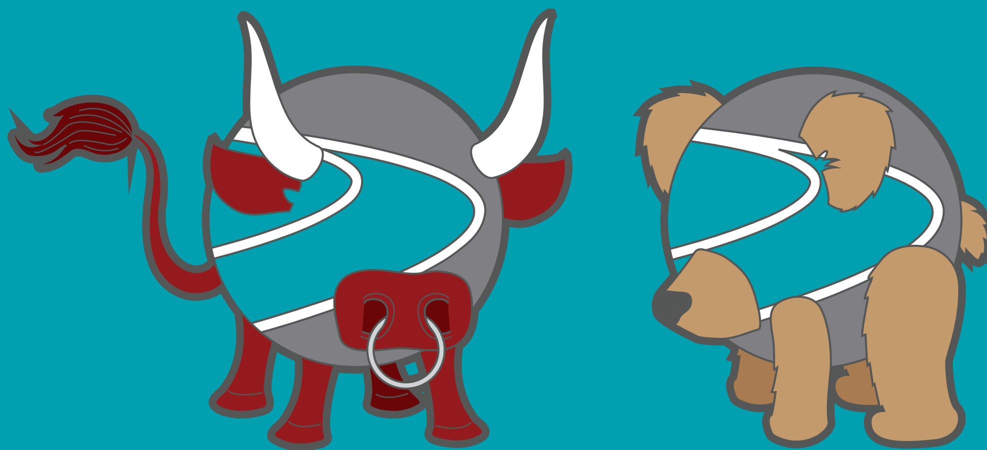
COVE STREET CAPITAL

The Fear Pendulum: From End of the World to Market Melt Up?

Number 15 | January 2014



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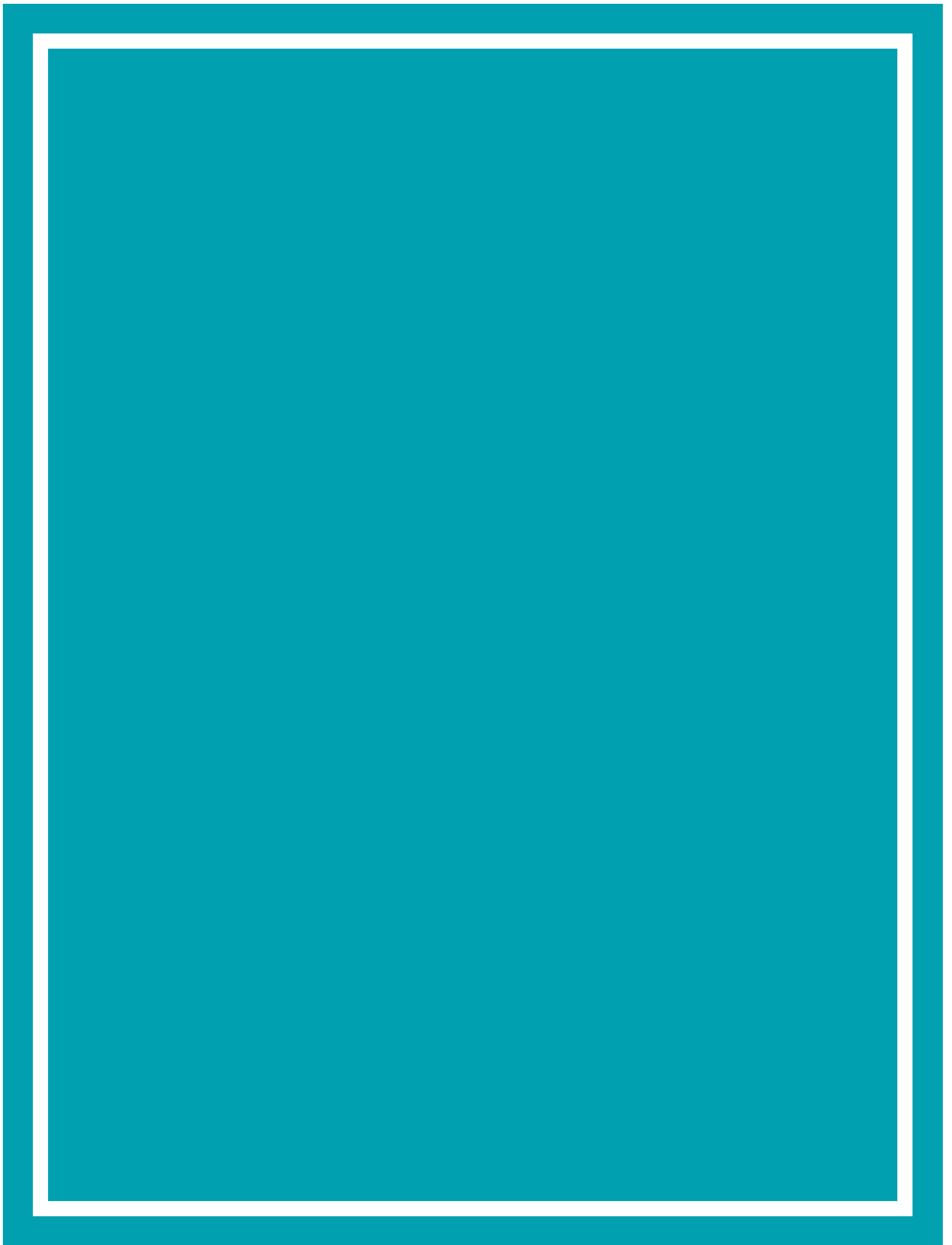


