

## Stock Picking and Playing Defense

The markets have breathed a collective sigh of relief. The magic words "whatever it takes" (ECB chief Mario Draghi's stated commitment to the Euro) and the magic number 7.8% (US unemployment rate) have brought a sense that the worst of the Euro crisis has passed and that the US economy remains on the mend. Optimism and low interest rates have propelled the nearly 4 year old bull market to new highs. EQR and S&P 500 total returns through the full economic cycle and during the bull market are below\*.

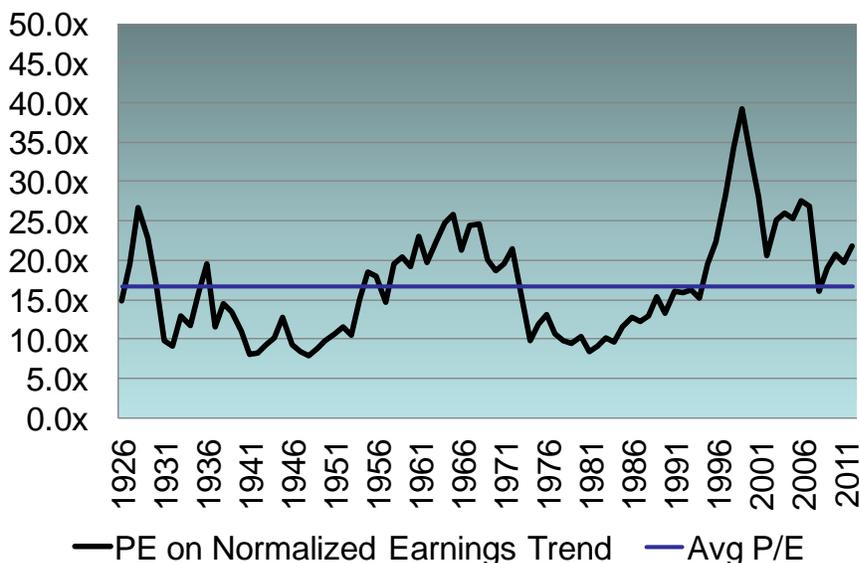
		Cumulative		Annualized	
		<u>EQR</u>	<u>S&amp;P 500</u>	<u>EQR</u>	<u>S&amp;P 500</u>
<b>2008-2012</b>	Bull & Bear Market	46.4%	9.0%	8.4%	1.8%
<b>2008</b>	Bear Market	-15.0%	-37.0%	-15.0%	-37.0%
<b>2009-2012</b>	Bull Market	72.2%	73.2%	15.6%	15.8%
<b>2009-2010</b>	Early Bull Market	51.1%	45.5%	22.9%	20.6%
<b>2012</b>	Current Year	9.8%	16.4%	na	na

*Note: 2012 ending 9/30*

\* EQR (Net 1.25%) is the total return (dividends and capital appreciation) of the Equity Quality Return Advised SMA Composite calculated net of a 1.25% hypothetical annual fee. The EQR (Net 1.25%) return calculation is supplementary information based on the average recommended fee schedule across our client/partner base. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site. Actual fees may be higher or lower than 1.25%.

The EQR strategy has been giving up ground relative to the S&P 500 as the bull market wears on. This is not surprising. As prices move higher, we become more defensive one stock at a time. Stocks scooped up during the bear market are sold as they reach full value, and cash may build until opportunity knocks in worthy replacements. ACR has never been afraid to hold cash when both general market prices are high and there are fewer pricing discrepancies across the market. The chart below helps to show why we began playing defense recently.

### S&P 500 P/E on Normalized Earnings 1926-2012



Sources: Standard & Poor's, Bureau of Labor Statistics, ACR

The blue line represents the historical average price to buy \$1 dollar of earnings in the stock market. It is just over \$16 (P/E of 16). Today the price to buy \$1 of earnings is approximately \$21 (P/E of 21). The market would have to fall 24% to get to its historical average. There is no particular reason this has to happen. However, we do consider the historical average to be a reasonable level based on textbook valuation mathematics. A P/E of 16 implies a real stock market return of approximately 6% (not including inflation), which we believe is a sensible required return for the risk taken. Today's P/E of 21 is not egregiously high, but it is in "playing defense" range. More importantly, our one stock at time valuation process confirms increasing market overvaluation as depicted in the chart.

The E in the P/E chart is based on normalized As Reported earnings rather than current earnings. "Normalized" means earnings are adjusted for economic cycles (we utilize a least squares trend-line of long term inflation adjusted earnings to normalize current earnings). "As Reported" means all special charges have been deducted from earnings. Earnings reported in the press are usually inflated by adding back these charges. We are very confident that using normalized bottom-line earnings is the correct methodology for assessing value at both the general market and company level. Note that at the company level, we make numerous other adjustments to earnings for business, industry, and accounting related reasons.

ACR's predilection for playing defense today does not mean that we are calling a market top or that we will forever hold cash. Consistently predicting market prices is, in our opinion, impossible. Moreover, ACR remains bullish on the US and world economy in the long run. Playing defense simply means being highly selective and cautious because market prices are high and sound values difficult to find.

ACR also believes that worthy candidates for investment can be found even if the market continues rising. We do not need a major decline to succeed, even though we do enjoy bear market bargains. Our objective is to produce an absolute equity-like return through a full market cycle regardless of market conditions. Under more normal market conditions, opportunity still knocks one stock at a time, and markets are almost always sufficiently choppy to produce the occasional bargain. For example, we purchased a new company at the beginning of the 4<sup>th</sup> quarter and have several potential candidates on deck. So we will continue to turn over many stones in search of favorably priced stocks, but we won't force cash to work at the expense of putting client capital at risk of loss.

*Nick Tompras  
Chief Investment Officer  
October 2012*

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*All statistics highlighted in this research note are sourced from ACR's analysis unless otherwise noted.*

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*The Equity Quality Return (EQR) Advised / SMA Composite consists of equity portfolios managed for non-wrap fee and wrap fee clients according to the Firm's published investment policy. The composite investment policy includes the objective of providing satisfactory absolute and relative results in the long run, and to preserve capital from permanent loss during periods of economic decline. EQR invests only in publicly traded marketable common stocks. Total Return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site at [www.acr-invest.com](http://www.acr-invest.com).*

*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.*