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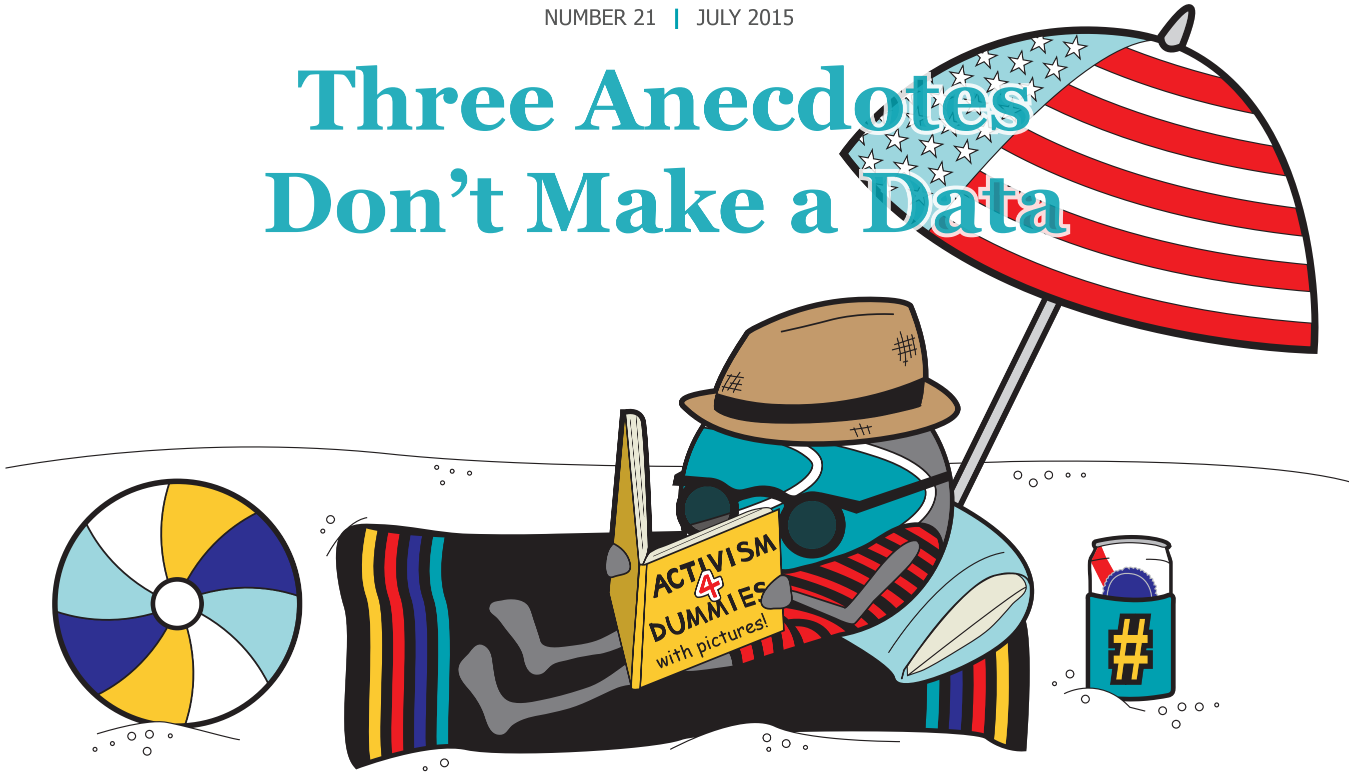
Three Anecdotes Don't Make a Data



Somewhere near the halfway mark of 2015, our reflections are similar to our initial thoughts as we began the year. We continue to observe with trepidation the often sad follies of man around us and prepare to take advantage of the opportunities that seem to arise from said follies.

We have had a very solid year in our Small Cap strategy, although we will admit to experiencing some "melting" within the last two months. This is an interesting and not so subtle "change" in the environment and it is masked in the Russell 2000 due to some of the latest fun and games in biotech and healthcare mergers. It bears watching. All Cap and Strategic performance has been solid but not outstanding, reflecting more general malaise in larger cap stocks and fixed income in general.