The Fear Pendulum: From End of the World to Market Melt Up?

JANUARY 2014 — It was a wonderful year to be an equity investor and while we innately lean toward spending time looking forward with the intellectual equivalent of a financial divining rod, it was a good enough year to rest on some laurels for a brief moment. Achieving absolute and relative outperformance is a particularly noteworthy achievement considering the very big year for all equity indices. The year was especially unique given that I have spent my career targeting "competitive returns in up markets and outperformance in down markets," as well as believing that "no one should apologize for being up 30% in a year."

While I can spend pages waxing eloquently about the astuteness of our stock picks, the biggest factor in the quarter and much of the past four years has simply been adherence to the Woody Allen Theorem: 80% of investment results accrue by just showing up. If you have done the work and have something to buy, buy it and worry about some PhD's argument regarding the impending end of the world later. The longer that I invest money professionally, the more apparent and self-evident the flaws and failings of "market timing" become.

Regarding some specifics, one thing we clearly learned in 2013 was "don't sell Yahoo at $19." While no one is perfect, this decision particularly pains me with the stock presently at $40. This incorporates two subplots. The first involves the identification of "critical variables" within the ocean of information in which we bob. The Cove Street team spends a lot of time thinking about this. The critical variable here was NOT the fact that Melissa Mayer is going to be the fourth CEO at Yahoo in 7 years to not be able to fix the core business. The critical variable was the fact that the Chinese internet monster called Alibaba, of which Yahoo owns 25%, was going to maintain a 40% growth rate and make our spreadsheet look silly. The jump in the stock also exposed the second issue: selling a stock after four years of boredom and frustration is rarely a wise idea.

One of our biggest contributors in 2013 was American International Group (AIG), which long-standing clients might recognize as one of the worst investments I have ever made. There are two takeaways from this recent success. The first is that "work" is not lost with time and there is nothing at all troubling about going back to the well a number of times in the same stock over a long period of time. The second is that "headline risk" is something that hobbles the investment industry and creates material opportunities for those not afraid to look stupid in the short-run. Without a sense of history and understanding, it is difficult to appreciate just how "core" AIG is in the global insurance market which, in and of itself, is core to the "machine" of global commerce. The chance to buy this retooled franchise in the face of institutional distaste (not to mention personal failure) at a severe discount to book value was a golden opportunity that has proven itself out and we think there

is more to come.

A recent addition to the portfolios was Taminco (NYSE-TAM), a specialty chemical company with the leading market share globally in alkylamines and their derivatives. TAM's business is characterized by high margins, high returns on capital, strong free cash-flow, and unusual stability for the industry given the wide usage of alkylamines in many consumer, industrial, and agricultural products. Maintaining a 50% market share in the U.S. and a 49% market share in Europe, the company only competes against three other chemical producers in each of its main geographies. Reinforcing the strong cash returns, Taminco has over half of its output sold under cost-plus contracts, a factor that will help stabilize margins in lean times.

TAM was buried in private equity for a decade after it spun-off from UCB and quietly went public in mid-2013. The current valuation suffers under fears of illiquidity and the overhang from the 55% ownership of its private equity parent. Our research suggests that these temporary issues will subside as recognition of TAM's excellent franchise, growth opportunities, and free cash-flow generation will result in a higher multiple on higher cash-flow in the years ahead.

On a bigger picture basis, a LOT of money has missed the past 4 years of returns in equity markets and in classic form and style, is piling in now. I guess the takeaway is that if you are going to make a very public market call (predicting the end of the world, for example), you had better get it right, make enough money to retire and take it off the table because the odds of you being very right on the other side are quite slim. The corollary is that VERY few money managers have a client base that will allow them to be wrong for four years. Accordingly, no matter how erudite the shareholder letter, "career risk" is looming for managers running a lot of money, particularly assets with high fees that are commensurate with an assumption of perfection. So the best summary of the financial world is that we are somewhere in the process of swinging from worrying about the end of the world to worrying about a "market melt-up," a turn of events that is anecdotally troubling for an investor as a number of these people like to use leverage and change their mind frequently.

