

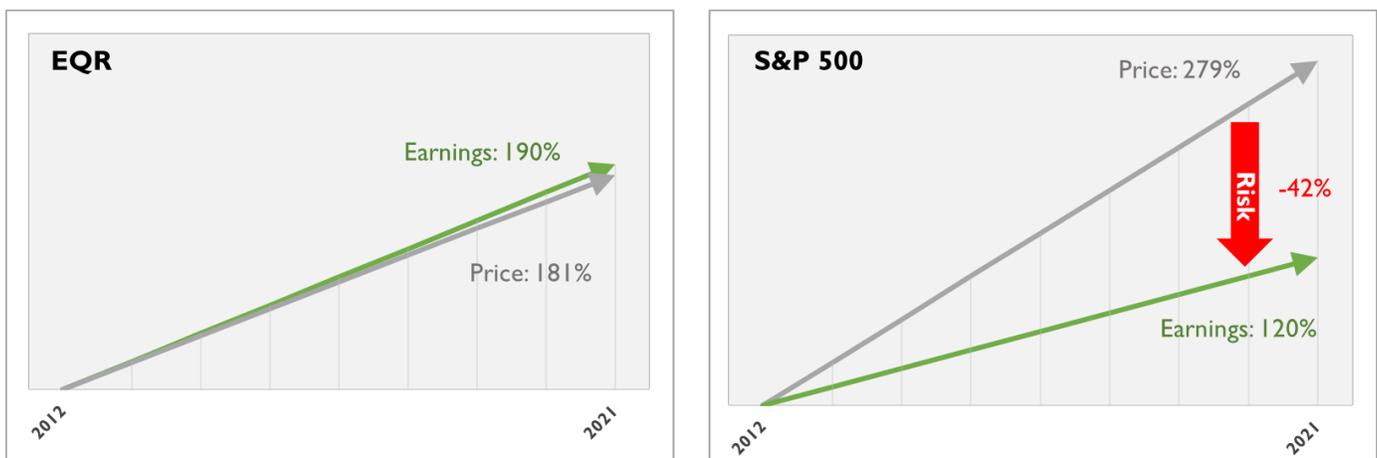
## Pruning Risk, Creating Value

The economy in 2021 was in full rebound mode. Real GDP reached pre-pandemic highs by year-end despite virus variants, supply constraints, and inflationary pressures. The massive pandemic fiscal stimulus continued to fuel spending, which spurred additional capital investment. Global financial markets soared. ACR strategy results can be found at <https://acr-invest.com/strategies>.

**We are pleased with the development of the *fundamental (or intrinsic) values* in our portfolios last year.** Fundamental value is established by the cash flows of our portfolio companies or debt instruments. This is not to be confused with *market value*. Market value is based on the current *prices* of our portfolio investments. The overall prices of our investments went up significantly last year. More importantly to us, though, our estimates of *fundamental values* rose commensurately (see Appendix 1).

**The same in our opinion *cannot* be said for the overall equity markets. By our reckoning, prices have risen much faster than fundamental values for the S&P 500 and other major indices.** The chart below depicts a 10-year view of earnings—the substance of fundamental value—compared to price for our EQR strategy and the S&P 500 (see Appendix 2).

### EQR vs. S&P 500: Price and Earnings 2012-2021



The charts above show the increase in corporate earnings and market price for both the EQR strategy and S&P 500 from 2012 to 2021. Earnings growth is calculated as the earnings yield (earnings / price or “EY”) multiplied by the portfolio price at the beginning and ending periods. Price growth for the EQR strategy is calculated by disaggregating the price and dividend return from the portfolio total return. See Appendix 2 for additional information.

Source: ACR and Standard & Poor’s

Three takeaways from these charts help to explain a key element of our investment strategy and the theme of our year-end commentary:

- 1) The change in EQR and S&P 500 earnings is based on (i) the earnings growth of the underlying companies and (ii) differences in the earnings of portfolio companies that are removed and added over time.
- 2) EQR earnings are 190% higher largely because we replaced companies when their prices overshot their earnings with companies whose prices were lower relative to their earnings.
- 3) ACR thereby “pruned” portfolios of valuation risk while capturing additional earning power and fundamental value.

