that if the bottom 1/4 of the world economy falls off the edge of a cliff, our margin of safety is a portfolio among the top 1/4 of companies least likely to suffer permanent loss.

Europe is the main global concern today. Its plight appears to us intractable. The Elephant in the room is the Euro – no one wants to talk exit strategy. A common currency combined with large fiscal deficits, disparate productivity levels, and inflexible economic institutions has proved a failure. Turmoil may once again strike as it dawns on the stock market that the risk is not "Too Big to Fail" financial institutions, but to "Too Big to Save" sovereign governments.

A messy collapse of the Euro may not produce the Big Reset, but a contraction ala 2008 is possible. Either way, we believe that the quality of our portfolio will protect us from permanent losses. Additionally, the US has dealt with its problems from 2008 quicker, and our financial institutions are in much better condition than in 2007.

The US economy is on the mend, European is near recession, and Asia is slowing significantly. That the US economy remains an island of 85-90% domestic production and consumption may not be such a bad thing this coming year. Looking out several years, the equity values in our portfolio imply sound returns, even if Europe suffers a contraction which spills into own backyard.

*Nick Tompras
Chief Investment Officer
January 2012*

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