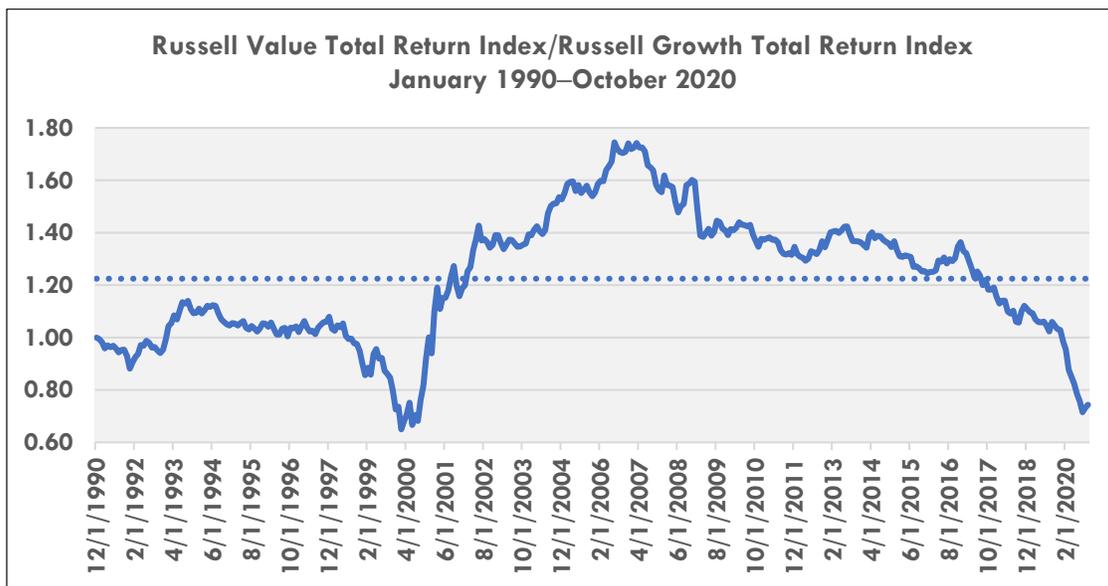


## A Value Depression Opportunity

Investors have much to worry about today: a global pandemic, severe recession, and a polarizing election. Yet, we believe these events will soon recede into the rearview mirror of American history, while productivity and profits will continue their long-run upward trajectory. We also think that presidents have far less impact on the macroeconomy than is commonly believed, and that recovery from the pandemic and recession is likely to continue in fits and starts this coming year.

The greatest economic concern is less obvious, in our opinion. The return that an equity investor earns (or doesn't) is determined by the price paid for future profits. Despite the pandemic, recession, and election, we have a good handle on future profits, as their long-run path is reasonably predictable. We also know prices, and therein lies the worry. In our view, the intelligent investor's chief concern today should be owning stocks at inordinately high prices.

Fortunately, there is a unique solution to this concern. A major dislocation continues to build as high overall market and growth stock prices increasingly disconnect from depressed value stock prices. Speculatively high prices present the risk of loss and disappointing returns, while the "value depression" offers the opportunity to secure future profits at low prices. Rarely do these conditions prevail in such stark contrast at the same time. The chart below illustrates how the current value depression is on par with the epic value depression of the late 1990s.



Source: Bloomberg

Generally, we prefer more accurate definitions of value (see our October 2019 commentary, [“True Value”](#)), but the divergence is so extreme today that these broad measures tell the story. While we do not know how much longer the value depression will last, value stocks are squarely in the bargain bin today when almost everything else is offered at precariously high prices.

Getting here has nevertheless been painful for value-oriented investors—at least on paper. Easy money has been made in many speculative stocks, while value remains depressed. The speculating show-off has much to crow about, whereas the disciplined tabulator of corporate profits looks out of touch. While we believe value will have its day again, perhaps the most important point to understand about the value depression is that no real economic ground has been lost getting to where we are today.

Our analysis shows that the profit value of our Equity Quality Return (EQR) portfolio companies has continued to accrue and that our valuation advantage has grown far more than the amount by which we have fallen behind. The figures below highlight these claims.

