

Risk and Volatility

Modern financial theory defines risk as volatility. The more volatile an asset's price, the riskier it is. The theory makes intuitive sense: variability in value seems a reasonable measure of risk. Unfortunately, there are several problems with defining risk as price volatility, and they have a bearing on today's financial markets.

Timing is one problem. Price volatility is measured in the past. Even if price volatility was a perfect barometer of risk, the past may tell us little about the future. A related problem is that price is not value. *Price* represents the collective opinion of market participants about security value. *Value* represents the future cash flows of the underlying assets upon which security holders lay claim. Investors in certain residential mortgage backed securities (RMBS) circa 2005 found this out the hard way. The trivial price wiggles of many RMBS securities did not reflect what really mattered – the ability of mortgage borrowers to pay off their loans – until it was too late.

At ACR we view price volatility as one data point which may help us better understand risk. It is not risk itself. Risk at the asset level is the chance of a permanent decline in a company's earning power below our estimates, or the inability of a borrower to pay interest and principal. Risk at the investment level is paying a price which is significantly higher than what is justified by future cash flows. Risk is assessed by studying the fundamental characteristics of companies – products, markets, management, competitive dynamics, and capital structure. A thorough analysis of fundamental risk is hard work. Shortcuts like reviewing historical price volatility or running naïve price-based factor regressions can mislead.

Price volatility reminds us more of an EKG than an indicator of risk. The irony is that price volatility can be a *contrary* indicator: *higher* volatility often signals *lower* risk, and vice-versa. When market participants are calm, so is their EKG. Risk is less of a concern, investors feel better, and they drive prices higher. When market participants panic, the EKG goes crazy. Risks are exaggerated, investors seek safety, and they drive prices lower. The following chart illustrates this dynamic.

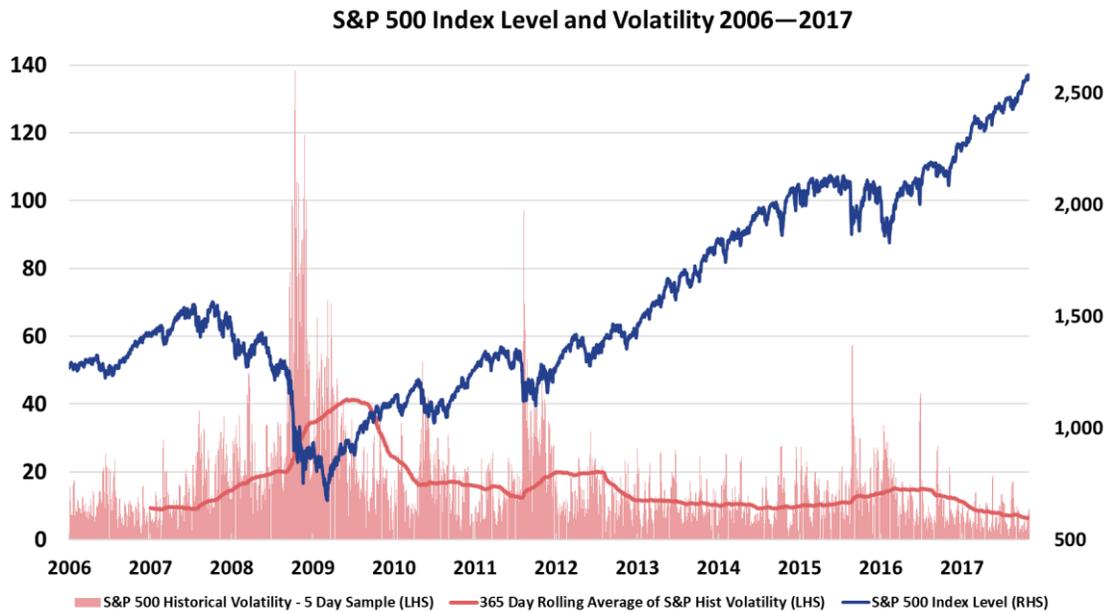


Figure 1 —Source: ACR Alpine Capital Research, Bloomberg, S&P Indices

Few would suggest that 2007 was a better time to invest in US stocks than 2009, after they became over 50% cheaper. Yet volatility was historically low near the peak in 2007 and historically high near the bottom in 2009. The economist Hyman Minsky said it best: “Stability is destabilizing. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits.” That insight brings us to risk and volatility today.