Since the "big picture" is somewhat more of the same and *The Checklist Manifesto* seems to be one of the "in" reads in the investment business, we might as well just list the current thoughts on our plate as we go about our business:

1. This is shaping up to one of the largest years in M&A (Mergers and Acquisitions) history. To paraphrase both Oscar Wilde and Samuel Johnson, "Corporate marriages are both the triumph of imagination over intelligence and of hope over experience." Yes, we have seen enormous wealth created via roll-up acquisition strategies now rebranded "Platform Strategies," but we have historically seen plenty of crash and burns from over-enthusiasm, easy and cheap credit and the lack of incredulity of investors near market tops. It's not hard to see abundant evidence of all of that these days, and when it stops…it tends to stop hard. (See the Chinese stock market.) Interestingly, we are also seeing a monster crop of corporate spin-offs, a large portion of which represent prior failed attempts at synergy, diversification, strategic deals for the next 20 years and "growth jump-starting." Is this yet another example of classic Wall Street cognitive dissonance?

2. There is nothing older in the world than attempts to prop up a quoted security's price when it is financially or politically expedient for that price to be higher than would be suggested by the private market's attempt to value it. China's efforts will fail like all those before it. What is scary is that you could easily replace the words "Chinese Central Bank" with "Federal Reserve." If the US stock market craters for any variety of reasons, how far of an intellectual stretch is it for an elected public official to call for public market support in order to save jobs, financial institutions, and middle class equality? What worries us is not China's stock market, but the deflation of Chinese "demand" that has likely inflated everything from copper to Louis Vuitton bags. It's a big number.

3 People are using the acronym FOMO—Fear of Missing Out. Yes, the Brooklyn cool-kid vernacular has finally made inroads into the investment management business. Compare and contrast FOMO with what the investment world grappled with just 6 years ago—FOLE—Fear of Losing Everything. I think it seems pretty clear that investors should lean harder into equities in the latter environment rather than in the former one.

4 Every quarter when I think I have seen the worst of how the investment management community allows corporate accounting to be "adjusted," I am proved wrong.

5 Quoting the *New York Times*: "Six years into a bull market run, with stocks smashing one record after another, the naysayers known as short-sellers have all but lost their voice." If there is one thing that the "Hedge Fund Industry" is (and it IS an industry, not an investment strategy), it is leveraged and trend-following to a degree we have not seen before. Hedge funds are a contrary indicator, a fact that makes recent headlines like the one above and "Hedge Fund Industry Net Short Gold for First Time" very interesting.

6 Quoting the *Wall Street Journal: The Fuzzy, Insane Math That's Creating So Many Billion Dollar Tech Companies* (See Unicorn.):

> "Some VCs defend the practice by saying valuations are just a placeholder number, part of an equation fueled by other, more important factors. Those can include market share, growth projections, and a founder's ego. The number is typically set by the company and negotiated alongside various provisions designed to protect a new backer's money. That often comes at the expense of employee shareholders and earlier investors, whose holdings are diluted to make room for new entrants. If you've seen the movie *The Social Network*, you have an idea of how that works."

This is likely not good. Advise your child it may not be a great time to leave Stanford and start-up the TruckerHat.com website and app.

7 From a shareholder at the Leucadia Annual Meeting: "Thank you for passing on your bonuses. The stock has been dead flat. It is a nice collection of assets and people, but when my clients ask me why we've underperformed this past year, I tell them it is because we own Leucadia and we didn't own Apple." (Amen brother—Leucadia is one of our largest positions.)

8 And once again on global Central Bank policy (from *Bianco Research LLC*):

— Conclusion —

- No One Has Ever Moved Rates Off Zero Before
- No One Has Ever Ended QE Before
- No One Has Ever Normalized Before
- No One Has Ever Used IOER and ON RRP To Hike Rates
- No One Has Ever Targeted a Market That Does Not Exist
- No One Has Tried All This When It Was Not Priced In
- No One Has Done It With Durations This Long
- No One Has Done This With Positions So Extreme
- No One Has Tried All This With A Goal of Minimum Financial "Instability"

— Raising Rates Matters, And It Matters A Lot —

9 We have nothing to say about Greece other than what is self-evident. There is no reform and the Far Left is for once right. "European Reform," which seems mostly to consist of raising taxes that aren't collected anyway, is not in any way a path for Greece to sustain itself as a national entity, much less one saddled by the anchor of the German Mark. (Oops, I meant the Euro.) This is by no means over—the Bronchick family Greece vacation is merely on hold.

10 As a matter of record, we have received zero commentary on our new business proposals regarding the idea suggested in our last **Strategy Letter** that if you choose a money manager or an investment strategy with proper and thoughtful due diligence, then a 7-year time horizon is the right measurement period by which to judge your astuteness. To re-quote Jeff Bezos who, as more time goes on, seems to be a more influential business figure than was Steve Jobs, "If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people. But if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people, because very few companies are willing to do that. Just by lengthening the time horizon, you can engage in endeavors that you could never otherwise pursue. At Amazon we like things to work in five to seven years."