**An economic win-win is possible when investors understand the fundamental value of their holdings and carefully prune portfolios of high-priced assets while simultaneously creating value via replacement with undervalued assets.**

The “price” of pruning is taxes. Many ACR clients are taxable investors (including the investment team), so we are well aware of this cost. Our overall annual turnover—the proportion of a portfolio that is sold each year—remains relatively low compared to most asset managers. For example, our EQR strategy turnover last year was 10%, close to its historical average of 13% (see Appendix 3). This compares to average turnover for US active equity fund managers of 47% last year and 55% over the past 10 years (see Appendix 3). EQR turnover, though low, still allowed us to reduce the risk of holding high-priced companies in the portfolio.

The virtue of passive index funds like those based on the S&P 500 is that their turnover is even lower than EQR’s. For example, over the 10-year period covered in our chart, 61% of S&P 500 companies remained at the end of 2021, whereas only 31% of EQR companies remained. The S&P 500 is therefore more tax efficient than EQR. Yet, in our opinion, there is a price to pay for this tax efficiency—runaway valuation risk. Our chart shows that the S&P 500 would have to decline 42% to get back to its price-to-earnings ratio just 10 years earlier.

ACR specifically builds tax efficiency into our valuation analysis by having a margin of safety on sales as well as purchases. That is, the price/value premium upon sale compared to our price/value discount upon purchase must be large enough to account for both variability in our valuation estimates and capital gain taxes. (Non-taxable investors may wonder if reducing turnover hurts them. We think that modestly reducing turnover by having a larger price/value margin of safety is likely to be rounding error for non-taxable investor returns.)

**Earnings development of 190% for EQR and 120% for the S&P 500 demonstrates the fundamental value ACR has generated compared to the market.** Underlying company earnings growth for EQR and the S&P 500 was an important driver of these results. However, the difference-maker for EQR was our ability to

carefully reduce exposure one-company-at-a-time when price relative to underlying value created too much risk. Just as importantly, we then patiently waited until the rare moment when another stock in our large universe of investable companies dropped to a price that justified purchase. Discipline is the key.

**The US stock market as represented by the S&P 500 is, in our opinion, poised for a “lost decade” of suboptimal returns at best, susceptible to large losses at worst.** Index holders can boast of a spectacular price return of 279% over the past decade. Yet, as measured by earnings development of just 120%, most of this growth is unsupported by underlying value. ACR is confident that whether alignment with earnings takes months, years, or decades, the economics of price and value will result in a favorable outcome for EQR relative to the market along the lines of EQR’s historical returns (see Appendix 4).

Regardless of earnings development, investors sometimes wonder exactly how we will catch up to the market *price* and understandably question whether so-called “value” stocks will remain values forever. “Growth” has been beating “value” now for well over a decade. Once riskier technology stocks of years past have become today’s blue chips and appear to be invincible juggernauts. The asset-light software and information economy has superior margins and returns on capital compared to old economy firms that are in secular decline. Perhaps this time is different, and growth has ascended value permanently.

**ACR is not waiting for the “growth versus value” Godot to reverse itself. Investors in our strategies prosper because the earnings of our portfolio companies are monetized in the form of real spendable dollars.** We think many leading growth companies today will be successful in the future, and we even own one of them. Investing with ACR is not in our view a bet against “growth”. The investment team does not even think in terms of growth or value. Rather, we think of our portfolio investments as interests in businesses that produce cash earnings for us as owners. We select businesses whose management, strategy, products, and markets are understandable and whose profits can be reliably forecasted. The upshot is that reliably forecasting profits translates into reliably forecasting investment returns (see Appendix 5).

Investors who are concerned that “value” will always remain cheap do not understand the mechanics of how company earnings are monetized. In the 2008 Berkshire Hathaway annual letter, Warren Buffett stated simply: “Long ago, Ben Graham taught me that ‘Price is what you pay; value is what you get.’” While pithy and profound, missing is an explanation of what this value really is. That is, fundamental value may be nice and all, but how do we actually make money? The mechanics are accessible but require elaboration. An example is provided in the appendix (see Appendix 6).

