A|C|R
alpine capital research

Staying Right Sized

Staying right sized is an essential ingredient for investment success. What do we mean by "staying right sized"? Metaphorically, we mean remaining humble. Literally, we mean limiting the size of the funds we manage. The goal of this commentary is to explain why we believe humility and fund size are directly proportional to investment success.

Anyone who is honest about investing knows it is a humbling business. All great investors make bad investments. All go through periods of underperformance. The vast majority of professional investors underperform the general market over their careers. Sir Isaac Newton, who mastered the law of universal gravitation, lost his fortune in the South Sea Bubble, finally realizing that even he was no match for the vagaries of market speculation: "I can calculate the movement of the stars, but not the madness of men."

Like Sir Isaac, another great thinker, John Maynard Keynes, discovered that successful speculation – in his case betting on currency and commodity price swings – was nearly impossible, despite being one of the most brilliant economists of all time. Keynes, however, learnt his lesson well and changed his strategy from speculation (macroeconomic) to stock investment. "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes."

Keynes went on to produce an outstanding track record as a value oriented stock investor on behalf of Kings College, Cambridge. Yet he still thought investing difficult: "[Investing] is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority." It is humbling that such great minds as Newton and Keynes found investing so challenging. Important to note, humility should not be confused with thinking less of oneself compared to others (though humility might be defined as thinking of oneself less!). Humility in investing is *honesty* about the difficult plight of all investors no matter how smart.

Lack of humility after a period of strong results can lead to overconfidence and errors in judgment. The Greeks called it hubris. Old Testament sages remind "how the mighty have fallen." Objective, rational thought is the foundation of sound investment decision-making. Emotion must be properly channeled. Courage is required to invest in undervalued securities which are by definition out of favor. Yet too much courage can spell disaster. Herman Melville's observations are as apropos for the investor as the sailor: "an utterly fearless man is a far more dangerous comrade than a coward."

An emotionally well-grounded investor is more likely to think in rationally weighted probabilities, recognizing the complexities of life and the limitations inherent in forecasting the future. When facts change, overconfident investors tend to defend their arguments despite evidence to the contrary, whereas more intellectually honest investors are more likely to change their minds. Humble investors

8000 Maryland Avenue, Suite 700 | Saint Louis, MO 63105
t 314.932.7600 | **f** 314.932.1111 | 877.849.7733 | **acr-invest.com**

an alpine investment management, llc group

are also more likely to remain teachable. One of the most rewarding aspects of being an investor is the limitless sea of knowledge on the subject of business and investing and all that touches upon it. The accumulated wisdom attained over many years of remaining teachable is a great advantage to anyone in life, especially the investor.

The "value ethic" – which we define as a passion for generating great results over asset gathering – is an attribute we seek in portfolio managers which tends to go hand in hand with humility. The investment industry attracts investors whose main focus is raising a lot of money, since revenues are based on a percentage of assets under management. The more one manages, the more one makes. We avoid asset gathering obsessed portfolio managers like the plague. We seek individuals who love the art of investing itself – whose greatest desire is to generate excellent results over a long career. Portfolio managers steeped in the value ethic know if they create a great track record, they will do well financially. Financial success is their reward, not their objective.

Portfolio managers steeped in the value ethic also know their limits – they generally prefer to manage less money than more. Why? All else being equal, the more money one manages, the more likely one is to underperform. As Warren Buffett has said, "size is the anchor of performance." While numerous studies have borne this out, the logic is simple and the factual evidence powerful. A review of our primary "on deck" list of companies for our flagship Equity Quality Return (EQR) stock strategy will illustrate the point.

