COVE STREET CAPITAL

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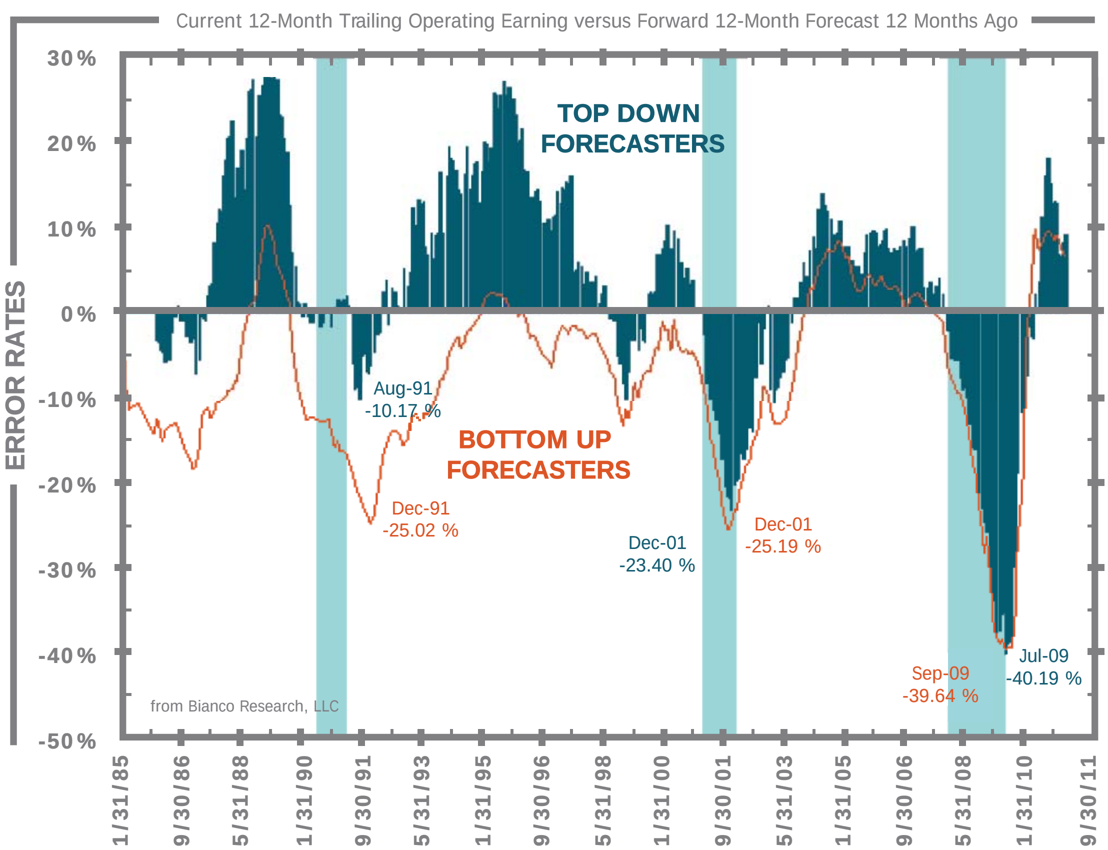
'Tis the Season I Doubt You Will Remember

Our reference is not to the possibility that random bouts of inebriation at holiday parties will disturb your normal patterns of retention, but rather to the solemn distribution of "The Outlook for the Upcoming Year," versions of which are beginning to clog our inboxes in both digital and ex-forestry form. The one good piece of news about this annual tradition is that as a relatively new firm, we haven't been "found" by every sell-side research firm in the world (although we are somehow receiving Mongolian Cement Research—I kid you not) and thus have retained some ability to think.

What is irksome should be obvious: who the heck knows what one cycle of the earth around the sun will bring for an investor? And if you really did, would you tell anyone? Do you remember the prognostications of December 2005, much less those of last year?

