COVE STREET CAPITAL

Volume 1
Issue 1

Number 1 | July 2011

"In the present world, the rational path for an investor is to start a new investment firm in Los Angeles that is deliberately focused on highly specific fundamental research on the intrinsic value of individual securities and the business models of the companies that issue them."

Volume 1
Issue 1

JULY 2011 — There has clearly been a philosophical and practical shift toward macro-economic divination in the investment community at the expense of "stock-picking" since the generationally searing experience of 2008. Since some had seen a variation of it coming (although even fewer had actually positioned themselves correctly in an appreciation of the extent of its wrath, this writer included), it therefore seems incumbent upon the rest of "us" to attempt to add macro as a core of an investment process.

In some ways, this movement has been greased by the very real and massive political intervention into the normal workings of economics and financial markets worldwide. It is not an irrational statement to suggest that if the ongoing Federal Reserve lab experiment presently entitled "Quantitative Easing XX" is capable of moving the Russell 2000® index of small cap stocks up 30% within nine months, then an investor had damn well better be paying attention to macro-economic policy. Simply stated, it is a fact that any number of financial market statistics and correlations are in uncharted waters as a result of political decisions and dollars sloshing around the system, and it remains unclear as to when and how "normalization" occurs. But how much does it help investment outcomes to expend precious moments to divine these tea leaves?

While many things change with the decades, and there is always a "new normal" that captivates headlines, some things don't change. The history of mankind and functioning financial markets instructs us that money finds and forces its way toward rationality—a reversion of sorts to an admittedly loosely defined mean. It also bulls and bears itself violently back and forth across any neatly constructed line of "normal." But in its usual mysterious way, excesses are punished and severe neglect and undervaluation are eventually rediscovered and elevated to a more appropriate status. As even a cursory analysis suggests, these zigs and zags must also be viewed within the non-linearity of financial history—there are simply whacky things that happen and they are no more predictable by armies of PhD's and MBA's than they were in ancient Rome. "Who can adequately express his astonishment at the changes of fortune, and the mysterious vicissitudes in human affairs," is roughly a 2011 year-old quote from Velleius' Roman History.

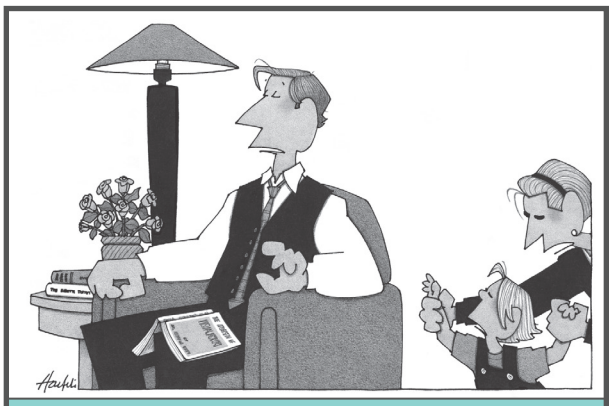
In my 27 years of investment experience, it has rarely been the case that a specifically bad macro-economic or political event actually ended the world. And as the joke goes, if you were positioned for the world to end, and it actually did, how would you collect? An investor is either amply paid to accept known- and unknown-risk, or he isn't, and that is the crux of the biscuit. Buying a real business run by real people who at least on surface seem dedicated toward shareholder value, and whose short term value happens to be publically traded, seems like an eminently more rational way to intelligently grow wealth. And jumping ahead a little, there seems

to be sufficient investable equities that are being priced somewhere between reasonably and very cheaply which may compensate investors for many of the headline risks that plague those whose timeline can only be measured on a CNBC screen. Fixed Income as an asset class is an entirely different story. Isn't Oaktree's proposed IPO ringing the bell for the end of the high yield market just as Blackstone top-ticked the LBO market in 2007?

When everyone is focused on the general and macro, there is opportunity in the diligent analysis of the specific. This is doubly reinforced by the mixed blessing that most of us are not responsible for investing an asset base that ranks in the hundreds of billions, and thus it is in the realm of the possible to actually discriminate between securities or markets versus having to own them all.

That brings us to the here and now. I would argue that in the present world, the rational path for an investor is to start a new investment firm in Los Angeles that is deliberately focused on highly specific fundamental research on the intrinsic value of individual securities and the business models of the companies that issue them. As of July 1st, we bring you Cove Street Capital. We presently manage approximately $400 mm of discerning institutional and high net worth assets in separate account form, as well as sub-advisory relationships with the Cove Street Small Cap Value Fund and the Masters Select Smaller Companies Fund.

We would like to be selectively larger by working with new client/partners and their intermediaries who understand the mathematics of compounding and are looking to take advantage of the opportunities offered by the occasionally bizarre pricing strategies set by Mr. Market. We invite you to call us at 424-221-5897 and/or explore some general thoughts about us at CoveStreetCapital.com. We will be writing a regular Strategy Letter as well offering some additional thoughts on the Cove Street Weblog.



"Don't disturb Daddy. He's busy visualizing unparalleled success in the business world and, by extension, a better life for us all."

Since the March 2009 lows, investor enthusiasm has waxed between a world viewed through a giant Japanese prism of deflation, consumer hesitancy and quagmire, or a world sitting on a massive pool of government-created liquidity that is on the precipice of fueling inflationary growth. As noted above, I am not sure I have to pick and be done with it. Rather, it has paid to examine the valuations produced by the current phase of consensus thinking and nose toward that which has been presently discarded.

