

Quantifiable Absolute Returns

Volatility has returned to financial markets in 2018, yet precipitous price declines have not. Daily volatility is higher, but the market is near break-even for the year. Underneath the surface, some securities have declined, giving rise to a few more ideas to research. Yet to keep the state of the financial markets in perspective, if this was the beginning of a bear market, we'd still be in the first inning with one out.

ACR welcomes bear markets because they provide us with attractive buying opportunities to deploy our cash. ACR investors also need not fear for their current holdings in a bear market, assuming our valuations were performed well up-front. A perfectly executed valuation mathematically quantifies an asset's future investment return – valuation and return are two sides of the same coin. To test the quality of an historical valuation, valuation parameters can be plugged into a formula to forecast a future return, which can then be compared to the actual future return. ACR has maintained this data for our Equity Quality Return (EQR) stock strategy since March 2003, and we thought this would be interesting information to share with you.

EQR Quantifiable Absolute Returns (Gross-of-Fees)

10-Year Period		EQR Equity-Only Forecasted Return ¹	EQR Portfolio Actual Gross Return ²	S&P 500 Index Actual Return ³
Beginning	Ending			
3/31/2003	- 3/31/2013	12.7%	11.5%	8.5%
12/31/2003	- 12/31/2013	10.2%	10.2%	7.4%
12/31/2004	- 12/31/2014	10.5%	10.5%	7.7%
12/31/2005	- 12/31/2015	11.2%	10.6%	7.3%
12/31/2006	- 12/31/2016	9.2%	9.8%	6.9%
12/31/2007	- 12/31/2017	10.4%	11.1%	8.5%
3/31/2008	- 3/31/2018	11.1%	11.3%	9.5%

EQR Returns (Net-of-Fees)

10-Year Period		EQR Portfolio Actual Net Return ⁴	S&P 500 Index Actual Return ³
Beginning	Ending		
3/31/2003	- 3/31/2013	10.4%	8.5%
12/31/2003	- 12/31/2013	9.1%	7.4%
12/31/2004	- 12/31/2014	9.4%	7.7%
12/31/2005	- 12/31/2015	9.5%	7.3%
12/31/2006	- 12/31/2016	8.8%	6.9%
12/31/2007	- 12/31/2017	10.0%	8.5%
3/31/2008	- 3/31/2018	10.2%	9.5%

Past performance is not a guarantee of future results

1. Equity Quality Return (EQR) Portfolio Forecasted Return is our annualized forecasted return at the beginning of the 10-year period based on ACR's intrinsic value and return estimates for EQR stocks not including cash. Individual stock 10-year estimated return formula: $(1 + \text{Required Return}) * (\text{Value/Price})^{(1/10)} - 1$. A ten-year horizon was chosen to encompass a full market cycle. Selecting a different period would significantly alter the forecasted return. The "Required Return" is the return ACR estimates is fair for the risk taken in each EQR stock. ACR portfolio managers assess risk based on multiple business and financial factors and assign a specific rate which in their judgement is commensurate with security risk. The Intrinsic Value/Price captures ACR's estimate of undervaluation. Intrinsic value is based on multiple business and financial factors and represents the portfolio manager's subjective estimate of business value. The portfolio return forecast is the weighted average of individual stock 10-year estimated returns. Forecasted returns do not represent actual trading. The portfolio during the forecast period was different than the portfolio when the forecasted returns were calculated.
2. EQR Portfolio Actual Gross Return is the EQR Advised / SMA Composite actual pure gross-of-fee total return (including dividends) annualized, including cash over the 10-year period. Gross of fee returns do not reflect the deduction of management fees. Actual client returns will be reduced by management fees. Fees are typically deducted quarterly for clients thus the compounding effect will be to increase the impact of the fees by an amount directly related to the gross account performance. For example, on an account with a 1% management fee, if the gross performance is 10% annually, owned for 10 years, the compounding effect of the management fees will result in a net performance of approximately 8.90% annual return.
3. S&P 500 Index Actual Return is the actual annualized total return for the S&P 500 Index over the 10-year period.
4. EQR Portfolio Actual Net Return is the EQR Advised / SMA Composite actual total return net of a 1% management fee annualized, including cash over the 10-year period.

The table shows that our forecasted ten-year EQR return at the beginning of the period is very close to the actual EQR return earned in the subsequent ten years. A few observations.

The actual return compares more favorably to the forecasted return after inflation. The ACR investment team has not lowered its nominal required return for the lower general inflation rate experienced in recent years. ACR's required return generally reflects 3% inflation. As inflation turned out to be lower, ACR portfolio managers did not explicitly reduce our required return accordingly. As a result, our forecasted return has been somewhat inflated in nominal terms, whereas an investor's actual purchasing power was only reduced by the lower actual inflation rate. A comparison of forecasted and actual returns reveals this dynamic. (See Appendix – Table 1).

