

Margin of Safety

2017 proved to be a glorious year for the global economy and financial markets. Preliminary estimates for 2017 global real GDP growth are well over 3%, and the world’s top 20 economies all grew for the first time in over 10 years. Global stocks returned 24.6% (MSCI ACWI), and emerging markets stocks returned a whopping 37.8% (MSCI Emerging Markets). ACR returns were in the double-digits across all of our vehicles, despite a highly defensive posture. Detailed fund returns with full disclosures can be found on the ACR web site.

Practically all asset classes are near all-time highs today, while interest rates and unemployment are near all-time lows. Unfortunately, the financial markets are like the children’s game “Opposites Day”: the better things appear, the worse they are. While we hate to play Debbie Downer, we cannot ignore two facts: (1) the higher asset prices rise relative to underlying income, the lower future returns will be; and (2) economies, markets, and investor psychology fluctuate in peaks and valleys, and we are very likely nearer a peak than a valley. The caveat is always that the “peaks” can last several years.

Regarding peaks, we are reminded of the legend of Icarus. Schoolchildren are taught the hazards of hubris when Icarus flies too close to the sun in his wax wings, despite his father’s warnings. In our view, many investors today are like young Icarus. They are flying high with no margin of safety, whistling past the graveyard of past bear markets.

ACR’s core ethos is to always maintain a margin of safety. Our commentary this quarter will explore this all-important concept by answering three questions:

- 1) What is a margin of safety?
- 2) How do you maintain a margin of safety today?
- 3) What is the opportunity cost of maintaining a margin of safety?

What is a margin of safety?

The concluding chapter of Benjamin Graham’s classic investment text, *The Intelligent Investor*, entitled “Margin of Safety as the Central Concept of Investment,” begins:

In the old legend the wise men finally boiled down the history of mortal affairs into the single phrase, “This too will pass.” Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY.¹

Everyone is familiar with the concept of a margin of safety from everyday life. It’s the extra time you leave when going to the airport so you don’t miss your flight. Or it’s building bridges to withstand

greater payloads than the weight of the vehicles which will pass over them. The basic idea is don't cut it close when something important is on the line.

The margin of safety is quantitative, such as in an extra hour, or 20 tons. The margin of safety in investing is typically expressed in ratios relating to income and value; two figures as fundamental to the economics of capital markets as force and mass are to physics. The specific ratios employed to calculate the margin of safety oftentimes depend on whether a debt or equity security is being evaluated; some statistics are naturally suited to one or the other type of instrument. The most fundamental metric used to assess the margin of safety is the yield (income / value), which can be applied to any asset class.

Graham opined in 1949: "In the ordinary common stock, bought for investment under normal conditions, the margin of safety lies in an expected earning power considerably above the going rate for bonds."ⁱⁱ Note that "earning power" to Graham was calculated as an earnings yield, which is the same metric as the P/E ratio, but expressed as a percentage (E/P) rather than a multiple (P/E). The framework is straightforward: the yield on stocks must be higher than the rate on bonds to compensate for the higher risk of owning stocks compared to bonds.

The summary below shows yields and risk premia moving up the risk scale from cash to stocks using the inflation-adjusted T-Bill yield, Treasury Bond yield, and the S&P 500 earnings yield (cyclically-adjusted).

	Current Real Yield	Historical Real Yield	Current Real Risk Premium	Historical Real Risk Premium
90-Day US Treasury Bill	(0.77%)	0.51%		
20-Year US Treasury Bond	0.48%	2.16%	1.25%	1.65%
S&P 500 Earnings Yield	3.13%	7.01%	2.65%	4.85%
	<u>Current</u>	<u>Historical</u>		
Consumer Price Index	2.11%	2.99%		