	EQR (Net)	S&P 500
<b>Cyclically Adjusted P/E</b>	8.6	34.9
<b>Cyclically Adjusted Earnings Yield</b>	11.6%	2.9%
<b>Price/Value</b>	0.73	2.56
<b>Valuation Differential</b>	+250% v S&P 500	–
<b>Since 2012</b>	-37% v S&P 500	–

**Past performance and current analysis do not guarantee future results.**

EQR is shown net of 1.0% fee except for valuation differential. The valuation differential is the estimated price/value difference between EQR and the S&P 500 as of 9/30/2020. Intrinsic value is based on multiple business and financial factors and represents the portfolio manager’s subjective estimate of business value. See more information on valuation differential in No. 3, below. 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.

Data as of 9/30/2020

The remainder of this quarter’s commentary will be spent answering three thoughtful questions posed to us this past quarter: (1) What could we be missing? (2) How do such valuation disparities develop? and (3) How will our estimated valuation differential be realized?

## 1) What could we be missing?

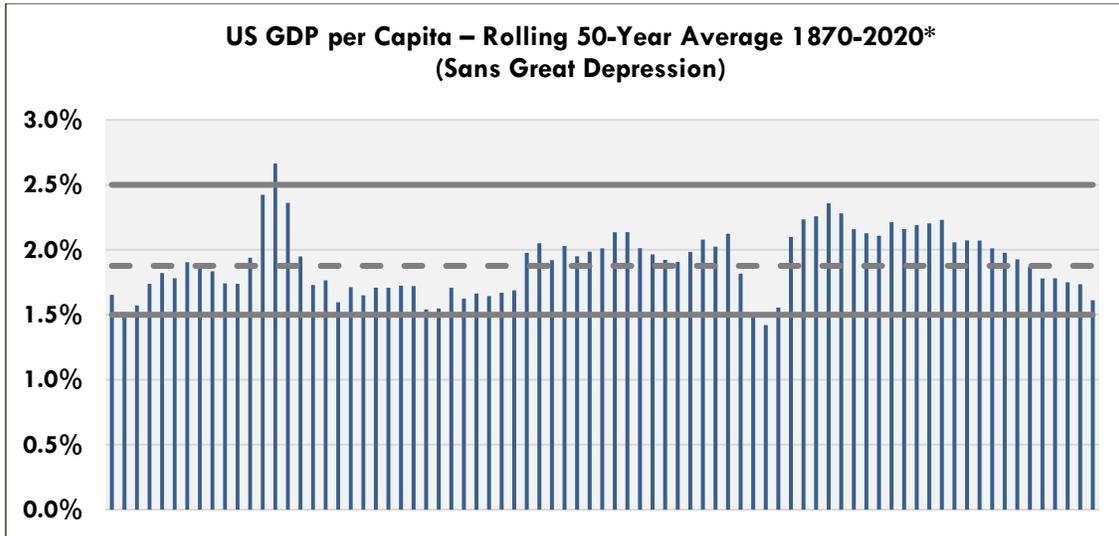
The short answer is that we do not believe we are missing anything significant, but the ACR investment team is always seeking to unearth and understand all relevant economic issues. At the micro level, each company and industry that we evaluate is subjected to rigorous counter-argument. We think deeply about known risks as well as factors practically no one considers. Our analysis includes a review of disruptive technologies that could hurt or help, and we evaluate threats that could impact multiple holdings. The micro risks that we evaluate are far too many to enumerate in a commentary, but we remain confident that we have the company and industry level well covered.

At the macro level, we review general economic developments and themes that could result in different outcomes than we have typically seen or can forecast. The litany of “this time is different” arguments appear to us even weaker today than in 1999 when the economy was arguably overheating. The “fourth industrial revolution” thesis is, in our view, *necessary* for GDP per capita to return to its historical growth rate, rather than being a catalyst for supernormal growth. Productivity has trended lower in recent years, so we are counting on new technologies such as 5G, the internet of things, and artificial intelligence to directly benefit our companies and raise global living standards.

