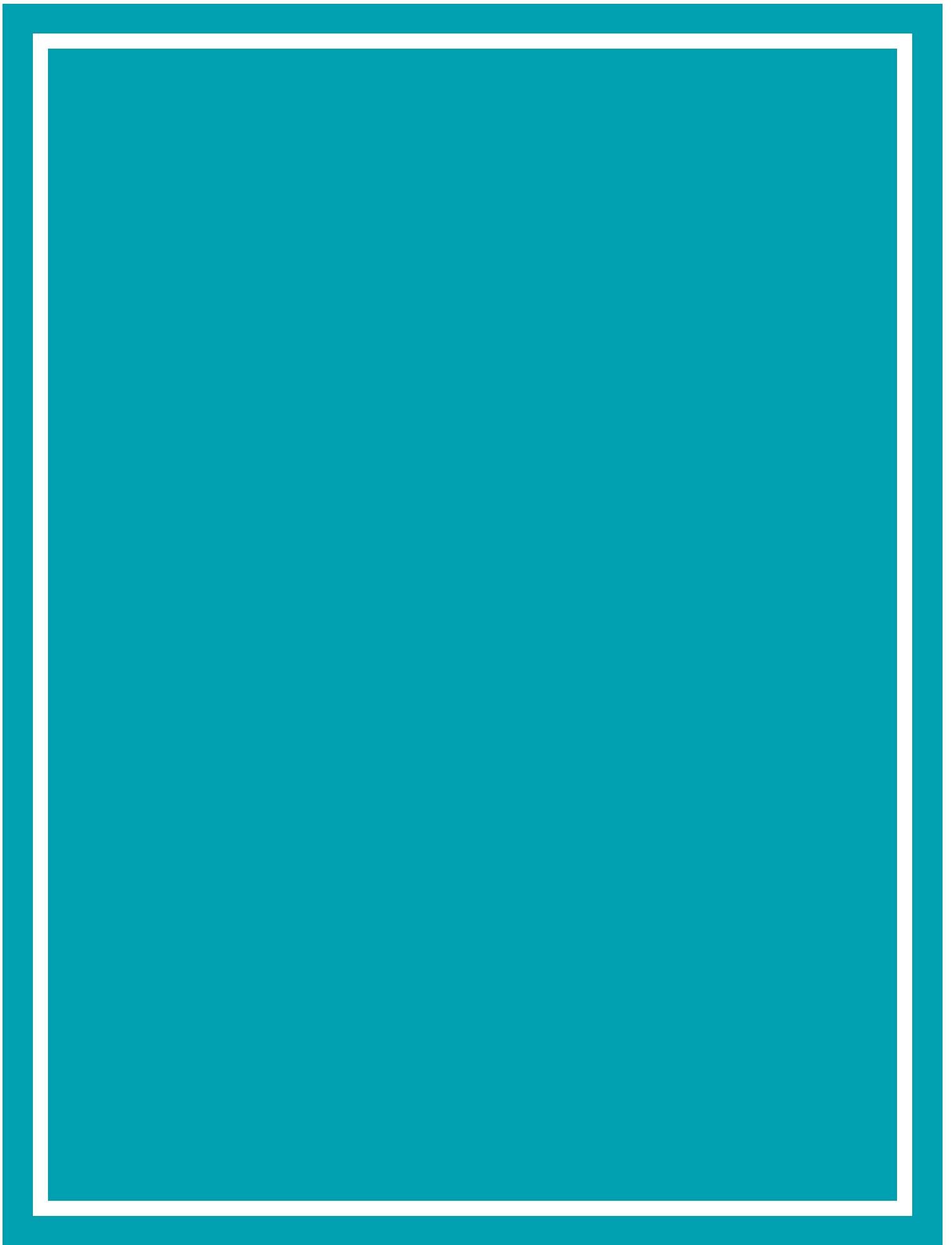


# Hockey is Nothing Like Investing

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# Hockey is Nothing Like Investing

JULY 14 — As one of the leading investment firms in El Segundo...PAUSE...we simply do not get tired of celebrating another Stanley Cup victory by a team that practices a mile away from our global headquarters, and whose entire roster lives within three miles of our office. And yes, putting a whopping on the Rangers AND the Blackhawks makes it even more fun.