*Figure 1 — Data from 1926-2017. Source: **90-Day US Treasury Bill** – A History of Interest Rates by Homer & Sylla for yields prior to 1933, FRED 3-Month Treasury Bill: Secondary Market Rate [TB3MS] from 1933-2017; **20-Year US Treasury Bond** - FRED 20-Year Treasury Constant Maturity Rate [GS20] and Ibbotson Associates for 1986-1993 and prior to 1953; **S&P 500 Earnings Yield** - ACR Cyclically-Adjusted S&P 500 As Reported Earnings Per Share (see Figure 2 for methodology), Robert Shiller, S&P Dow Jones Indices, U.S. Bureau of Labor Statistics; **Consumer Price Index** - U.S. Bureau of Labor Statistics, CPI for All Urban Consumers: All Items [CPIAUCNS]; ACR Alpine Capital Research*

Interestingly, the yield on stocks is higher than the yield on bonds, thus seeming to qualify as having a margin of safety under Graham's definition. Margin of safety or not, investors have been rushing headlong into stocks. We think this is a short-sighted mistake. The yield on stocks may be higher than the yield on bonds, but this is principally because the yields on cash and bonds are so low. In our opinion, the Treasury markets have given stock investors a big margin of safety head fake.

The deficit in the margin of safety today becomes most obvious when yields and risk premia are compared to historical norms. The previous table shows that current yields and risk premia are both inordinately low compared to historical yields and risk premia. Cash, bonds, and stocks *all* lack a margin of safety today, with the largest spread between past and present in stocks. The following chart illustrates the relationship between rising earnings yields and stock price declines.

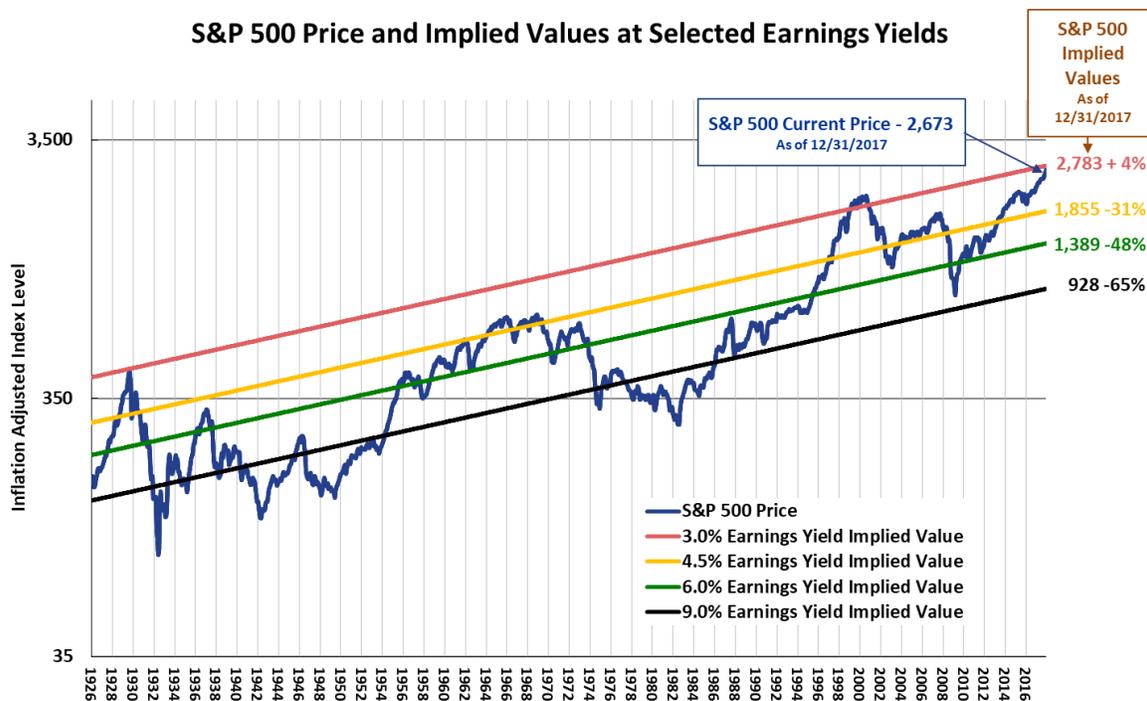


Figure 2 — Data from 1926-2017. ACR Cyclically-Adjusted S&P 500 As Reported Earnings Per Share is the historical inflation-adjusted least-squares trend-line of S&P 500 As Reported Earnings Per Share from 1926-Present. Source: S&P Dow Jones Indices, Robert Shiller, U.S. Bureau of Labor Statistics, ACR Alpine Capital Research