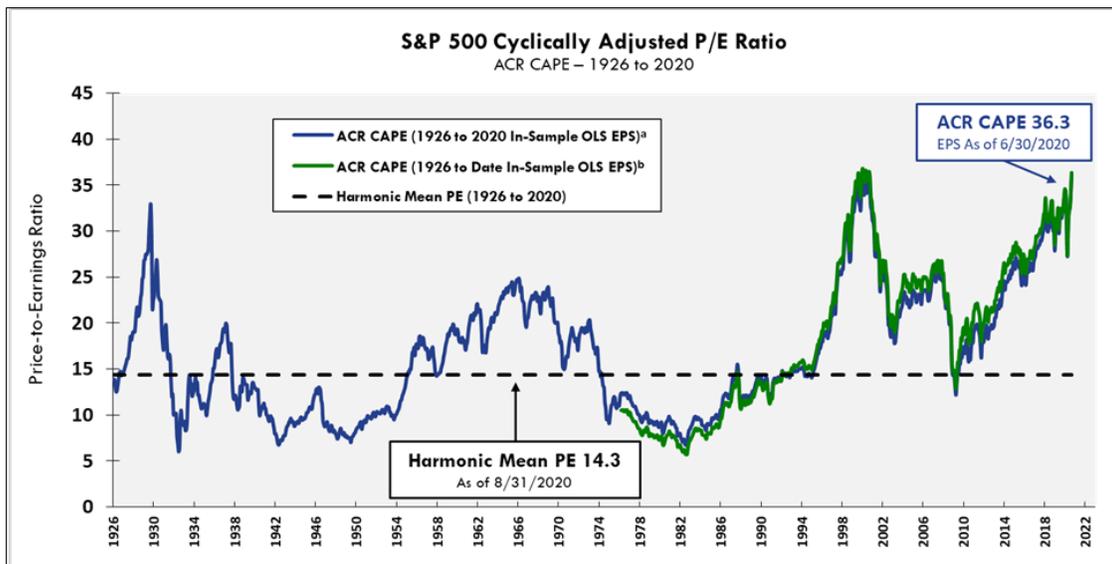
The most plausible argument for what we could be missing is that some great growth companies will turn out to be “values.” That is, their profit growth will be extraordinarily high for many years to come, thus justifying their high prices today. Certainly, this will be the case for certain companies. While we are skeptical that such a group can be easily identified in advance, our goal is not to beat out a small group of outliers. Indeed, more power to those who can.

ACR’s return goals are twofold: (1) generate a satisfactory absolute return and (2) beat the overall market in the long term as measured by the S&P 500. Regarding the second objective, for the S&P 500 to produce a return greater than 5% per year over the next decade, either corporate profits would have to grow faster than they ever have or price/earnings (P/E) ratios would have to hold steady or expand further. Count us as skeptics on both points.

First, the real growth rate of corporate profits closely tracks real GDP per capita, which as noted above, has been tracking lower in recent years but has never really jumped too much higher or lower than 2% in the long run. Second, the cyclically adjusted P/E is near all-time highs, and we believe is far more likely to decline than rise. The following charts illustrate these points.



\*2020 US GDP per Capita figure is an estimate by The Conference Board  
 Source: The Conference Board Total Economy Database, Angus Maddison, International Monetary Fund, ACR Alpine Capital Research



<sup>a</sup> ACR CAPE based on Real S&P 500 Price Per Share (PPS) divided by Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to 2020.  
<sup>b</sup> ACR CAPE based on Real S&P 500 PPS divided by OLS Regression trendline of S&P 500 Real EPS from 1926 to the period to date.  
 Price as of Aug 31, 2020; EPS as Jun 30, 2020. EPS data has been log-transformed.  
 Source: S&P Dow Jones Indices; Robert Shiller; BLS- CPI Data; ACR Alpine Capital Research

## **2) How do such valuation disparities develop?**

We can only speculate about the reasons. To start, research has shown that value outperforms the market in the long term. A reason often cited for cheaper value stock outperformance is that investors are willing to overpay for inherently sexier growth stocks. Note that ACR does not invest in “value” for this reason. We are just as happy to own a rapidly growing company that is reinvesting its free cash flow as we are a company that is not growing but instead returning its free cash flow to us. Both growth and the return of cash to shareholders are valuable. The point is to properly assess the value of a company based on all relevant factors, including its risk, return-on-capital, growth prospects, and cash returns to shareholders.