We cannot and will not overtly provide the silly 2014 forecast (even though it will come up 40 times in the next three months), as I can assure you that our collective cognitive abilities have simply proven not to be more advanced than that of others in mangling a forecast for the future. Let's leave it as: "Stocks will fluctuate irregularly around a long-term intrinsic value trend. When stocks move strongly upward as they have, it's either a catch-up from a downturn and/or is anticipatory of better things to come. If things do get better economically from here, then we will be happy with our current portfolio. If they don't, then the stocks that represent ownership of good businesses will have temporary declines and the stocks of flawed businesses will suffer a permanent decline. We work hard at appreciating the difference."

While seeming a bit snarky, it really is a game plan. Cove Street is always expending effort to learn more about how businesses work, who is running them and being more thoughtful about valuation. But the fact is that good investing involves a lot of sitting around and waiting for stuff to happen and opportunities to be created. We know that "many shall be restored that are now fallen and many shall fall that are now in honor," but Horace's timing hasn't gotten any better in 2031 years.

What we see on a day-to-day basis is less value. It remains a simple fact that great current performance "fixes" undervalued opportunities and steals from our future performance—always has and always will. Our formulaic screens show fewer ideas and one starts to scratch one's head about the assumptions required to maintain some current holdings, regardless of "quality."

Things that bother us in 2014 include:

- Continuing regulatory nightmares no matter where you look and no reprieve for at least another three years. The U.S. is truly a wonderful and innovative nation that manages to get out of bed in the morning and create wealth and prosperity while our elected officials spend their days turning an 11-page mandate (Dodd-Frank) into 1838 pages of rules "fixing" the banking industry.

- There is clearly what we call an "idiot" element in parts of the technology sector that is as silly as any hype cycle that has come before it…and we have seen a few.

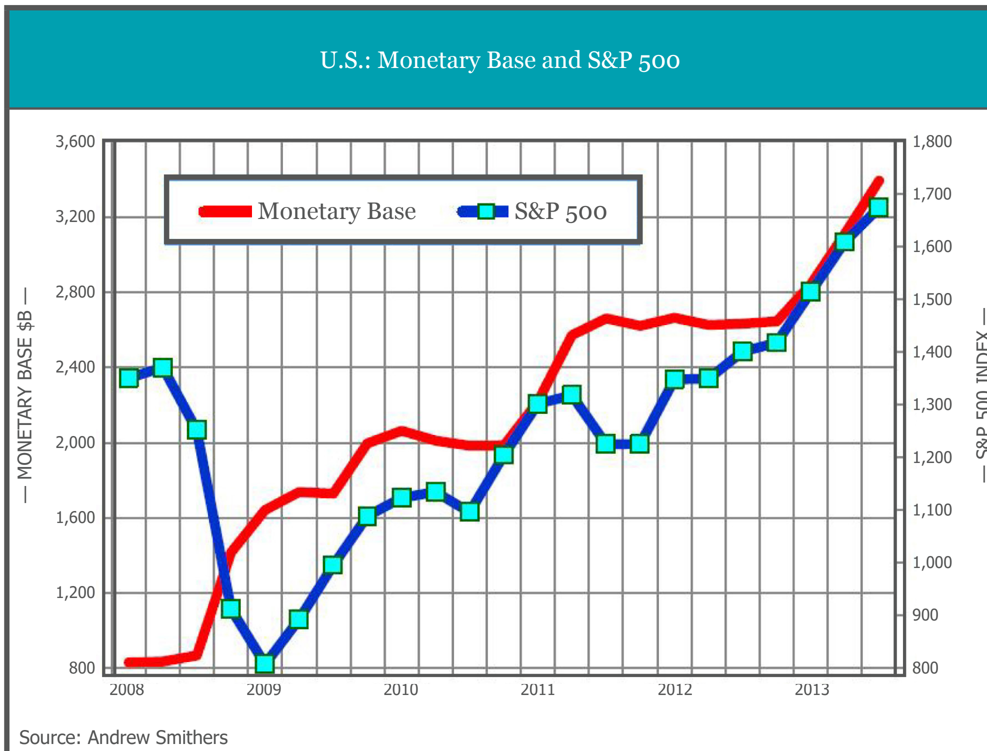
- The record narrowing of "quality versus junk spreads" in both bonds and stocks. This almost defines the term "cyclical relationship."