EQR Primary "On Deck" List

Market Value ($mil)	Number of Stocks	Total Stocks	Total Holdings %	Required Return	Implied S&P Rating
$100,000 - $664,653	29	492	100%	9.2%	AA
$50,000 - $100,000	27	463	94%	9.5%	A-AA
$10,000 - $50,000	172	436	89%	10.1%	A
$5,000 - $10,000	94	264	54%	10.9%	A-BBB
$3,000 - $5,000	65	170	35%	11.1%	BBB
$2,000- $3,000	42	105	21%	11.4%	BBB
$1,000 - $2,000	31	63	13%	12.0%	BBB
$250 -$1,000	30	32	7%	12.8%	BB-BBB
< $250	2	2	0%	14.0%	BB-BBB

The table shows the number of stocks on EQR's primary "on deck" list categorized by market value. For example, there are 29 stocks with a market value of $100 billion up to the largest company on the list at $664.653 billion. The required return is the average of the individual required returns for all companies in each respective market value category. The required return is one of the most important figures in our valuations. First, it is the single summary figure which quantifies a thorough assessment of each company's risk. Second, it has a significant mathematical impact on the calculation of intrinsic value. Market value and risk are related since company size is an element of risk. However, risk is multi-faceted. Numerous larger companies in our universe are riskier (with *higher required returns) than numerous smaller companies. The implied S&P rating takes ACR's required return and converts it into an estimated S&P credit rating for illustrative purposes. Source: ACR Alpine Capital Research.*

EQR's strategy has been to target roughly 5% positions or 20 holdings. Generally we take smaller positions in smaller, lower investment grade companies. Conversely, we take larger positions when quality is higher and undervaluation greater. Given how we manage position size, a very rough estimate for illustrative purposes is that we can purchase a company with a market value half our fund size. For example, given this metric, a fund size of $4 billion would limit our purchases to companies with a $2 billion market value or greater. The rough math behind this illustration is that a 3% portfolio allocation results in the purchase of 6% of a company's shares outstanding. ACR may take a larger position when the intrinsic value of a company is durable and its price highly discounted, and in such a case would be comfortable owning a correspondingly larger level of shares outstanding. Important to note, as liquidity declines, influence with management and corporate strategy increases, which in certain cases can offset less liquidity.

Referring to the table above and employing the "half our fund size" metric, a $4 billion fund would eliminate about 13% of our current "on deck" purchase universe. The very bottom market capitalization companies are generally not very fertile ground for us to find quality prospective investment opportunities, so we are comfortable with this general threshold. ***Importantly, we are not comfortable letting EQR run up to $6 to $10 billion in assets based on current market values, since we would eliminate a much larger proportion of companies (21% to 35%, respectively, according to the table above) in more fertile ground for quality investment prospects.*** Note that actual company market value limits will most likely be different than these general illustrative thresholds, since determinants of liquidity and other factors will ultimately be company specific. The "half our fund size" metric and corresponding table data nevertheless provide a reasonable idea of overall magnitudes.

One might ask why not just increase our number of holdings or analysts? Were it only that simple! The reason it's not that simple is based on a few core beliefs we have about the nature of investing.

1. Investing is the creative work of the individual. Have you ever heard of a great novel written by committee? So it is with investing. Giving Warren Buffett 100 analysts will not make him a better investor. It would be detrimental to his success. He would have to spend all his time managing analysts instead of investing.

2. One highly skilled investor can only know so much. Returning again to Keynes: "It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence… One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence." While we prefer to hold more than a few stocks, we are confident that the top 20 best ideas of a skillful portfolio manager will perform far better than the next 20 best ideas.

3. ACR's growth will be limited by the number of skillful portfolio managers we attract, and just as importantly, the number we want to manage. If finding undervalued securities is difficult, finding skillful portfolio managers is even harder. We have several policies to help assure our success with portfolio managers. First, elevate only the unequivocally proven. With investor capital on the line, we have no choice but to field the best. Second, portfolio managers are full time investors. Client service, management, and marketing are important activities, but for the portfolio manager investing is job #1. This means more than a 40 hour work week. Third, portfolio managers operate with a full portfolio of holdings. We believe most great portfolio managers want to compound great returns with a discrete pool of capital, and we want to attract great portfolio managers. Fourth, limit asset size so each portfolio manager generates ideas from a sufficiently large universe of small, mid-sized, and large companies. That is, stay right sized. Today we are fortunate enough to have three solid portfolio managers who we plan to use with several analysts across three strategies: EQR, MQR, and EQR International (launch date TBD). That is enough to keep us busy for the foreseeable future.

ACR is committed to staying right sized culturally and through the proper scaling of our strategies. We believe there are few more important ingredients for the long term success of our clients, partners and firm.

Nick Tompras
October 2015