Volatility is at all-time lows as shown in the previous chart. Despite claims that investors are not as ebullient as they were at past market peaks, the market EKG is telling us that they are pretty relaxed today. Low volatility at a minimum raises a red flag. What about risk? Corporate earnings relative to security prices tell us more about today’s risks. The following chart shows three measures of income relative to valuation for a large swath of companies in the US stock market.

S&P 600 - Small Cap Index - Market Multiples

(Cyclically Adjusted Earnings)

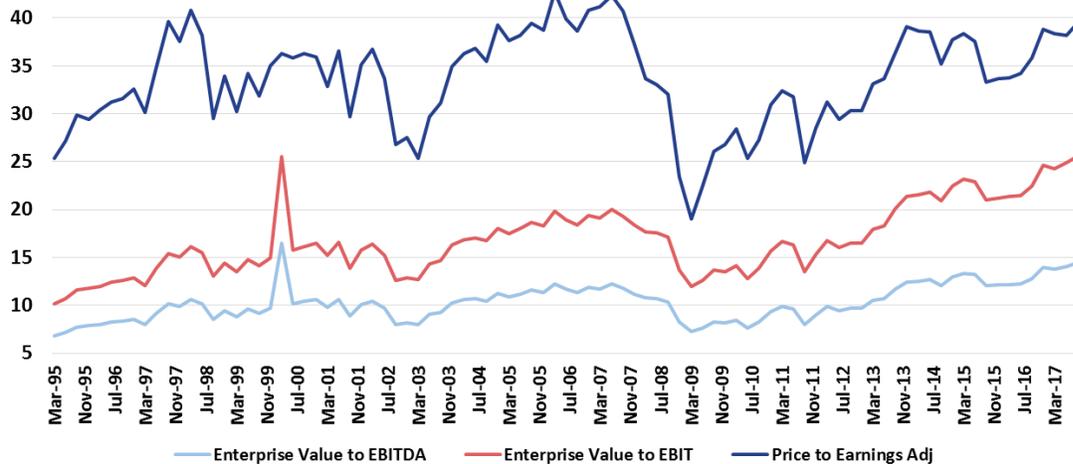


Figure 2¹ —Source: ACR Alpine Capital Research, Bloomberg, S&P Indices

Two key observations jump out to us when reviewing this chart.

1. US small company stocks are high-priced today. The current earnings yield of 2.5% (inverse of a 40 P/E) – is in our view inadequate considering the risk of investing in small companies.
2. US small company stocks have been in an elevated P/E range of approximately 20 to 40 for many years, yet we suspect most investors base their investments on far more optimistic data. The reason is that P/Es reported in the press are almost always significantly lower due to accounting distortions. The effect is even worse for small companies compared to large companies. For example, in March of 2009 the properly adjusted small company S&P 600 P/E was 19.0, whereas the large company S&P 500 P/E was 12.6 using a similar adjustment methodology. Small company stocks were over 50% higher relative to earnings than large company stocks. The S&P 600 P/E is still approximately 30% higher than the S&P 500 P/E today. In our opinion, there is no reason for small company stocks to be valued that much higher than large company stocks. ACR will publish a white paper in the coming months with more detail on this topic.

Ironically, the conventional wisdom today is that large company stock values are “efficient”, meaning they cannot be undervalued, but that one can still find value in small company stocks, since smaller

¹ACR applied cyclical adjustments to EBITDA, EBIT and Earnings Adjusted (EPS) as these figures better reflect long-term trends. Cyclically adjusted earnings are based on a least-squares trend-line of EBITDA, EBIT, and Earnings Adjusted (1995-2017). Earnings Adjusted are calculated by subtracting from S&P 600 Operating Earnings an average of the difference between S&P 600 Operating Earnings and S&P 600 As Reported Earnings to account for special and unusual charges. Data are quarterly.

companies are less researched. Beware conventional wisdom. Like investors who are unaware of accounting distortions in small company earnings, we believe that many small company stock managers are oblivious to absolute overvaluation. Tasked solely with beating a small company stock index, they are siloed like frogs in a lone economic well, only evaluating one small company relative to another. We saw how badly the relative return game in large company growth stocks ended circa 2000-2002. A similar fate may await small company stocks this time around.