The ACR investment team does not know what the coming year will hold. The past two years have been nothing if not full of surprises. Come what may, we will maintain our recipe of constructing and managing all-weather portfolios of quality holdings at the best values possible. Thank you as always for your trust and confidence, and may you enjoy much health and happiness in 2022.

*Nick Tompras*  
*January 2022*

## Appendix

### 1. EQR Fundamental Return

EQR Fundamental Return					
EQR Portfolio	Return - Market		Return - Fundamental		P/V
	Stock TR	Portfolio TR	Stock TR	Portfolio TR	(Period End)
2021	31.82%	26.34%	31.11%	24.87%	0.85
2020	13.62%	17.33%	12.58%	10.18%	0.85
2019	21.68%	15.05%	4.03%	3.46%	0.84
2018	-8.12%	-3.33%	16.13%	10.78%	0.72
2017	25.64%	16.63%	21.50%	13.97%	0.91
2016	12.79%	9.63%	11.51%	7.97%	0.88
2015	0.56%	0.87%	7.49%	4.40%	0.87
2014	20.32%	12.66%	19.03%	11.55%	0.93
2013	36.96%	25.00%	17.61%	11.75%	0.92
2012	15.33%	12.30%	12.41%	9.25%	0.79
2011	5.84%	5.06%	17.83%	14.74%	0.77
2010	24.93%	19.98%	29.33%	21.85%	0.86
2009	28.34%	29.07%	-8.15%	-6.52%	0.89
2008	-16.21%	-13.88%	16.10%	13.30%	0.64
2007	4.31%	4.31%	17.35%	14.21%	0.88
2006	20.28%	17.88%	0.84%	1.40%	0.99
2005	-1.65%	-0.19%	6.65%	5.60%	0.83
2004	12.76%	9.34%	19.03%	13.76%	0.90
2003	33.31%	28.20%	5.84%	5.13%	0.95
<b>CAGR % (since 03/31/2003)</b>	14.09%	11.75%	13.33%	9.96%	

Source: ACR Alpine Capital Research. Past performance is not indicative of future results.

The EQR Fundamental Return table seeks to show the EQR strategy total return based on fundamental value and market value. Total return based on fundamental value includes the change in fundamental value and dividends. Total return based on market value includes the change in stock price (realized and unrealized) and dividends. Fundamental value is ACR's estimate of what a company is worth based upon our estimate of its future cash flows and their riskiness. The calculation of the fundamental return includes approximations of certain data based on a monthly rather than daily data set. ACR began recording the data necessary to calculate the estimated attribution of EQR's fundamental return on a monthly basis starting March 31, 2003, and this dataset is presented in its entirety.

## **Definitions:**

**Return - Market: Stock TR** is the EQR strategy stock-only (excluding cash) total return component of the EQR strategy total return.

**Return - Market: Portfolio TR** is the EQR strategy “pure gross” (gross of all fees including brokerage commissions) total return, including cash. Total return includes unrealized gains, realized gains, dividends, interest, and the reinvestment of all income. See EQR’s full composite presentation at <https://www.acr-invest.com/strategies/eqr-advised-sma-composite/94>.

**Return - Fundamental: Stock TR** is the EQR strategy fundamental value stock-only (excluding cash) total return and reflects both the strategy stock-only total return and change in the price/value ratio.

**Return - Fundamental: Portfolio TR** is the EQR strategy fundamental value total return, including cash, and reflects both the strategy total return and change in the price/value ratio.

**Fundamental Value** is ACR’s estimate of what a company is worth based upon our estimate of its future cash flows and their riskiness.

**Price/Value (P/V)** is the ratio of EQR strategy prices to ACR’s estimate of the EQR strategy fundamental value.

**CAGR** is the compound annual growth rate, or annualized return over a specified investment period.

## **2. EQR vs. S&P 500 Price and Earnings Chart Explanation**

The EQR vs. S&P 500 Price and Earnings Chart shows the increase in corporate earnings and market price for both the EQR strategy and S&P 500 from 2012 to 2021. Earnings growth is calculated as the earnings yield (earnings / price or “EY”) multiplied by the portfolio price at the beginning and ending periods. Price growth for the EQR strategy is calculated by disaggregating the price and dividend return from the portfolio total return.