EQR's forecasted return does not include cash; EQR's actual return does include cash. Since cash has earned such a low return in recent years, one might wonder how our actual return with cash could be better than our forecasted return without cash. One reason is that our average holding period was less than ten years. In other words, we realized value quicker, which generated a higher stock return that offset the lower cash return. The question of whether our cash added value on a risk-adjusted basis is more difficult to answer. We are exploring various methodologies for addressing this question and will share the details if we find a credible result.

There is nothing magical about a ten-year period; a full cycle is the relevant period for evaluating results. Ten years was chosen for simplicity of presentation and because it is usually long enough to encompass a full cycle. Interestingly, unless we have a bear market this year, the full cycle will extend beyond ten years, a relatively rare occurrence. ACR defines a full cycle as a peak-to-peak period which includes a price decline of over 20% and a subsequent price increase above the previous peak.

While the forecasted return has been a good barometer for the actual return, we are more conservative when estimating future capital market returns. ACR's philosophy rests on the margin of safety principle. We therefore adjust our forecast return lower for planning purposes because we don't want to cut it close (see our January 2018 commentary for a full discussion on "margin of safety"). Private client wealth planning goals, endowment and foundation spending rates, and pension return on plan asset assumptions, all rely on sound capital market return assumptions. ACR is very diligent about getting these numbers right. Your ACR client relations representative can provide additional details.

The ending years in the previous table occur during highly buoyant markets. Market returns, even over longer periods, can look very different during less favorable markets. ACR believes that today's historically high valuations of over 30x cyclically adjusted earnings could produce significantly lower future market returns. The data support our view. The last time the market was valued this high was from 1998-2001. Subsequent ten-year stock market returns from this period were poor, as shown in the following table.

**EQR and S&P 500 Returns During Challenging 10-Year Periods
(Gross-of-Fees)**

10-Year Period		EQR Portfolio Actual Return ⁵	S&P 500 Index Actual Return ⁶
Beginning	Ending		
12/31/1998	- 12/31/2008	na	-1.4%
12/31/1999	- 12/31/2009	na	-0.9%
12/31/2000	- 12/31/2010	9.8%	1.4%
12/31/2001	- 12/31/2011	7.9%	2.9%

See Appendix – Table 2 for EQR net of 1% fee returns.

Past performance is not a guarantee of future results.

5. EQR Portfolio Actual Return is the Equity Quality Return (EQR) Advised / SMA Composite actual pure gross-of-fee total return including cash over the 10-year period. The EQR portfolio's inception date is April 2000, thus "na" for the 10-year periods beginning in 1998 and 1999. Gross-of-Fee returns do not reflect the deduction of management fees. Actual client returns will be reduced by management fees. Fees are typically deducted quarterly for clients thus the compounding effect will be to increase the impact of the fees by an amount directly related to the gross account performance. For example, on an account with a 1% management fee, if the gross performance is 10% annually, owned for 10 years, the compounding effect of the management fees will result in a net performance of approximately 8.90% annual return.

6. S&P 500 Index Actual Return is the actual annualized total return for the S&P 500 Index over the 10-year period.

Investment returns during challenging ten-year periods highlight the meaning of the term “absolute” in the title of this commentary. ACR’s objective is to seek satisfactory absolute returns over a full market cycle. As it turns out, our absolute valuation discipline produced a satisfactory result, even during periods when the market did not. As shown in the previous table, markets do not always provide a satisfactory return over a full cycle. A return of 2% per year would have beat the market during the 2000-2010 period, but we would not consider this “relative” return satisfactory on a standalone basis.

In a market like today’s, which implies lower future returns, ACR will not waiver from our absolute return valuation discipline. With the benefit of experience and data on our side, we are unafraid to under-perform the market in the short-term when we are confident of the continued success of our strategies at achieving their valuation forecast returns in the long-term. We greatly appreciate your patience during this period of elevated prices.

*Nick Tompras
April 2018*

Appendix – Table 1

EQR Quantifiable Absolute Returns – Inflation Adjusted (Gross-of-Fees)

10-Year Period		EQR Equity-Only Forecasted Return ⁹	EQR Portfolio Actual Gross Return ¹⁰	S&P 500 Index Actual Return ¹¹
Beginning	Ending			
3/31/2003	- 3/31/2013	9.4%	9.0%	6.0%
12/31/2003	- 12/31/2013	7.0%	7.6%	4.9%
12/31/2004	- 12/31/2014	7.2%	8.2%	5.4%
12/31/2005	- 12/31/2015	8.0%	8.6%	5.4%
12/31/2006	- 12/31/2016	6.0%	7.9%	5.0%
12/31/2007	- 12/31/2017	7.2%	9.3%	6.8%
3/31/2008	- 3/31/2018	7.8%	9.6%	7.8%

See Appendix A – Table 1 for EQR net of 1% fee returns.