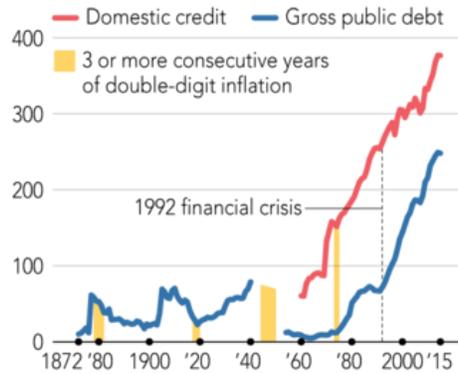
Accounting distortions and relative value myopia are less common explanations for why asset prices are elevated. The most common narrative usually emphasizes low interest rates. Central banks are keeping rates low through interest rate targeting and asset purchases or “quantitative easing.” While no one knows the magnitudes with precision, it is safe to say that central banks are contributing to lower rates and higher asset prices. The question is whether the ability to prop up asset prices is sustainable. We think there are reasons to be skeptical.

To understand the various economic factors better, we must first acknowledge that central bank policy is not the only reason interest rates are low. In our view low interest rates are being caused as much, if not more, by anemic economic growth and low inflation. A more robust economy and higher inflation would almost certainly cause rates to rise. Assuming this is the case, equity prices may face a lower P/E Catch-22. Higher growth, while increasing earnings, also raises inflation and interest rates, which puts downward pressure on P/Es, all else being equal. Lower growth puts downward pressure directly on P/Es by lowering future earnings.

Central bank policy is in effect amplifying the low interest rates which are due to anemic growth and low inflation, with the outcome being several years now of negative real short-term rates. What if central bankers decided upon a policy of indefinite negative real interest rates? Would this produce a permanently higher equity price plateau? That is the narrative articulated by some. Two real world examples will help illustrate why we remain skeptics.

Let us begin with Japan. The following chart shows long-term historical debt levels in Japan.

Public debt, private credit, inflation in Japan (as percentage of GDP)



Sources: International Monetary Fund, Ministry of Finance, Historical Statistics of Japan, Reinhart and Rogoff (2009), World Bank

Debt drove the epic Japanese real estate and equity bubble of the 1980s, and the Japanese government and Bank of Japan engaged in the issuance and purchase, respectively, of massive quantities of government debt after the bubble burst. The upshot is that nominal and real interest rates have been kept very low for many years. What has been the impact on equity values? P/Es in the past ten years on the Nikkei 300 have largely remained below 20. Perhaps more ominously, low rates did not stop the Nikkei from hitting a P/E of 9.6 in March of 2009.

Our second example is closer to home. Macroeconomist Carmen Reinhart points out that in the United States, real interest rates in the 1950s and 1960s were kept low by central bank policies and financial regulation. Yet the P/E on the S&P 500 in the 1950s remained below 20, only rising to the mid-20s in the late 1960s, before collapsing back to the single digits in the 1970s. Low rates in the 1950s and 1960s did not cause the kind of high equity prices that low rates are presumably causing today.

As we have said many times, there is no economic law which says current valuations must return to long run historical norms, only the risk. ACR's objective is to protect against such risks. With capital protection in mind, our response to current market conditions is three-fold:

1. Limit investor cash flows to strategies as warranted
2. Hold liquid reserves, or execute draw-down structures, rather than force capital to work
3. Search far and wide to find the most endangered of species – a good buying opportunity

On the first point, we deliberately slowed asset flows into our flagship EQR domestic equity strategy last year due to both strategy size and a paucity of opportunity in US equities. On the second, we will continue to hold ample cash reserves and un-invested capital as long as there is more to sell than to buy. Lastly, we are still finding a few undervalued securities here and there despite the general lack of opportunity. We added two US equity and two debt positions to our strategies in the third quarter.

The ACR investment team will continue our recipe of valuation discipline, limiting investment to a shrinking pool of undervalued securities, while knowing that one day greater volatility and opportunity are likely to resurface. We greatly appreciate the patience that you, our investors, afford us at times like these, and we look forward to reaping the benefits of our discipline in the years ahead.

Nick Tompras

October 2017

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