The S&P 500 actual price (inflation-adjusted) is compared to four S&P 500 implied values based on earnings yields of 3%, 4.5%, 6% and 9%. The implied value is calculated in monthly intervals as trailing 12-month S&P 500 earnings per share (cyclically-adjusted) divided by the selected earnings yields.

The earnings yields chosen were not arbitrary. A 6% earnings yield is generally considered by ACR to be an acceptable level for what we believe are quality equities with GDP-like growth prospects and average returns on capital. As the overall stock market, or a company with these characteristics, moves from an earnings yield of 5% to 4%, we become cautious. In the case of an individual equity, we typically sell. A historically high earnings yield of 9% on the market would warrant aggressive buying generally, as it is likely many stocks would be even cheaper, but we mark it in black because getting there via a 65% decline in market values would be enormously painful.

ACR's stubborn insistence on maintaining a margin of safety in the rising markets of the past several years is based upon simple logic:

1. *Only God knows what future yields will be.* Mankind has many reasons to be humble; one of them is the inability to forecast interest rates and inflation. We have elaborated on this subject in past commentaries, and while we have examined various economic nuances, the additional analysis has not changed our premise that yields are unpredictable.
2. *A margin of safety requires a conservative estimate of future yields when current yields are near all-time lows.* If one assumes it is impossible to accurately forecast future yields, some form of mean reversion is the only rational analytical paradigm. In other words, if yields are lower (higher) than their historical mean, we assume they mean revert higher (lower) over time. Most importantly, it would be imprudent to think that all-time low yields will remain so forever. The margin of safety must be considered as a function of historical yields as well as risk.

ACR has maintained a margin of safety in recent years by assuming higher normalized future yields in our valuations. The chart above shows that stocks would have to decline by 48% to get to ACR's typical starting point of 6% plus inflation for quality equities. From there, we generally require an additional margin of safety by paying at least a 20% discount to intrinsic value. We apply the same logic to debt investments and special situations, with adjustments appropriate to the asset class, security, and specific circumstances. These punitive assumptions beg the question which begins our next section.

How do you maintain a margin of safety today?

ACR's answer is to in effect short asset classes via two primary mechanisms (actual shorting in our view is generally too risky except for a relatively small portion of a portfolio):

- 1) Invest in idiosyncratic special situations rather than broad asset classes
- 2) Hold cash either directly or through draw-down structures

Active investing in high-priced markets is necessarily idiosyncratic. In our opinion, an active portfolio should be a collection of one-off valuation discrepancies. Such discrepancies may still occur in conventional securities like stocks of well-known companies. In these cases, however, there are unique circumstances acting on the security. For example, events may precipitate a large price decline, and occasionally, it is found that intrinsic value has not declined as much. The company may be temporarily under-earning or cash earning power may be obscured. Whatever the case, opportunity occasionally knocks even in high-priced markets.

The right structure is required to take advantage of such opportunities. A relatively small strategy size allows for a large opportunity set, and a large opportunity set combined with a focused portfolio allows

for a high degree of idiosyncratic selectivity. ACR structures mandates broadly in terms of selection universe and limits capital inflows to assure portfolio managers are not backed into a corner of ever-fewer larger capitalization holdings.

Cash is our other key weapon against high prices. Our absolute return discipline necessarily causes us to sell when the margin of safety disappears, even if we don't have a replacement investment. In this way, our cash builds one security at a time, and is put back to work one security at a time. Our willingness to hold cash is no doubt an allocation-based decision, but it is made on a bottom-up basis to assure that we maintain an overall margin of safety in our portfolios. ACR is also able to manage draw-down structures for certain asset classes and clients who can fully commit to capital calls, which has the same effect as holding cash.