Which brings us to the longer form essay. As Nobelist writer Anatole France noted, "If 50 million people say a foolish thing, it is still a foolish thing." I think I have been around long enough to understand how the early part of a Presidential election involves candidates moving outward from their bases to get a party nomination and then tacking back to the center for the general election. So, let's view the following in terms of historical facts and overwhelming probabilities based upon an actual analysis of history, rather than building a "narrative" and collecting random "white papers" to barely support what is still a contentious thought. No, I am not talking about Global Warming. The topic clearly refers to what appears to be the front-running economic theory of front-running candidate Hillary Clinton, as articulated in several recent economic speeches. Let's focus on four areas. The first comment is simply a general statement that can easily be debated on all sides and thus I will leave this as a general statement: in a world of tremendous technological change, it seems like an auspicious time to be raising the price of "introductory labor," jobs which seem the most likely to be replaced by a labor saving device or process.

Moving on, Mrs. Clinton seems to think that the big problem in life is that "short-termism" is destroying the world as we know it. The not so subtle implication is that this is one of the hellish planks that support the "contention" that income inequality is growing and its mere existence is a plague that needs to be corrected, apparently by regulatory intervention and the tax code. Let's ignore the juicy irony of the political candidates who live on a self-proclaimed "daily news cycle" decrying the short-termism of business people. Working backward, anyone who has ever filed taxes would agree that more simplicity in a tax code is better than more complexity. On that simple premise alone, in the spirit of Dorothy Parker, having 6 tiers of a new capital gains code is an idea that should not be taken lightly, it should be thrown out with great force. It will help no one except our accountants and attorneys, bless their souls. I should also mention that institutional money management is inherently premised on managing money for tax-exempt entities and over 50% of individual investments are held in IRA-like vehicles. So, I guess that explains the lack of revenue scoring associated with the release of the tax trial balloon.

But let's go back to Mr. Bezos—and in fact the entire premise of Silicon Valley—and also consider the complete global dominance of our "interventional" health care industry. All of it is premised on literally hundreds of billions of dollars of investment in what is sometimes nothing but a hope and prayer for long-term gains. I simply don't understand how people completely miss this and focus only on high frequency trading, Michael Lewis, and a handful of New York hedge funds.

The idea that people want "a lot, they want it now, and they want it without putting forth a lot of effort" has existed well before Dodd-Frank, the Volcker Rule, the Reagan Era, and day-trading cattle futures. It has been codified as a key functionality of our biological basis of behavior that has dominated all life since inception. I would argue that this statement can be applied to almost any story in today's headlines as ubiquitously as "between the sheets" can be applied to any fortune cookie aphorism.

To re-tie it to the investment business, the off-piste book *The Rediscovered Benjamin Graham* brought forth some interesting thoughts to ponder in this regard and please note he was lamenting about the state of affairs in the late 1940's. Our point is that he might as well have been writing in the 1600's or yesterday:

"In one important respect we have made practically no progress at all, and that is in human nature. Regardless of all the apparatus and all the improvements in techniques, people still want to make money very fast. They still want to be on the right side of the market. And what is most important and most dangerous, we all want to get more out of Wall Street than we deserve for the work we put in."

"I could not comprehend how the management of money by institutions has degenerated from the standpoint of sound investment to this rat race of trying to get the highest possible return in the shortest period of time. Those men gave me the impression of being prisoners of their own operations rather than controlling them. I say 'prisoners' in the sense that they have held themselves out as being able to do what their employers or contractors want them to do – which is to obtain a better-than-average return on the enormous amounts of money they handle. By definition, that's practically impossible to do. They are promising performance both on the upside and on the downside that is not practical to achieve."

So who is at fault and who is going to change and how? If we stop teaching "modern" finance in business schools, will we eventually produce a generation of investors who view stocks as pieces of real businesses rather than small pieces of math to be traded? Should we legislate that investment committees of pension plans, foundations, labor unions et al. must not be allowed to meet but every seven years? Must we regulate against picking money managers on the basis of three year trailing performance? Is it necessary to outlaw the hiring of compensation consultants who are paid to rig corporate pay schemes? Will the world be better if we kill-off CNBC and investment blogs?

So once again, the fault lies not in thine stars or in thine regulation, but in ourselves.