Overenthusiasm, a fixture of financial markets dating as far back as the early 17<sup>th</sup> century tulip mania, is another reason that valuation disparities develop. Market participants can bid prices unreasonably high when new era economic theories are adopted out of miscalculation, ignorance, or greed. Another related reason for valuation disparities is the insidious “performance cycle.” A self-fulfilling phenomenon of outperformance develops as more money is added to “winning” fund managers and taken from “losing” fund managers. Then one day everyone realizes that the “winning” managers are sitting on an overpriced house of cards, and a new cycle begins.

Ultimately, no one can say precisely what drives markets to the kind of extremes we are seeing today. What we can safely say is that markets, much like a pendulum, tend to swing from one extreme to another, and that a keen awareness of fundamental value is the only reliable way to stay grounded during such times.

## **3) How will our estimated valuation differential be realized?**

The EQR valuation differential is estimated to be 250%. This figure is based on the price/value gap between EQR and the S&P 500  $((1 \div 0.73) \div (1 \div 2.56) - 1)$ . It can also be broken down into estimated realized returns.

EQR cash returns are earned as dividends are paid and gains are realized. Realized gains can be further broken down into two components. The first is based on earnings-per-share growth from share retirements and business expansion. The second is a rise in market price relative to intrinsic value. The reason we are confident that the market will confirm our estimated intrinsic value is that we have modest expectations. The EQR cyclically adjusted P/E would need to rise from 8.6x to 11.7x—not a heroic assumption. Putting it all together, the EQR strategy’s estimated return is approximately 12.3% per year based on a 3.3% dividend yield, 6.0% earnings-per-share growth rate, and 3.0% increase in the P/E ratio over a 10-year horizon.

S&P 500 cash returns are earned according to the same mechanics. The difference is that we have much less confidence in the market price declining to meet our intrinsic value estimate. The die is still cast, however, based on the fundamentals. Our valuation model assumes a 1.4% sustainable dividend yield and a 4.3% earnings-per-share growth rate, implying a 5.7% annual return *if the cyclically adjusted P/E holds*. Given that the S&P 500 cyclically adjusted P/E is near all-time highs, we think it is more likely to contract, resulting in an S&P 500 return that is less than 5%. The more it contracts, the worse the return. An approximate 30% contraction over 10 years would result in an S&P 500 return of approximately 2% per year (1.4% dividend yield + 4.3% earnings-per-share growth – 3.7% P/E ratio contraction).

The ACR investment team takes the disclaimer seriously that current analysis and past performance do not guarantee future results. That is, we could always be wrong. However, the divergence in values is so great today that it is hard to imagine being directionally incorrect. Time will tell. In the meantime, we are especially grateful for the loyalty of our investors. ACR's success depends upon partners like you who allow us to break away from the crowd, even if that means we are the tortoise in the race while the hare temporarily scampers ahead. Thus, we conclude, as always, with a hearty thank you for your continued trust.

*Nick Tompras  
October 2020*

## **IMPORTANT DISCLOSURES**

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

*The Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values.*

*The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.*

*The price-to-earnings (P/E) is the period price divided by earnings per share (EPS). The earnings yield (EY) is the inverse of the price-to-earnings ratio (i.e., EPS/Price). EY represents estimated earnings that could be paid out in dividends as a percentage of current price. Yields (income/price) are the most fundamental metric to compare the margin of safety for an investment (e.g., earnings yield for equities, yield to maturity for bonds).*

*EQR Cyclically Adjusted P/E and EY are based on the weighted 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.*

*S&P Cyclically Adjusted P/E and EY are based on Real S&P 500 Price Per Share (PPS) at quarter end divided by Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to 2019.*

*The Price/Value is ACR's estimate of undervaluation based on market prices and Fundamental Value. Fundamental Value is ACR's estimate of what a company is worth based upon our estimate of its future cash flows and their riskiness. Ultimately, Fundamental Value represents the portfolio manager's subjective estimate of business value.*

*The Valuation Differential is the estimated price/value difference between EQR and the S&P 500 as of 9/30/20. Intrinsic value is based on multiple business and financial factors and represents the portfolio manager's subjective estimate of business value.*

## **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](http://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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*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 investment outlook represents ACR's views on the economic factors that may affect the international capital markets. There can be no guarantee that these factors will necessarily occur as ACR anticipates, nor that if they do, they will lead to positive performance returns. There can be no assurance that any objective will be achieved.*

*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 Strategies section of our web site at [www.acr-invest.com/strategies/eqr-advised-sma-composite](http://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.*