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A Russian Tragedy

The streak of historic surprises that defined the past two years unfortunately continued in the first quarter of 2022. The Russian invasion of Ukraine has become the largest European war since 1945. The complex economic crosscurrents originally caused by the pandemic and the multi-trillion-dollar global stimulus—a booming economy, supply-chain crisis, near double-digit inflation, and rising interest rates—are now further confounded by war.

Our job is to protect and maximize the purchasing power of the assets under our stewardship. With this solitary objective in mind, we assess economic and geopolitical events through a single lens: their impact on the long-term business performance of the companies we own. We spend no time attempting to trade securities based on how their *prices* might respond to these events. Rather, we assess how unfolding conditions could affect the markets, employees, revenues, costs, assets, and, ultimately, the cash profits of our holdings.

Broadly, based on available information, we think the war is unlikely to materially change how many cars are sold globally over the next 10 years. Nor do we think it will materially change how many property & casualty insurance policies are written, software subscriptions are renewed, loans are issued, or disease-fighting drugs are developed. We do not see the war significantly altering the long-term path of progress in per capita GDP over the past two centuries. More to the point, we do not see specific company-level effects from the war that will change our long-term investment return assumptions. Nevertheless, we are never sanguine about risk. Our obsession with it is never-ending. Below is a brief discussion of today's war-related risks.

Direct and indirect risks to our companies, assuming war is contained between Russia and Ukraine. ACR portfolios have minimal risk in Russia and Ukraine, with less than 1% of company revenues exposed. Indirect risks are more significant but appear manageable. Our EQR strategy earns approximately 16% of its revenue in Europe. Several companies have reported war-related write-downs and exposures, and there will surely be more to come. Our current analysis shows the potential impact is likely to be less than 5% of affected company valuations. Generally, higher commodity prices will add to cost pressures for many of our companies in both the US and Europe. Some companies have pass-through contracts or sufficient pricing power to pass along these costs, and our energy exposure provides a more direct hedge. Other companies that are impacted negatively have so far not warranted a major adjustment to our long-term earning power estimates.

Macroeconomic risks, including commodity prices, inflation, and interest rates. Higher commodity prices feed directly into higher inflation and could cause central banks to raise interest rates quicker and higher than previously planned. A war-related slowdown in economic activity and the blunt instrument

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of rate increases could cause a recession. While the Russian-Ukrainian War may exacerbate macroeconomic uncertainty, the complex dynamics among inflation, interest rates, and employment are nothing new. ACR's forecasts for our cyclical and interest rate-sensitive companies include adjustments for normalized earning power and interest rates. Nothing we have seen thus far has caused us to change our long-term assumptions, which were already relatively punitive.

A wider war or nuclear event. The ACR investment team often thinks about the unthinkable. A catastrophic natural disaster, a war among superpowers, the unleashing of weapons of mass destruction—these are always possibilities, even if remote. Economically, such events end up as major economic dislocations or depressions. Limiting business risk and financial leverage to protect against economic calamity is essential. Should the riskiest one-fourth of the world fall off the edge of a cliff economically, owning assets among the safest one-fourth is the best way to protect against loss. Owning quality assets means giving up some return along the way, but we sleep better at night knowing that the odds are with us when the 100-year economic flood strikes. One final fact to remember is that the 20th Century witnessed two world wars and a major depression, yet the global economy continued its long run ascent.

Our prevailing assessment is that the war has a low chance of causing significant harm to the long-term profits of our companies or overall corporate profits. We continue to believe that inflated asset prices are the greatest risk facing investors today. Fortunately, ACR does not invest in the overall financial markets. Rather, we invest in a limited number of companies with very different valuation characteristics than the market. In our opinion, the market remains highly bifurcated between a large, high-priced pool of assets and a much smaller inexpensive pool. Market choppiness this year has allowed us to add to the inexpensive group and lower our cash balances, while we still have sufficient cash to take advantage of further volatility.

The needless death and destruction that Vladimir Putin has perpetrated upon Ukraine and Russia is tragic. More than anything, we wish for a quick end to the heartbreaking loss of life and devastation in Ukraine. As investors, despite the awful humanitarian crisis, we do not see a global economic tragedy unfolding. Rather, we see the potential for price volatility and stand ready to selectively deploy additional capital in undervalued assets.

Nick Tompras
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