The EQR Advised-SMA Composite pure gross of fees total return (including cash) was 236% from Dec. 31, 2011 to Dec. 31, 2021. The dividend return was 20% based on the EQR strategy period dividend yield multiplied by the equity allocation. The portfolio total return and estimated dividend return establish a price return of 181%. The EQR strategy EY based on our company-level earning power estimates was 8.6% (P/E of 11.7) as of Dec. 31, 2011 and 8.8% (P/E of 11.3) as of Dec. 31, 2021. The price growth of 181% and EY increase of 3% results in calculated earnings growth of 190%. EQR company cash earning power estimates were chosen because we believe that they are more accurate and conservative than other earnings measures. Based on as reported earnings (diluted EPS excluding extra items from S&P Cap IQ), the EQR strategy EY was 7.9% (P/E of 12.6) as of Dec. 31, 2011 and 13.8% (P/E of 7.2) as of Dec. 31, 2021. This results in earnings growth of 391%. As reported and operating earnings of concentrated portfolios like the EQR strategy often contain distortions that render them less accurate and informative. We believe the EQR cash earning power estimate removes these distortions and is the best representation of earnings for the EQR strategy and this analysis.

The S&P 500 Index price return was 279% from Dec. 31, 2011 to Dec. 31, 2021 (total return was 363%). The S&P 500 EY based on trailing 4Q as reported earnings was 6.9% (P/E of 14.5) as of Dec. 31, 2011 and 4.0% (P/E of 24.9) as of Dec. 31, 2021 (4Q21 earnings are based on the current estimate provided by S&P Dow Jones Indices). The price growth of 279% and EY decrease of 42% results in 120% earnings growth. As reported earnings result in the most favorable earnings growth rate for the S&P 500. Operating earnings resulted in 109% earnings growth and normalized earnings using ACR’s cyclical adjustment method resulted in 52% earnings growth.

The analysis for both the EQR strategy and S&P 500 includes changes in the underlying companies owned from Dec. 31, 2011 and Dec. 31, 2021. Earnings growth is impacted by both the earnings growth of portfolio companies and changes in portfolio composition. For the EQR strategy, the analysis shows how changes in the portfolio's composition—as we “prune” the portfolio of companies we believe are overvalued and replace them with companies we believe are undervalued—have resulted in the capture of significant earnings growth.

### 3. EQR Historical Turnover

EQR Turnover	
Year	Turnover %
2021	10%
2020	14%
2019	10%
2018	19%
2017	13%
2016	15%
2015	13%
2014	11%
2013	14%
2012	13%
2011	19%
2010	20%
2009	14%
2008	19%
2007	10%
2006	3%
2005	5%
2004	18%
2003	24%
2002	9%
2001	10%
2000	12%
<b>Average</b>	<b>13%</b>

EQR Historical Turnover is based on EQR strategy dollar turnover on an annual basis. From 2011 forward EQR turnover is calculated as the lesser of purchases or sales of equities divided by average assets (average of beginning of year and end of year composite assets). Prior to 2011 turnover was calculated based on sales of equities divided by average assets. ACR changed its methodology for 2011 forward to better align with the calculation approach used by major databases.

US active equity fund turnover was calculated as the average turnover of funds with available data in eVestment. There were 413 observations in 2021. Turnover in eVestment is calculated as the lesser of purchases or sales of securities divided by average market value.

#### 4. EQR Return Since Inception

EQR Since Inception	EQR (Gross)	EQR (Net) <sup>1</sup>	S&P 500
4/03/2000 – 12/31/2021	12.4%	11.3%	7.5%

<sup>1</sup>EQR (Net) is net of 1% fee.

