A|C|R
alpine capital research

Struggling to Find Value

The S&P 500 has returned 21% per year (appreciation and dividends) over the past four years (4/1/09-3/31/13). Investors who hesitated to invest in recent years are pouring money into stocks today. In the words of Saturday Night Live's Seth Meyers, *really?*

Buying high and selling low is a hardy perennial in the annals of economic history. The reason in our opinion is investor ignorance of an important paradox. Economic recovery produces increasing confidence and higher stock prices; yet higher stock prices, all else being equal, produce lower future returns. The converse applies during economic contractions.

Our investment commentary during the economic contraction of four years ago was entitled "Exactly the Wrong Thing" (March 2009). The "wrong thing" was that everyone was selling (or at least not buying). We concluded the commentary as follows:

> *The profit value of the stocks we own is demonstrably and significantly higher than the market value reported on your statement. What we really have today is the buying opportunity of a lifetime.*

And so we bought. The world was in a state of hysteria. Panic selling was rampant. There were cries of Depression. All good signs. The S&P 500 bottomed that month at 666. ACR versus market returns on the way back up from January 2009:

	EQR (Net 1.25%) Total & Annual	S&P 500 Total & Annual
2009-2013(Mar31)	**90.5% 16.4%**	**90.6% 16.4%**

As always we strongly warn against assessing results only in an up market. Intelligent investors know the current period for assessing an investment manager should begin in 2008, since this time frame covers both up and down cycles. ACR returns versus the market over the full cycle from January 2008:

	EQR (Net 1.25%) Total & Annual	S&P 500 Total & Annual
2008-2013(Mar31)	**62.0% 9.6%**	**20.1% 3.6%**

** 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%.*

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Today the S&P 500 is over 1500. The world is feeling a lot better, almost normal. We suspect "normal" will be more fully felt when unemployment dips below 7%, which may not be too far off assuming Europe or China do not pull us back into recession in the near term.

So what is one to do? Are investors who missed the bull market out of luck?

In our opinion, the market today is modestly over-valued and a new bubble will be inflating if the current trajectory persists. There are decent buys here and there, but not many. Caution is the order of the day.

While being entirely in the market is probably a bad idea, being entirely out of the market today is probably an equally bad idea. The proper approach in our opinion is to own a select basket of companies at reasonable valuations, and to not force capital to work unless you can buy at the right price.

The "not forcing capital to work" part is the reason our average account holds over 18% cash and new accounts hold over 50% cash. The struggle to find value and protect capital go hand-in-hand. We won't let our guard down. We will continue to remain highly selective, and will not fret over missing out on a little return in a lofty market.

The remainder of this commentary consists of evidence for our view and provides historical perspective for the more technically minded.

The first piece of evidence is biased, but we believe it is the best of all. Only 20 or so stocks on our 450+ stock "on deck" list appear to be under-valued. To contrast and compare, well over ½ of the list appeared under-valued in early 2009, whereas there were fewer than 5 companies in the under-valued category at the end of 2007. To better understand why we think this is a useful barometer, a little background about how this list is formed will help.

The stock investment process at ACR begins by using the Capital IQ database of corporate financial statements to pull up a comprehensive universe of approximately 4500 US exchange traded companies with sufficient liquidity and size. Companies with insufficient profitability or too much debt are immediately screened out. The 3200 companies left are then reviewed one at a time. This is where the real work begins.

Financials are pulled into spreadsheets and analyzed to assess corporate performance. The company's accounting is reviewed and factors of financial performance are identified. The corporate 10-K/Annual Report and the company's business, products, markets, management, and competitive position are then