ThreeCasting - Another Broken Crystal Ball



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Don't the Shakespearean farce and the follies of market volatility over the past five years suggest that investors' efforts might be better spent in areas that have proven more often than not to contain the possibility of adding value? As is our nature, we would suggest such efforts include careful analysis of company fundamentals, a realistic and probabilistic assessment of value and a time horizon that is longer than one year and thus does not arbitrarily follow a celestial pattern. It is precisely that these seemingly trite ideas are "out of favor" in what passes for orthodoxy in institutional investment circles that makes them entirely more relevant today and, most importantly, gives sticking to them a much higher likelihood of investment success. If the world is focused on what happens next week, and is busy analyzing what is the best pooled vehicle to create exposure to "risk-on" or "risk-off," isn't your time better spent on the "specific?" Despite some spectacularly high correlation days (499 out of 500 stocks moving either up or down in the S&P) in recent times, we have north of 110% conviction that the "stock-picking is dead" theme will go the way of any number of other suffocating consensus views that have periodically passed for new age thinking in investment management.

Any and all of our observations are based upon the value of the cards we are being dealt. What is obviously statistically cheap today are financials (which doesn't necessarily mean banks); the "housing turn" sector; big swathes of technology; and nearly any large cap, dividend-paying equity versus its corporate bond equivalent. There are any number of deep-ish values in both the large and small cap arenas that possess their own set of independent variables capable of producing very respectable returns, with or without help from the market at large. Some markets appear to be efficiently reflecting underlying risks: very decent European equities are being priced correctly for what will be a long and drawn out affair with truly a "who knows" range of outcomes. As the author, I will issue myself a partial exemption to the forecasting ban and simply note that another year has passed and we are sticking with our assertion that buying Treasuries is like picking up nickels in front of a steam-roller.

Now that we are freed from saying something "important" about 2012 for right now, we will move on and conclude our trilogy on investing where we left off from November's piece. Having devoted a lot of time in the past year to contemplating the proper evolution of an investment philosophy and a process that keys into what is crucial and material, what consistently comes up for me in both theory and practice is the "value" versus "business" conundrum. This is also phrased here as the "Warren Buffett vs. Ben Graham" tug of war. This perpetual struggle involves the mental definition of the sweet spot of value—that special place where the value is deep yet the business is not so miserable that the game clock consistently ticks against you—or its counterpart—where the business is very good but the higher price weighs upon on your ability to achieve superior returns like a European summit meeting. Despite endless and global jabbering on the subject, we still get the "which is more important" question many times in meetings with consultants who troll through our offices and I thought we would settle the matter once and for all. Both.

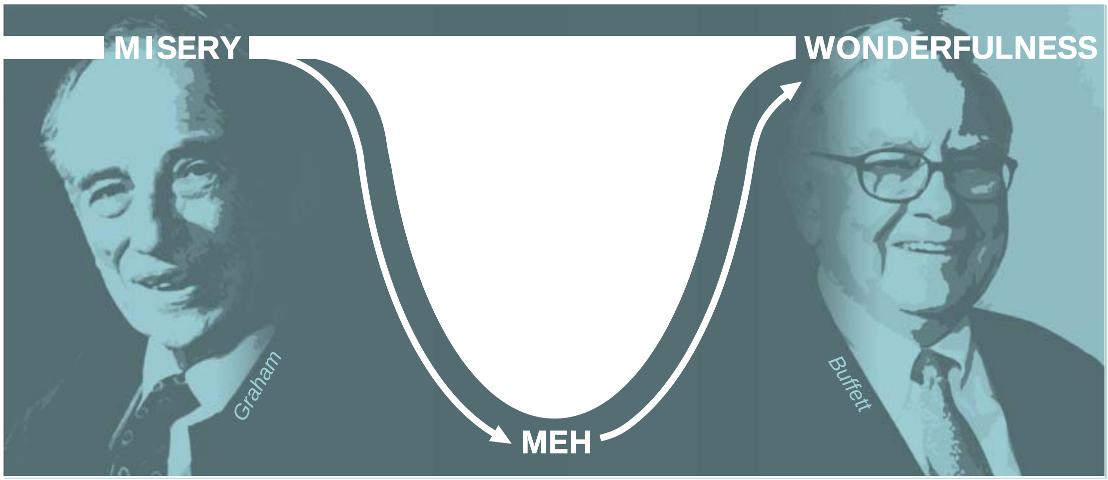
It's almost a trick question and then again it isn't. If we ran $50 billion dollars, it would be an entirely elegant investment solution—in theory and in practice—to buy the statistically cheapest 2500 stocks and then every x quarters, rebalance by buying and selling stocks to ensure we remained invested in the cheapest segment. Such an investment philosophy is based on the classic reversion to the mean principle and there are miles of academically driven tree-stumps that prove it works. You inevitably get some bankruptcies and will sell a few winners prematurely, but you get the rule of large numbers working for you.