Past performance and current analysis do not guarantee future results. Please review the EQR Advised/SMA composite performance disclosures located at <https://acr-invest.com/wp-content/uploads/2021/10/eqr-advised-sma-qips-report-2020.pdf>

#### 5. EQR Underwriting Table

EQR Returns (Gross of Fees)			
10-Year Period Ended	EQR Forecasted Total Return <sup>1</sup>	EQR Actual Total Return <sup>2</sup>	S&P 500
12/31/2009 <sup>^</sup>	N/A*	12.0%	-1.2%
12/31/2010	N/A*	9.8%	1.4%
12/31/2011	N/A*	7.9%	2.9%
12/31/2012	N/A*	9.6%	7.1%
03/31/2013	12.7%	11.5%	8.5%
12/31/2013	10.2%	10.2%	7.4%
12/31/2014	10.5%	10.5%	7.7%
12/31/2015	11.2%	10.6%	7.3%
12/31/2016	9.2%	9.8%	6.9%
12/31/2017	10.4%	11.1%	8.5%
12/31/2018	14.3%	12.4%	13.1%
12/31/2019	10.9%	11.1%	13.6%
12/31/2020	11.1%	10.8%	13.9%
12/31/2021	11.0%	12.9%	16.6%

<sup>^</sup>Partial 10-year period (inception 4/3/2000)

\*ACR did not publish forecasted returns prior to 2003.

**Past performance is not a guarantee of future results.**

Equity Quality Return (EQR) Forecasted Total Return is our annualized forecasted return at the beginning of the 10-year period based on ACR's fundamental 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 Value/Price captures ACR's estimate of undervaluation. Fundamental 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.

EQR Actual Gross Total Return is the EQR Advised/SMA Composite actual 'pure gross' 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.

## 6. Company Earnings and Fundamental Value Monetization

The following explanation of how companies create and monetize value for shareholders, including the economics of share repurchase and company capital allocation, are factually uncontroversial yet often misunderstood.

10,000 shares of XYZ stock is purchased at a price of \$10.00 per share ("PPS"). XYZ has 1 billion shares outstanding. The initial market value of XYZ in our brokerage account is therefore \$100,000 ( $\$10.00 \text{ PPS} * 10,000 \text{ shares}$ ). XYZ earns \$1.00 in earnings per share ("EPS") and therefore earns for us as shareholders \$10,000 ( $\$1.00 \text{ EPS} * 10,000 \text{ shares}$ ). Note this represents a price-to-earnings ratio ("P/E") of 10x ( $\$10.00 \text{ PPS} / \$1.00 \text{ EPS}$ ) or an "earnings yield" of 10% ( $\$1.00 \text{ EPS} / \$10.00 \text{ PPS}$ ). The market value of the entire company is \$10 billion ( $\$10.00 \text{ PPS} * 1 \text{ billion shares}$ ) and the earnings of the entire company are \$1 billion ( $\$1.00 \text{ EPS} * 1 \text{ billion shares}$ ).

Companies use their earnings to create value for shareholders in three ways (holding capitalization constant): dividend payments, share repurchases, and growth investment (either by increasing productive capacity or acquiring other businesses).

- **Dividends.** XYZ pays a \$0.25 dividend on a per share basis (dividends per share or "DPS"), which is \$250 million ( $\$0.25 \text{ per share} * 1 \text{ billion shares}$ ) of its \$1 billion in earnings. Given our ownership, we receive \$2,500 in cash ( $\$0.25 \text{ DPS} * 10,000 \text{ shares}$ ) or a 2.5% dividend yield ( $\$2,500 \text{ cash dividend} / \$100,000 \text{ purchase value}$  or  $\$0.25 \text{ DPS} / \$10.00 \text{ PPS}$ ). Dividends represent a direct monetization for shareholders. Interestingly, the lower the stock price, the higher the dividend yield.
- **Share repurchase.** XYZ spends another \$0.25 per share or \$250 million ( $\$0.25 \text{ per share} * 1 \text{ billion shares}$ ) of its \$1 billion in earnings to buy back its stock. At a stock price of \$10.00 per share, XYZ would buy or "retire" 25 million shares ( $\$250 \text{ million} / \$10.00 \text{ PPS}$ ), leaving 975 million shares outstanding. EPS grows 2.5% from \$1.00 to \$1.025 ( $\$1 \text{ billion earnings} / 975 \text{ million shares}$ ). Assuming the P/E of 10 holds, PPS also rises by 2.5% from \$10.00 ( $\$1.00 \text{ EPS} * 10 \text{ P/E}$ ) to \$10.25 ( $\$1.025 \text{ EPS} * 10 \text{ P/E}$ ). Share repurchase requires a stock sale by shareholders for monetization. To realize the 2.5% increase in value, the investor would have to sell a small portion of stock at the now higher price. Notice that the cash used by XYZ to pay the dividend and retire its stock were both \$0.25 per share, and both resulted in a 2.5% return. The main differences are taxes and timing. The dividend has the advantage of being in cash today but is taxed immediately. The share repurchase has the advantage of tax deferral but the disadvantage of requiring future stock sale for monetization. Most interestingly, investors will want the stock price to stay low while the company is repurchasing its shares. The lower the stock price, the more stock that is acquired, and the greater its EPS growth.