But careful analysis of the playoffs offers some very subtle lessons applicable to the day-to-day practice of investing. The particular example worth noting here is the measurable improvement in the Kings' quality of play as the regular season morphed into the playoffs and then again as the playoffs progressed and even more so as individual series progressed into 7th games and overtimes. Contrast that with participant behavior of an ongoing bullish financial market, which despite the apparent low volatility, has become increasingly erratic, intellectually sloppy, a cause of perplexed head scratching, and decidedly less than world-class. In other words, with more at stake at higher valuation levels, the level of play seems to be playing second fiddle to the innate desire to get in the game.

As for this Letter, Jason Zweig at the *Wall Street Journal* was once asked at a journalism conference how he defined his job. The reply: "My job is to write the exact same thing between 50 and 100 times a year in such a way that neither my editors nor my readers will ever think I am repeating myself."

Lacking somewhat in the subtlety category, we repeat our core beliefs:

- We have had terrific trailing performance which mathematically steals from future performance, a challenge which has mostly played out in 2014— notwithstanding a "where-did-that-come-from-like June."
- An extended period of low interest rates and the increasingly wide availability of credit have squashed many available return opportunities in many asset classes and many countries. This is not sustainable.
- If you have the ability and the mandate to be patient and opportunistic, time tends to fix these things. First, valuation is mean-reverting and secondly, tenacious analysis can and will uncover unobvious opportunities, particularly in small cap stocks. But, again, it takes time.

So we are just plugging along this year. Little has gone terribly wrong, but our ideas have simply not "matured" at an appropriately calendrical pace. While not the desired outcome, a nice by-product of low volatility is that we are not doing as much. That can be a good thing frankly, but the truth remains that a value manager needs volatility. We analyze and establish an intrinsic value for a particular business. What could be simpler than buying below that and selling above it? The problem with today is that many stocks are hanging around our

reasonable sense of fair value and are not coming down to levels we think represent a margin of safety. And we are sick and tired of it, dammit. To rehash some prior frustration, a policy of suppressing interest rates enables a thought process that treats the stocks of individual companies as commodities whose sole determinant of current valuation is the current level of interest rates. Divide 100 by 10%. Now divide by 5%. Voila, you get the justification for Dow 36,000, just 14 years later. This is simply not an easy environment in which to invest, because any capital outlay can be justified if you incorporate current interest rates.

The idea of “mean reversion”—the tendency for extreme periods to inexorably be pulled back to some sort of a long term average—is a core tenet of value investing. But life is not “fixed” and long term averages are not always to be trusted as things do change. But there are two things that we would suggest are intrinsically shackled to the principle of mean reversion—financial market volatility and the willingness of people to extend credit. Regarding the former, we will simply say that quiet, calm periods are invariably followed by hectic, chaotic periods (and vice versa) and it can be a very painful mistake to extrapolate the recent past into the future without some longer term context. The Mandarins in Washington remain hard at work attempting to prevent anything from upsetting the fragile status quo and they have admittedly done a remarkable job of not freaking out the global system—to date. (See [CoveStreetCapital.com/Blog](http://CoveStreetCapital.com/Blog) titled *Very Scary*) We all desire a nice, neatly packaged world of low volatility and consistent and predictable returns. It’s like apple pie and Chevrolet, or hockey and sushi in LA. Calm, rational markets are the lynchpin of most of academic finance and are implicitly (or explicitly) referenced on the first page of every hedge fund presentation and those things still seem to sell like hotcakes. But to paraphrase author Anais Nin, we don’t see things as they really are, we see things as we really are. Re-read the Daniel Kahneman book *Thinking, Fast and Slow*—we are flawed and messy people and all of us bring some part of those flaws to the investing table. Trying to prevent volatility is reminiscent of modern forestry practices: fighting forest fires as soon as they break out seems like the right thing to do, but it ignores the natural ebb and flow of nature—the health of the forest requires intermittent fire to clean out potential “fuel.” Without a certain amount of forest volatility, you set up some extreme circumstances that tend to not turn out that well. You get the point.