Holding cash in a rapidly-rising market can be painful in the short-term. As we enter into the third longest economic expansion in US history, as well as the second longest bull market on record, holding cash for extended periods can feel like "waiting for Godot". Just as we are humbled by the inability to forecast rates and inflation, so we are humbled by our inability to fully capture upside price moves. The investment team much prefers to be fully invested, and we take seriously the potential risks of maintaining a significant cash allocation. Indeed, we make calculations in this regard, which leads to our final question.

What it is the opportunity cost of maintaining a margin of safety?

A broad yet imprecise method for measuring the opportunity cost of maintaining a margin of safety would be to measure underperformance relative to the benchmark. ACR of course reports performance relative to benchmarks for each of our strategies. However, we do not consider short-term underperformance our opportunity cost. ACR will underperform and outperform benchmarks in the short-term, which has little to do with opportunity cost. Indeed, we expect to underperform in high-priced markets which continue to rise, and we expect to make it back when prices readjust to reflect intrinsic values.

Put another way, we do not view market underperformance as an opportunity cost when future market prices decline. Just the opposite, cash creates value at these times. As we have discussed in past commentaries, cash has "optionality": holding cash gives us the opportunity to buy all securities cheaper in the future. Importantly, the entire market does not have to decline for us to exercise this optionality. In the midst of a raging bull market, the one new security that we added to our EQR (Equity Quality Return) stock strategy last year had declined over 50% from its November 2015 peak prior to our purchase.

Opportunity cost in our view comes not in the form of a lost *market* return, but in the forgone *fundamental* return. As discussed in our 1Q-2017 commentary, the lost fundamental return consists of

the corporate income we would have earned by holding a basket of equity investments rather than cash. Corporate income produces two potential benefits for shareholders: cash dividends and per-share business growth. The fundamental return can therefore be properly estimated as the dividend yield plus the growth in cyclically-adjusted per-share earnings. The S&P 500 fundamental return from 2012-2017 was 39.8% or 5.8% per year, and our average cash balance was 31.4%, which equates to portfolio fundamental return drag of 10.8% or 1.7% per year.

ACR takes the fundamental return drag from holding cash seriously – 10.8% over six years is significant. That said, we believe it is a relatively small price to pay for maintaining our margin of safety and the optionality of cash. We will continue to report the fundamental return drag from holding cash and periodically re-evaluate this opinion. After all, we cannot hold large amounts of cash indefinitely. Either we will invest the cash, or we must return it to our investors. For the time being, the fundamental return drag would have to rise considerably before we believe it would begin to impair the intrinsic value difference between our portfolios and their benchmarks, and the optionality of cash.

Conclusions

The financial markets and investor sentiment have in our opinion become unhinged. We are optimistic about the long-term health of the global and US economy, but in our opinion, investors do not understand that lower taxes, better business conditions, and general optimism are still highly unlikely to justify current prices. The math by our reckoning just doesn't work.

Moreover, profits, employment, and financial markets have always vacillated, and interest rates have varied widely over the years. What is it in human nature that tends to extrapolate current conditions indefinitely? Many expected sky-high interest rates and 13% stock earnings yields in the early 80s to prevail for years. Today many expect low rates and 3% stock earnings yields as far as the eye can see. The most rational expectation is in our opinion something in between. Luckily for us, we do not need the stock market to crash for this happy median to develop. We just need a few good values. The investment team will continue its search far and wide for such values in the coming year, but we will not relent on our discipline of maintaining a margin of safety.

*Nick Tompras
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IMPORTANT DISCLOSURES

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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.

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.

ⁱ Graham, B. (1949). *The Intelligent Investor*. (p. 253). New York: Harper & Brothers.

ⁱⁱ Graham, B. (1949). *The Intelligent Investor*. (p. 255). New York: Harper & Brothers.