- Growth investment.** XYZ has returned \$0.50 to us as shareholders through dividends and share repurchase. Based on its EPS of \$1.00, it has \$0.50 to reinvest back in its business. XYZ can earn a 10% return on its investment in new productive capacity. The amount it reinvests, \$500 million ( $\$0.50 \text{ DPS} * 1 \text{ billion shares outstanding}$ ), will earn \$50 million on the additional productive capacity (10% return-on-equity \* \$500 million capacity investment). EPS grows 5% from \$1.00 to \$1.05 ( $\$1.050 \text{ billion earnings} / 1 \text{ billion shares}$ ). Assuming the P/E of 10 holds, PPS also rises by 5% from \$10.00 ( $\$1.00 \text{ EPS} * 10 \text{ P/E}$ ) to \$10.50 ( $\$1.05 \text{ EPS} * 10 \text{ P/E}$ ). Earnings growth requires a stock sale by shareholders for monetization. To realize the 5% increase in value, the investor would have to sell a small portion of stock at the now higher price.

Putting it all together, the fundamental return that XYZ shareholders earned is 10%: 2.5% cash dividends + 2.5% share repurchase + 5% earnings growth. In our stylized example, since XYZ's earnings yield is 10% ( $\$1.00 \text{ EPS} / \$10.00 \text{ PPS}$ ) and its return on reinvestment is 10%, its fundamental return is 10%. However, only 2.5% of this return has been monetized. Can the remainder still be monetized if the stock remains "cheap"? Yes! As described above, investors are able to monetize share repurchase and earnings growth via capital gain as EPS and PPS grow commensurately at a stable P/E of 10. The P/E does not have to expand.

Regarding capital allocation, if we start with a P/E of 5 instead of 10, XYZ should spend its entire \$1 billion in earnings or \$1.00 per share to buy back its stock. At a stock price of \$5.00 per share, XYZ could buy back 200 million shares ( $\$1 \text{ billion} / \$5.00 \text{ PPS}$ ) leaving 800 million shares outstanding. EPS grows 25% from \$1.00 to \$1.25 ( $\$1 \text{ billion earnings} / 800 \text{ million shares}$ ). Assuming the P/E of 5 holds, PPS also rises by 25% from \$5.00 ( $\$1.00 \text{ EPS} * 5 \text{ P/E}$ ) to \$6.25 ( $\$1.25 \text{ EPS} * 5 \text{ P/E}$ ). Paying out earnings in a dividend results in an inferior return of 20% ( $\$1.00 \text{ DPS} / \$5.00 \text{ PPS}$ ) and reinvesting back in the company at 10% an even more inferior return. Examining another scenario, say the P/E is 10 and the company can reinvest for growth at a 20% return. In this case, XYZ should reinvest all its earnings to grow. ACR seeks management teams who understand these capital allocation principles. Surprisingly, many management teams are either focused on other metrics or have different agendas. A wonderful book called *The Outsiders* by William N. Thorndike chronicles eight rare and extraordinary CEO's who get these principles. Just two of the eight are still active. They are Chairmen of two ACR-owned portfolio companies.

## 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 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. See EQR's full composite presentation at [www.acr-invest.com/strategies/eqr-advised-sma-composite](http://www.acr-invest.com/strategies/eqr-advised-sma-composite).