The next golem under Mrs. Clinton's purview is shareholder activism. Like most good ideas in life, activism has an inflection point at which it stops becoming a good idea, and I have seen enough recently to say that there are a lot of bad ideas running around that are mindlessly short-term. But it is at least an attempt by OWNERS to do something to fix the classic agency problem—that by which people love to spend other people's money and will continue to do so until countered. Why it seems like a national imperative to "do something about this" in every geography but that which is bordered by the Washington, D.C. property line remains a painful mystery. To further suggest that we need regulation to pick between intelligent reform and the latest ninny idea is…unwise.

And lastly, we have a **Thoughts** section on our website in which we have painfully (time and time again) explained what share repurchase is, how it is practiced—often badly—and how it can and should be utilized as a terrific tool to create value for shareholders. As part of a narrative that decries corporate greed and short-termism, it is a painfully stupid inclusion and one that is simply not supported by the facts. While economic cycles come and go, and different industries take turns attracting insane amounts of money and then are subsequently starved for capital, as a "whole" the Western capitalist system continues to spend capital well in excess of depreciation—at least as measured by the 2700 companies that make up 80% of the capitalization of public companies as tracked in a recent study by Fidelity. Share repurchase is NOT being pursued at the expense of capital investments. Michael Mauboussin of Credit Suisse has a nice chart which we reproduce on our website (under "**Thoughts**") which also conclusively shows that capital expenditures net of depreciation (think replacement value) remain not only a positive number for the last 25 years but it is a number that has a high correlation with economic activity. In other words, when things are good and we feel confident, we invest. In a bear market and regulatory uncertainty, we do not. This is not short-termism, but an IQ over 80 without a looming re-election. The other chart also available on our website is a look at "manufacturing jobs as a percentage of total jobs" which shows a nearly continual decline as a ratio since 1949. In other words, it is a completely false petard to lob a longing for what the American economy was like 56 years ago into a legitimate debate over global economic policy.

In fact, or by anecdote, to which I can attest with over 30 years of experience, less than 1% of CEO's and Board of Directors I have ever met wake up on any given day and say "let's repurchase shares versus invest in nearly anything." These people are human beings (and often red-blooded Americans to boot) who innately want to do something important, self-satisfying and with meaning, and it is a rare breed that counts share repurchase as a corporate bucket list item. Take a poll of CEO's and ask them to ponder this: "Do you want to be known as the next Steve Jobs or the next Henry Singleton (Teledyne)?" I would be happy to take your money on that outcome.

To try and regulate share repurchase as an antidote for any real or imagined social ill is as idiotic an idea as one I have ever seen. And yes, editors, this deserves its own paragraph.

That said, share repurchase wastes a lot of money for a lot of people because an awful lot of Boards do not understand basic corporate finance. Intelligent share repurchase is an investment decision: "Is our stock undervalued and does the return from repurchasing have a higher return than the returns available through investment in plant and equipment, people, or other people's assets?" Much corporate stupidity and shareholder value destruction would be avoided if this were the conversation at Board Meetings and if share repurchase was used as a hurdle rate for marginal activity.

Critics of share repurchase are mostly correct regarding the math because most people don't understand how to use it or succumb to the behavioral biases when things are good—FOMO—and not investing when things are awful—FOLE. It is also a terrible tool when used to cover-up dilution from stock issuance for compensation plans. That does not dismiss it as a dumb and counterproductive idea any more than eating 2 pints of Ben and Jerry's mean that ice cream is a bad idea. Personally, if the stock is not "inexpensive" I do not think share repurchase is a good tool for distributing excess corporate cashflow, although I understand the tax implication arguments relative to paying out dividends. Dividends truly give money back to people so that they can re-invest it elsewhere. It is not "lost" and it is not somehow part of social justice theory. "Special dividends" are a tool that are not used nearly enough as part of effective capital allocation. They are definitive, they allow Boards to sidestep arguments about the value of their stock, they can help self-regulate internal investment, and they provide optionality. In other words, this year we have nothing to do, next year we might.

And that concludes our summer rambling. Cove Street was built upon the idea of trying to lean toward what "nearly everybody" knows are the correct principles of successful investment, but are tenets that are legitimately difficult to practice within the business of investment management. We have a talent dense team, a narrow focus, and I think we attract the kinds of clients who support the mission of patiently looking for inefficiencies in public markets. Continuous improvement remains underway.

— Jeffrey Bronchick, CFA | Principal, Portfolio Manager

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