This process is similar to the classic “Graham/Cigar-Butt” approach: buy cheap and the returns will take care of themselves. As most investors have in some way descended from the muck surrounding Lake Wobegon and do not manage $50 billion, other possibilities spring from this well. If value investing “works,” then its ultimate application is simply to concentrate and buy the cheapest equities one can find. While directionally “right,” its downside is that you may end up having bought GM every year since 1946 and there is a propensity for collective awfulness in miserable market years, the mathematical taste of which is not pleasant and lingers. (Trust me on this.) I grudgingly quote David Swenson from Yale:

> *While deep value investors tend to perform well over reasonable time frames, adjusting reported performance for risk poses a substantial problem. Deep value portfolios contain lower-quality, fundamentally riskier assets. Returns ought to be higher to compensate for greater underlying risk. Under conditions of severe economic distress, higher risk levels in value portfolios lead to disastrous investment results. Akin to the damage wrought by the sixty-year flood, severe financial trauma causes widespread damage by meting out extraordinary punishment for weak, lower-quality, deep value securities. Failure rates skyrocket, taking stocks out of the game and eliminating the possibility of recovery. Regression to the mean fails to perform its magic, and value investors suffer permanent losses.*

The so-called “Buffett/Munger Evolution” from Ben Graham’s teachings involves a much heavier weighting on the “quality” of the business and what is known as a “moat.” While mathematically not definitive, the principle suggests that buying a good business selling at a 20% discount to fair value is equivalent or even better than investing in a mediocre business selling at 50% discount to a reasonable estimate of fair value. This strategy relies on identifying the compounding machines—companies that generate high returns on capital, high free-cash flow and allow investors to just sit back and let the performance pile up behind the tailwinds of solid growth and prudent capital allocation. It’s not clear whether this evolution was driven philosophically or was precipitated by the recognition of the constraints of Berkshire’s size, or by the fact that it is a heckofa lot easier in theory than trolling for cigar-butts. And when the process works, it’s a thing of beauty. Thus, it should not be a surprise that a number of noted value investors have experienced the same evolution from cheap and dirty to “boy isn’t this nice?”

So the intergalactic realization here at Cove Street is…why not both? We screen for and look at very cheap securities, try to determine the risk of the business model and we also have a fancy list of wonderful businesses that I personally used to wish to be married into, but now would be very happy just being adopted by. The key issue in practice is doing one’s best to understand which is which from the start, an effort colloquialized in the Cove Street Investment Process Checklist (also known as the list of 57 mistakes I will admit to or remember making in 27 years) as the Graham vs. Buffett check point. As noted in the picture below, a Graham stock is bought at a price that reflects misery and is most likely sold at a price that reflects mediocrity. While somewhat disheartening for management teams to hear, and for a shareholder to painfully understand, many businesses only earn their cost of capital in good times and a valuation that reflects mediocrity is a bid that should be hit.



On the opposite end of the spectrum, the other way for us to add value is to understand and identify "the wonderful" and not be afraid to step to the plate when the business model is unchanged but the valuation is erroneously discounting mediocrity. In many cases and over many years, you can shave the position size of the wonderful as it approaches fair value and then step back in during a period of mindless volatility, thus allowing the compounding machine to keep working for you.

Over time, the portfolio reflects what the market is offering, with an underlying bias toward the "the good." While there is often great value to be had in parsing the obtuse and doing the dirty work where others cannot be bothered, there is no shame in life in general, and portfolio management specifically, in taking the easier path to the same reward. There are no bonus points given in investment management for making the same amount of money in a more difficult, potentially hair-raising corporate challenge.

Our very best for the New Year and beyond.

- Jeffrey Bronchick, CFA | Chief Investment Officer

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