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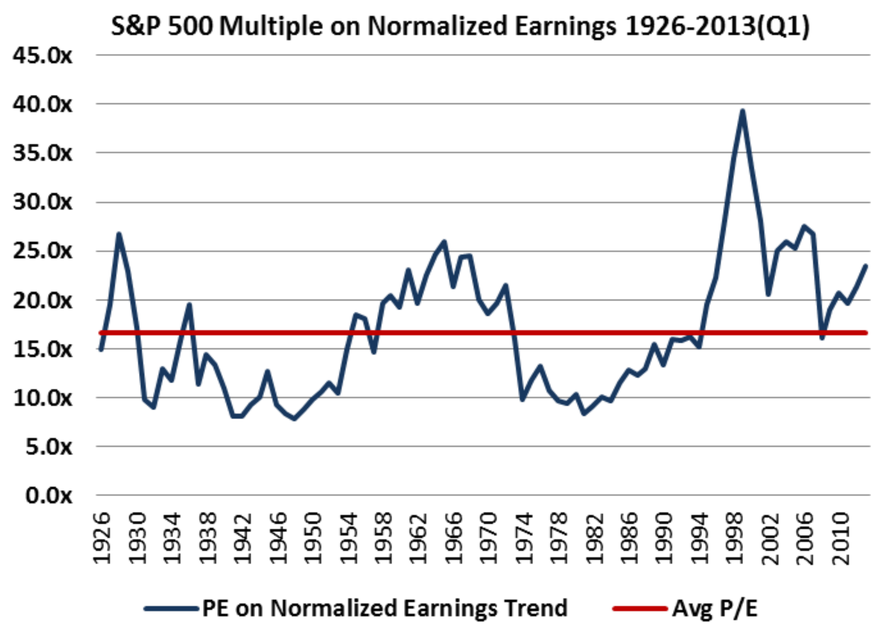
analyzed. The final step in the process of forming the "on deck" list is to calculate the intrinsic value of the companies that we consider desirable investments.

The 450+ stock "on deck" list therefore contains companies that we have valued. It is the best barometer that we have for whether or not the market is over or under valued, since the analysis occurs at a more granular company by company level. 20 potentially under-valued companies out of 450+ tells us that the market is not exactly ripe with opportunity today.

To close the loop, the final step in the process of forming the actual ACR portfolio is to analyze in much greater detail the cheapest among the companies on the "on deck" list to determine if they are either worthy of our excess cash or replacing a current holding.

The second piece of evidence that prices are high can be seen in overall market valuations. The following chart shows the price to buy $1 of earnings in the stock market. Important to note, the earnings in this chart are "As Reported" as opposed to "Operating", which means that special charges are properly deducted. Even more important, the earnings in this chart are smoothed using a log-linear trend-line to factor out distortions caused by the economic cycle.



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

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The difference today between current Operating and smoothed As Reported earnings is approximately 30%. Investors using current Operating earnings would conclude that the market is fairly valued. We think this is wrong. The chart based on smoothed As Reported earnings shows we are at the upper end of the historical range, especially if you remove the epic, probably anomalous stock bubble of 2000. Including the 2000 bubble, the current cost to buy $1 of earnings is $23, whereas the historical average is $16.

The picture at both the company and general market level therefore reveals that stock prices are high. Yet high prices do not mean the market will decline. We have no idea what the market will do – market predictions are in our view an exercise in futility. The point of identifying high prices is to protect capital by avoiding speculative excess, and to continue searching cautiously and ever diligently for the rare bargain.

Our caution should not, however, be confused with pessimism. We believe that the US economy is in much better condition today than it was prior to the Great Recession, and that sectors of the economy such as housing and commercial real estate development which suffered most during the crisis are finally returning to health.

Regardless of the macro economy and overall market prices, we will continue our job of reviewing the cheapest companies on our "on-deck" list and adding new companies from our 3200 stock list. Additionally, we will continue reviewing other opportunities that come to our attention outside of our formal screening process. We are confident that this "turning over stones" search process will continue to produce opportunity in the coming months and years, with or without another bear market.

Nick Tompras
Chief Investment Officer
April 2013

IMPORTANT DISCLOSURES

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This information is intended solely to report on investment strategies implemented by Alpine Capital Research ("ACR"). Opinions and estimates offered constitute our judgment as of the date set forth above and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. There are risks associated with purchasing and selling securities and options thereon, including the risk that you could lose money. All material presented is compiled from sources believed to be reliable, but no guarantee is given as to its accuracy.

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.

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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