A | C | R
alpine capital research

The Bubble in the Crash

Today's market has required us to navigate a narrow strait between dangerously high equity prices and Great Lockdown capital impairments. We believe valuation risk is near all-time highs with the S&P 500 selling at 33.2x cyclically adjusted as reported earnings. In the meantime, our flagship Equity Quality Return (EQR) strategy is selling at 8.8x our estimate of cyclically adjusted earnings and capable of withstanding a severe recession.[1]

If corporate profits still matter, we believe these ratios are wildly off the mark. Indeed, the market is presenting us with an historic opportunity, strikingly like the one that prompted ACR's founding in 2000. Below is a comparison of the two periods with differences underlined.

Then (2000)	Now (2020)
1) The decade of the <u>2000s</u> is likely to produce historically low stock returns—low single-digits or less—as US market values are above 30x cyclically adjusted earnings.[2] (*It did.*)[3]	1) The decade of the <u>2020s</u> is likely to produce historically low stock returns—low single-digits or less—as US market values are above 30x cyclically adjusted earnings.
2) ACR has identified a small group of value stocks—selling at <u>about</u> 10x earnings—which we believe will produce double-digit returns.[4] (*They did.*)[5]	2) ACR has identified a small group of value stocks—selling <u>below</u> 10x earnings—that we believe will produce double-digit returns.
3) "Value" is a four-letter word. Value strategies have underperformed in recent years, which has created the current opportunity.	3) "Value" is a four-letter word. Value strategies have underperformed in recent years, which has created the current opportunity.
4) <u>9/11 was about to change</u> the world.	4) <u>COVID-19 is changing</u> the world.

The biggest difference between then and now is that today we are in a severe recession, whereas in 2000 we were over a year away from a mild recession. One does not expect to see a bubble in a crash, but our analysis shows that this is exactly what has happened. Strangely, we have the valuation distortions of 2000 with the economic calamity of 2008.

Another difference between then and now is that then ACR was just starting, whereas we now have a 20-year performance track record. Our updated performance data for our flagship EQR strategy as compared to relevant indexes is shown on the next page.

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Please see page 3 for important disclosures.

EQR Since Inception and YTD[6]

Gross and Net Total Return (Annualized)

	EQR	EQR (Net)	S&P 500*	S&P Value	S&P Pure Value
04/03/00–06/30/20	10.9%	9.8%	5.7%	5.4%	8.8%
YTD 06/30/20	-6.1%	-6.6%	-3.1%	-15.5%	-29.8%

EQR by Decade[7]

Gross Total Return (Annualized)

Decade:	EQR	S&P 500
2000–2009	12.0%	-1.2%
2010–2019	11.1%	13.6%
2020–2029**	11.0%	< 5%

Past performance and current analysis do not guarantee future results.
EQR (Net) is net of 1% fee.
*Benchmark
**Estimated total return—see calculation method and disclosures at: www.acr-invest.com/commentary/38-commentary/143

Source: ACR

The last difference worth highlighting is that we avoided the underperformance of value during the 1990s with our inception in 2000, but we have had to endure the underperformance of value during the 2010s. We keep close track of such periods because one of our three primary objectives is to beat the broader market in the long term. Here are the numbers:

The EQR composite total return (market appreciation plus dividends) is currently 31% behind the S&P 500 since 2012. Yet our valuation work shows a 224% intrinsic value differential between EQR and the S&P 500 today.[8] Therefore, even if the valuation differential is much less than we have estimated, we are not too concerned about making up for lost ground.

Turning to the economy, the decade of the '20s began with a crisis for the ages. In response, our longest-ever first-quarter commentary covered a great deal of ground. We refer you to this commentary for a full analysis of the economy and markets in relation to the COVID-19 pandemic and the associated Great Lockdown. Our assumptions and conclusions have not changed since then. The equity market, however, has changed quite a bit.

Stock prices went on a tear in the second quarter. As the virus showed signs of containment and the economy started to reopen, market participants reacted with unfettered relief. Stocks rose across the board with little change in underlying valuation disparities. Imbalances that had risen to historic proportions from 2017 to 2019, and which grew even wider during the March declines, have held relatively constant during the rebound. Thus, the greatest bifurcation of values in modern history remains.

While a downward reckoning is a real possibility for the broader market, our research shows a narrow group of value stocks should rise over time. Manufacturing, financials, telecoms, and energy shares have not fully recovered, as the year-to-date return for the S&P Pure Value Index shows. Our cash was used to scoop up stocks in these sectors during the March declines. The upshot is that we are poised to monetize these bargains without the pain of year-to-date value index results.

Like much of pandemic life today, equity markets are downright strange. Who would have thought rampant stock speculation could coexist with runaway coronavirus fears? Yet, witness the proposed secondary stock offering of bankrupt Hertz stock, or the zero-revenue hydrogen truck startup Nikola's $34 billion market value. If the market is a voting machine in the short term, voters appear to have gone mad. No one, however, should be too surprised. Gambling, fear, and greed are constant fixtures in financial markets. Fortunately, the market is a weighing machine in the long term as real value accumulates in the form of profits. On that score, we look forward to harvesting capital gains and dividends in the coming years as the cash flows produced by our companies generate real spendable dollars.

Nick Tompras
July 2020

Important Disclosures

[1] The price-to-earnings (P/E) is the period price divided by earnings per share (EPS).

- The EQR Cyclically Adjusted P/E is based on the weighted average market value divided by the weighted average estimated normalized cash earnings for the investment holdings in ACR's Equity Quality Return Strategy at quarter end.
- The S&P Cyclically Adjusted P/E is based on Real S&P 500 Price Per Share (PPS) as of 6/30/20 divided by Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to 2019.

[2] See ACR commentary (www.acr-invest.com/commentary/38-commentary/80-the-worst-of-times.html).

[3] The S&P 500 returned -1.2% annualized from 2000-2019 (inception 4/3/2000).

[4] See ACR commentaries (www.acr-invest.com/commentary/38-commentary/80-the-worst-of-times.html) and (www.acr-invest.com/commentary/38-commentary/73-patient-investing.html). EQR portfolio P/E reference based on commentary reference and actual P/E of 11.4x of the 2000 portfolio as of 3/31/00.

[5] EQR returned 12.0% gross of fees annualized from 2000-2010 (inception 4/3/2000).

[6] Total return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income.

[7] All starting dates are January 1, except 2000, which aligns with EQR's inception date of April 3, 2000.

The 2020-2029 Estimated 10-Year annualized return formula for the EQR portfolio is: (1+Required Return) * (PV2/PV1)^(1/n)-1 where PV1 = 0.84 = Price/Intrinsic Value (PV) of EQR at January 1, 2020; PV2 = 1.0 = ACR estimated PV 10 years from now; n = 10; Required Return = 9.1% for EQR as of January 1, 2020.

[8] The intrinsic value differential is the difference between EQR's estimated price/value (P/V) and the S&P 500's estimated P/V as of 6/30/20. Intrinsic value is based on multiple business and financial factors and represents the portfolio manager's subjective estimate of business value.

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.

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

Other Disclosures

ACR Alpine Capital 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.

This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer to sell or a solicitation to invest.

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 reinvestment 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 Strategies section of our web site at www.acr-invest.com/strategies/eqr-advised-sma-composite.

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.

S&P 500 Value: Value stocks are measured using three factors: the ratios of book value, earnings, and sales to price.

S&P 500 Pure Value: This index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style attractiveness-weighting scheme.