The other mean reversion inevitability is credit extension. We posit...again...the following theory: global interest rate suppression is important to everyone in all walks of life, since it can finance nearly any economic activity

at “accretive” levels. We all know we can continue to have a wonderful debate about the “when” of interest rates, but I do not think rational minds will disagree on the direction of the next big change. So the same questions remain: Can you trust the Federal Reserve to get it right? Will they lag the anticipation of financial markets or lead them? How much suppression is there versus the possibility we are really in a long game of Japan-style deflationary pressures? We obviously don’t know either answer and the total length of quantitative easing has clearly turned Keynes’ famous quote on its head—the longer rates stay down, the more solvent we get. We would suggest that the risk at issue is not rising rates per se, it is the likelihood that credit spreads to treasuries on all sorts of instruments will also begin to rise from historic lows. And an environment where rates are rising and spreads are rising is an environment that is going to make a lot of people unhappy and fearful. Unhappy and fearful people working under Dodd-Frank, Basel III and who knows what else is coming down the pike are not going to extend credit like they are doing now. I am not sure investors are going to like that combination, and it is a risk that does not appear to be priced into many stocks.

So it bugs us that with valuation stretched in many equities, we are essentially being “told” that it’s okay, the Fed won’t act until 2015. At Cove Street, we don’t want to be “reassured” by the Federal Reserve—we want to buy good businesses at values that stand on their own. Depending upon the kindness of strangers in financial markets is a truly wonderful and blessed thing when it works, but over thirty years of direct experience and a careful reading of the few hundred years before it suggests that you are likely to be disappointed in your fellow person—in this very specific case the head of the Federal Reserve. We have often noted that flexibility and opportunism are rational responses to a world that is volatile and uncertain. In a world that is trying to cage volatility and uncertainty, the rational response should be caution.

Here is a mini-list of other things that are beginning to bug us or are on our mental radar:

**1 | Penny stocks.** From a recent *Wall Street Journal* article:

The investors are buying up so-called penny stocks—shares of mostly tiny companies that aren’t listed on major U.S. exchanges—at a pace that far eclipses the tech boom of the late 1990s. Those include firms that focus on areas ranging

from medical marijuana and biotechnology to fuel-cell development and precious-metals mining—industries that are perceived by some investors as carrying strong growth potential. Average monthly trading volume at OTC Markets Group Inc., which handles trading in shares that aren't listed on the New York Stock Exchange or Nasdaq Stock Market, NDAQ, has risen 40% this year in dollar terms from a year ago, to a record \$23.5 billion.

Steve Templeton, 42 years old and a full-time day trader, said his winnings on unlisted medical-marijuana stocks allowed him to move to Tennessee, where there is no state capital-gains tax, from California earlier this year.

"I like things below three cents, because of the upside potential, and it limits the downside," Mr. Templeton said. "I buy twice what I want, and when it [doubles or triples], I sell half, and keep the rest."

Seriously???

**2 | The continued worsening of earnings quality, which is making corporate earnings reports as useless as is sell-side research.** "Adjusted and non-GAAP" metrics are making accounting practitioners into artisanal salami makers. In the book, *Financial Statement Analysis: A Practitioner's Guide*, authors Martin Fridson and Fernando Alvarez noted that "the real purpose of financial accounting is to obtain cheap capital...Simply stated, the lower the interest rate at which a corporation can borrow, or the higher the price earnings ratio which it can sell stock to new investors, the greater the wealth of its stakeholders [sic—in the short-run]. From that standpoint, the best kind of of financial statement is not one that represents the corporations condition most fully and most fairly, but rather one that produces the highest possible credit rating and the price-earnings multiple." Word.

**3 | Idiot companies and the people who run them.** Athena Health Chairman and CEO Jonathan Bush told CNBC last month that hedge fund manager David Einhorn's disclosure of a short case against his company allows him to get out and educate investors about the company's value. "I'm absolutely sure this is a \$1,000/share stock," Bush said in a *Squawk Box* interview. "I have no idea when it gets there." But he admitted: "I don't know anything about valuations, so for all I know [Einhorn] is right." (source: [CNBC.com/id/101654089#](http://CNBC.com/id/101654089#))

**4 | The unsated desire for yield.** Again, according to Marty Fridson, "the" high yield academic: the growth of the face value of high yield issuance is growing at 11% versus a nominal GDP of 4%...the default rate in 2009 was 13.3%, 10.8% in 2001 and 10.3% in 1990... long-term over decades the average default rate is 4.6%, the rate now is 2.4%." In other words, spreads are tight, availability is high, fear is low, and terms are easy. There is little that is more dangerous today than the thundering herd's search for yield without regard to underlying values.