Past performance is not a guarantee of future results.

9. Equity Quality Return (EQR) Portfolio Forecasted Return is our annualized forecasted return at the beginning of the 10-year period based on ACR's intrinsic value and return estimates for EQR stocks not including cash. The forecasts have been inflation adjusted. ACR's nominal returns assume a 3% constant annualized inflation rate. This has been reversed to arrive at inflation adjusted forecasts. Individual stock 10-year inflation adjusted estimated return formula: $((1 + \text{Required Return}) * (\text{Value/Price})^{(1/10)}) / (1 + 3\%) - 1$. A ten-year horizon was chosen to encompass a full market cycle. Selecting a different period would significantly alter the forecasted return. The "Required Return" is the return ACR estimates is fair for the risk taken in each EQR stock. ACR portfolio managers assess risk based on multiple business and financial factors and assign a specific rate which in their judgement is commensurate with security risk. The Intrinsic Value/Price captures ACR's estimate of undervaluation. Intrinsic value is based on multiple business and financial factors and represents the portfolio manager's subjective estimate of business value. The portfolio return forecast is the weighted average of individual stock 10-year estimated returns. Forecasted returns do not represent actual trading. The portfolio during the forecast period was different than the portfolio when the forecasted returns were calculated.

10. EQR Portfolio Actual Gross Return is the Equity Quality Return (EQR) Advised / SMA Composite actual pure gross-of-fee total return (including dividends) annualized, including cash over the 10-year period. These returns have been inflation adjusted by reducing the EQR gross nominal returns by CPI-U. Gross of fee returns do not reflect the deduction of management fees. Actual client returns will be reduced by management fees. Fees are typically deducted quarterly for clients thus the compounding effect will be to increase the impact of the fees by an amount directly related to the gross account performance. For example, on an account with a 1% management fee, if the gross performance is 10% annually, owned for 10 years, the compounding effect of the management fees will result in a net performance of approximately 8.90% annual return.

11. S&P 500 Index Actual Return is the actual annualized total return for the S&P 500 Index over the 10-year period. These returns have been inflation adjusted by reducing the S&P 500 nominal total returns by CPI-U.

Appendix – Table 2

EQR Quantifiable Absolute Returns (Net of Fees)

10-Year Period		EQR Portfolio Actual Net Return ⁷	S&P 500 Index Actual Return ⁸
Beginning	Ending		
12/31/1998	12/31/2008	na	-1.4%
12/31/1999	12/31/2009	na	-0.9%
12/31/2000	12/31/2010	8.7%	1.4%
12/31/2001	12/31/2011	6.8%	2.9%
12/31/2002	12/31/2012	8.5%	7.1%
3/31/2003*	3/31/2013*	10.4%	8.5%
12/31/2003	12/31/2013	9.1%	7.4%
12/31/2004	12/31/2014	9.4%	7.7%
12/31/2005	12/31/2015	9.5%	7.3%
12/31/2006	12/31/2016	8.8%	6.9%
12/31/2007	12/31/2017	10.0%	8.5%
3/31/2008*	3/31/2018*	10.2%	9.5%

Past performance is not a guarantee of future results

7. EQR Portfolio Actual Net Return is the Equity Quality Return (EQR) Advised / SMA Composite actual total return net of a 1% management fee annualized, including cash over the 10-year period.

8. S&P 500 Index Actual Return is the actual annualized total return for the S&P 500 Index over the 10-year period.

* For comparison to tables above, these periods do not begin and end on December 31st.

IMPORTANT DISCLOSURES

ACR Alpine Capital Research LLC is an SEC registered investment adviser. For more information please refer to Form ADV on file with the SEC at www.adviserinfo.sec.gov. Registration with the SEC does not imply any particular level of skill or training.

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

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the examples discussed. You should consider any strategy's investment objectives, risks, and charges and expenses carefully before you invest.

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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. Pure Gross returns are gross of all fees and do not reflect the deduction of transaction costs in wrap portfolios. Pure Gross returns are supplemental information. Net of ACR Fee returns are Pure Gross returns reduced by 1.0% per annum, which is the standard management fee for the Equity Quality Return strategy. 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.