- It is not only rising interest rates that are problematic, but also the high probability that there will be credit contraction as rates go up. It's not just about the price of money; it is also its availability and just as the low price of money is coinciding with more availability, as rates rise, credit can contract. Said another way, monetary policy is likely putting all sorts of entities into risk at the wrong price and time. There is an

inverse correlation between availability of capital and the quality of the opportunity.

- The "European rebound" is a very difficult pill to swallow given a 1.40 Euro. Like Japan, material economic growth without currency debasement will require navigating a very difficult road.
- This statement made the Federal Reserve December 2013 minutes: "In their discussion of potential risks, several participants commented on the rise in forward price-to-earnings ratios for some small cap stocks, the increased level of equity repurchases, and the rise in margin credit."
- This chart:

"But we can all remind ourselves that the richness of this country was not born in the resources of the earth, though they be plentiful, but in the men that took its measure. For that reminder is everywhere—in the cities, towns, farms, roads, factories, homes, hospitals, schools that spread everywhere over that wilderness. We can remind ourselves that for all our social discord we yet remain the longest enduring society of free men governing themselves without benefit of kings or dictators. Being so, we are the marvel and the mystery of the world, for that enduring liberty is no less a blessing than the abundance of the earth."
— Vermont Royster



Source: Andrew Smithers

One of the other things I would also note is that I am simply in awe of the ability of Corporate America to "pull cash-flow out of the hat" given the punk economy. One of the bigger and seemingly reasonable bearish arguments is that corporate profitability is "too high" and mean reversion is inevitable. As noted by one prominent investor: "One of the biggest risks for equity investors is the historically high level of corporate profitability." (Jeffrey Bronchick, CFA, 1994 Strategy Letter.) Of course, that was written when the Dow was at 4000.

On the proverbial other hand is something that was said to me recently by a group of non-US investors and corporate executives and the gist was that we—as U.S. citizens—have no idea how good we have it. The investment community can be a cynical bunch and the bearish side almost always sounds much more erudite and "precise." I am not sure if it's due to the curse of IQ or the result of inbreeding of certain echelons of higher education. But if we combine the following quote from the late editor of the *Wall Street Journal*, Vermont Royster, with the realization that we are sitting on a generation of low cost, world class energy reserves, maybe it is accurate to say that things do work out reasonably for the investor with patience and some judicious discretion.

André Gide comfortingly noted: "Everything that needs to be said has already been said. But since no one was listening, everything must be said again." So we reiterate that we are investing in small pieces of much larger businesses and there is inevitably a management team discussing the same issues we are and adapting the business portfolio and processes to the uncertainty of the future. This fact is one of the key misunderstandings of "stock investing" and is a crucial reason why we see our job as investing in "businesses" and not in "asset classes." It is a crucial distinction to make.

It is a part of probability that improbable things will happen. We assume the world is messy, companies are poorly managed and government officials will find some way to snatch defeat from the jaws of victory. In other words, assume the worst. We attempt to protect ourselves with

judicious asset allocation where we have the latitude to do so and focus on either quality and/or material undervaluation in security selection when we don't. We do not project a 30% to 40% return in 2014, but we think we are comfortably positioned for enough things to work out in our favor to have another decent year.

We appreciate your partnership with our efforts.

—

Jeffrey Bronchick, CFA
Principal, Portfolio Manager

Period Ending December 31, 2013

	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR	★ SINCE INCEPTION
Classic Value | Small Cap	**10.2**	**37.5**	**22.6**	**28.1**	**10.1**	**13.4**
Russell 2000® Index	8.7	38.8	15.7	20.1	9.1	9.3
Classic Value | Small Cap Focus	**4.2**	**36.3**	**26.9**	**30.5**		**9.5**
Russell 2000® Index	8.7	38.8	15.7	20.1		7.6
Classic Value | All Cap	**7.0**	**38.1**	**19.3**	**20.9**	**7.9**	**11.7**
Russell 3000® Index	10.1	33.6	16.2	18.7	7.9	9.6
Classic Value | Strategic	**4.4**	**27.4**	**14.5**			**13.7**
HFRI Equity Hedge (Total) Index	5.0	14.6	4.1			5.3
60% Russell 3000® | 40% BCGCI	6.0	18.7	10.9			11.0

★ Inception dates are as follows: Classic Value | Small Cap — 12/31/93; Classic Value | Small Cap — 09/30/07; Classic Value | All Cap — 09/30/92; Classic Value | Strategic — 03/31/10.
Composite returns are shown net of management fees. Periods greater than one year are annualized. Past performance may not be indicative of future results.
Please read in conjunction with the disclosure notes located on page 159.

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