On that basis, what seems to be an excellent and present opportunity are the equities of companies whose business models are being materially plagued by the unusual state of interest rates, that being the low kind. What is a fact is that interest rates in the United States, and thus by a variety of convoluted proxies, much of the rest of the world, are being manipulated by the usual cast of political entities for any variety of desirable human outcomes—such as re-election and the conceptual betterment of mankind. It is a very strong opinion that policy directives have unintended consequences and the disturbing tendency to lack staying power and instead reverse themselves according to the whim of the moment, a process in this day and age that can gain the proportions of gale force rapidity upon reaching an inflection point. We conclude with one additional fact—we have no idea when we will reach an inflection point, although it sure is an interesting juncture with the world's newest and largest buyer of Treasury bonds (the Fed, not the Chinese) about to take a breather.

But using BNY Mellon as an example, we appear to have a material margin of safety to wait for a set of events that would confirm an opinion that we are somewhere near generational lows in interest rates and that any subsequent movement upward would be both helpful to the earnings of BNY, as well as to the multiple that investors will accord to it.

BNY is truly a mission critical company—rather than TBTF (Too Big to Fail)—to a lot of the world financial system via its roles in clearing, transfer, custody and recordkeeping within what is something of an oligopolistic market. It

also is one of the ten largest global money managers. Decimalized levels of interest rates are more than offsetting the benefits of a positively sloping yield curve as the ability to economically charge customers for the basics of liquidity management and the ability of BNY to subtly appropriate float on the flotsam and jetsam of global cash movement is nearly impossible. BNY sells at slightly less than 10 times current cash earnings, a multiple that seems unduly modest for a non-bank processing company with 20% returns on tangible capital. And while it is easy to throw around numbers, some reasonable math creates 25 cents per share in incremental earnings for each 1% rise in interest rates, a development that the current consensus would likely suggest is a virtual impossibility. While we patiently wait for interest rates to do something crazy like trade above the current rate of inflation, we the shareholders benefit from continuous improvement programs, globalization of world securities markets and a 2% current yield that is likely to grow much faster than earnings. BNY also appears to have more than sufficient capital to deal with whatever nonsense finally rolls out of the world banking meetings in Basel.

And while the Basel III Accords have become the topic de jour in some circles, have we forgotten to ask what happened to Basel II, which was the agreement signed by the world's regulating geniuses in 2000 that somehow missed (and arguably spawned) the greatest financial disaster since the Great Depression? Are we expected to believe that the latest generation of bureaucrats has figured out the future this time? Is it not ironic that two of the most leveraged financial institutions in the world—the European Central Bank (ECB) and the Federal Reserve—are running around telling banks how much capital they need when the ECB in particular is so stuffed with peripheral sovereign debt that the bank itself has become the largest impediment to a Euro restructuring because it can't afford to mark its balance sheet to market?

Similarly, it is no surprise that the three areas on which Washington is most focused—housing, employment and interest rates—are the most problematic. Forcing lower interest rates is not helping the economy and, in fact, I would argue is doing more harm than good. The mortgage market is almost immune to the absolute level of rates given the deep freeze being put on the lending community as a result of their own prior mistakes. This has been compounded by disastrous intervention into lending practices, inconsistent regulatory practices, capricious capital requirements and the inability to legally enforce hundreds of years of contract law.

The present level of interest rates is also penalizing the entire population of savers in an enormous negative wealth feedback loop. A large swathe of Americans seem to be stuck living a McVersion of recent Japanese history as they have to scrimp and save more and more to preserve a current lifestyle that cannot be sustained on today's return on fixed assets, classic symptoms of a deflationary cycle.

Holding down rates also supports the "junk versus quality" trade as the nearly free after-tax cost of debt enables just about any troubled company to resolve its finances and encourages potentially foolish acquisitions on the ground that they are "accretive to earnings." On a relative basis, it penalizes good companies with high free cash-flow and good balance sheets and gives the free ride to the risky, the dumb and the leveraged. That in and of itself has been a great investment theme as will be the advent of its polar opposite.

A value investor rarely needs to create "themes"—they tend to be handed to you by the relative pricing offered by the market. It is mathematically difficult for interest rates, particularly on the short end, to decline much further. Thus, companies with good business models that are facing short-term earnings headwinds from what temporary state of affairs and whose stocks are priced cheaply because of the investment community's inability to guess when things will change, present an opportunity.

—

Jeffrey Bronchick, CFA
Principal, Portfolio Manager

Visit our weblog at CoveStreetCapital.com/Blog and sign up to receive commentary from the CSC research team.

The opinions expressed herein are those of Cove Street Capital, LLC (CSC) and are subject to change without notice. Past performance is not a guarantee or indicator of future results. Consider the investment objectives, risks and expenses before investing.

You should not consider the information in this letter as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that any of the securities discussed in this report are or will be profitable, or that recommendations we make in the future will be profitable or equal the performance of the securities listed in this newsletter. Recommendations made for the past year are available upon request. These securities may not be in an account's portfolio by the time this report is received, or may have been repurchased for an account's portfolio. These securities do not represent an entire account's portfolio and may represent only a small percentage of the account's portfolio. Partners, employees or their family members may have a position in securities mentioned herein.

CSC was established in 2011 and is registered under the Investment Advisors Act of 1940. Additional information about CSC can be found in our Form ADV Part 2a, http://www.covestreetcapital.com/FAQ.aspx.