**5 | "Record M&A" and the great stream of new public offerings.** Not bullish.

**6 | Forgetting that nothing is permanent.** In this category we include Thomas Piketty's reload of freshman year economics and the inability of the *New York Times* subscriber base to understand the history of wealth—it rarely perpetuates. When Forbes compared its list of the wealthiest Americans in 1982 and 2012, it found that less than one tenth of the 1982 list was still on the list in 2012, despite the fact that a significant majority of members of the 1982 list would have qualified for the 2012 list if they had accumulated wealth at a real rate of even 4 percent a year. Ignoring the newcomers, we would suggest that private jets, Aspen and London real estate, hostile takeovers at huge premiums, Wall Street advice and fees, divorce, philanthropy and generations of heirs running around LA and Gstaad in Teslas constitute a nice, not-so-invisible hand that impairs the sustainability of an entrenched rentier class. And it would help to actually read the book as opposed to prominently displaying it on your coffee table or in your office. I read the Piketty book and understand why it is one of Amazon's most downloaded but least read e-books—it has a painful 577 pages that are causing people to confuse effort with being correct.

**7 | The debate about market strength versus economic growth.** We do not worry too much about some very public fretting about the apparent disconnect between market activity and economic activity, as they are rarely in sync and neither are very well predictable on their own—or in relation to each other.

**8 | Share buybacks are at record levels...and private equity selling is at record levels.** Just about every company we run across has a share buyback authorization of some kind in place. There are only two good reasons to repurchase shares: company management and the Board think the stock is cheap in comparison to the company's assets and/or prospects; or as a way to return excess capital to shareholders on a tax efficient basis. Even the latter has limits in that a

special dividend delivers more per unit value than buying back expensive stock. In practice, these two rules are mostly ignored. Most companies buy back stock to offset the candy-store giveaway of equity to management. Many others seem to be run by the investor relations department whose surveys suggest that investors would like a buyback—in theory—and who know that having one helps “earnings per share.” This is simply awful thinking that truly makes little difference in the long run. And I would simply say that private equity firms are likely better at selling than corporate boards are at buying.

But all is not awful. To again ignore Jason Zweig’s advice, we continue to: focus on company and industry research rather than market watching; exercise patience where the mandate is not to be fully invested; and concentrate on our best ideas rather than stretch for worse ideas. There are always ebbs and flows and it is always the case that there are interesting businesses run by interesting people that have stock prices still more volatile than are the underlying business fundamentals—even in the era of volatility suppression. Specifically, we continue to like large cap financials and still don’t understand why NO ONE looks at Leucadia. Additionally, there are interesting values in agriculture, retail, the plethora of spin-offs coming to market, and the languishing IPO’s of “boring” companies being leaked into the market by private equity. But to paraphrase Fred Schwed as he so eloquently noted in the classic, *Where Are the Customers’ Yachts: or A Good Hard Look at Wall Street*, “There are certain things that cannot be adequately explained either through words or pictures. Like all of life’s rich emotional experiences, the full flavor of losing important money cannot be conveyed by literature.” We are careful.

Finally, Cove Street Capital just celebrated its third year anniversary. Current and “committed but not yet funded” assets are JUST shy of \$1 billion. (Feel free to wire us another \$11mm.) We are moving our offices one

mile north to what should be a near-permanent space and we continue to spend liberally on technology and systems to maintain “talent density.” Speaking of talent, we have added Rohan Rangaraj, CFA to our research team. Rohan is a 34 year-old Claremont McKenna graduate who worked at Cascade Investment in Seattle (Bill Gates’ money), spun-out to run a dedicated healthcare fund for Cascade, and then partnered in a long-short fund here in Los Angeles. We are excited to add his contribution to our research efforts and overall Cove Street Joie de Vivre.

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Jeffrey Bronchick, CFA  
Principal, Portfolio Manager

Visit our weblog at [CoveStreetCapital.com/Blog](http://CoveStreetCapital.com/Blog) and sign up to receive commentary from the CSC research team.

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