COVE STREET CAPITAL

T.I.N.A. Will Be a Cruel Mistress

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JULY 2016 — Let's get this out of the way. We are going to contribute little to any analysis of "Brexit" for several reasons, not the least of which is the pace at which it has leapt through our collective conscious—rates previously only known to overnight sensations such as kale and IPA beer. It is difficult to remember an event for which so much has been said so quickly but that matters so little and has very little practically attached to it. We do not think it "changes everything," but anything that sharply changes relationships overnight in the world's largest financial market—foreign exchange—is akin to the break in billiards, things are moving at uncertain velocity and direction.

We are not worried about Britain. It is an island nation that has been successful at sticking its proverbial nose in global finance and trade for a lot longer than the EU has been around. And the U.K. can join the U.S., Canada, Russia, China, Japan, India, and Australia and countless other two-bit nations that don't have official trade deals with the EU. The Brits arguably have the strongest economy in the EU (ex-Germany of course) and the exit of Britain from the EU will take as interminably long to accomplish as does any other thing the EU tries to accomplish—and in the meantime, life will manage to go on. What is obviously worrisome in my uselessly speculative opinion is that contagion risk is very real. A currency union without legitimate enforcement has always been a moronic structure destined for collapse and it is morally unacceptable to shackle Southern Europe to a German-dominated currency and entitled French farmers. Good luck with that folks.

So the only practical lesson an investor should take from the last few weeks is the oldest one: the future remains uncertain and volatility is a natural part of investing and of nature. Brexits, hurricanes, dinosaur extinction, and teenagers becoming drivers are just things that happen, and thus creating a Financial Stability Board does not make a damn bit of difference to anyone but James Tarullo (the latest unelected lawyer who claims to have the fix for our financial system) and Elizabeth Warren (ok, she was at least elected). Financial assets are clearly elevated to some hard to determine degree by zero interest rate policy, and therefore it is easy for anyone to generate 7 forces that could topple stocks by 20% in any given quarter. Brexit is...or isn't...just a flavor of the month.

That the economy stinks, a stronger dollar hurts U.S.-based companies doing business overseas, our monetary leaders globally remain embarked on a failed mission that is fated to do the opposite of what is intended, and that Europe has been a short versus the United States since 1960 is not new news to us. This year we have been careful about dumpster diving in an environment where many financial assets are elevated on nothing but a zero interest rate fulcrum. However, we welcome short bouts of fear as opportunities to buy decent-to-great businesses at decent-to-great prices.

But practically speaking, this reinforces the validity of what I call the Prem Watsa world overview: slow growth, deflation, monetary and economic policy tinkering, a strong dollar, and sub-optimal capital allocation—A.K.A. the artificially-induced "New Normal." And absolutely zero seems likely to change on our side of the ocean this upcoming November. This is a less friendly view of the world for equities by the way.

To reiterate, we want volatility and confusion and short-term nonsense. It gives grounded investors an opportunity to put money to work in reasonable businesses run by conceptually reasonable people at reasonable prices. You just have to have patience as an investor, patient clients, and a long-term time horizon, all things which clearly trade in abundance in institutional money management. But apparently we are in the minority, judging by the $12 billion of assets in the iShares MSCI USA Minimum Volatility ETF, which has seen a tripling of assets over the past 12 months. Now, we are not materially dumber than the next person and thus we share everyone's desire to be up 1% a month for the rest of our lives and call it a day. But as Madoff and an awful lot of long/short hedge funds have expensively proven, it's just not an attainable goal. We will also note that volatility is not a "thing" that one can possess; it is an inherently backward-looking measure that is classically mean-reverting. In other words, when it has been low, it will likely revert to being higher and when it has been high, it is likely to revert to being lower.

What can make life difficult in the shorter run is that value investing in many ways exists at the opposite pole of what passes for investing convention today. We are often looking at companies that don't "screen" well for inclusion in an ETF theme, have had recent poor performance, and have recently exhibited high volatility. It is exactly these rearview mirror themes that often create opportunities. We naturally then expect reversion—and price appreciation—as things settle out, timing uncertain. Markets exist as a place for volatility and pricing to be worked out, not as a global playpen for regulators with feelings. If our real goal is to generate long-term asset growth for clients in order to help them achieve their goals, what counts more is the tally at the end rather than how we got there—"better a lumpy 12% than a steady 8%."

Right now, we are still looking for the 8%. We watched a very strong start to the year revert to more "in line with the averages" performance by the end of the first half. The U.S. corporate sector as a whole continues to face sluggish topline growth, rising labor pressures, and questionable allocation of capital derived from a near zero percent hurdle rate. This is in addition to putting on a brave show for public shareholders via financial reporting contortions that would make a 19th century French courtesan blush. And we are paying at least fair value for the equity asset class at large. Said another way, many stocks we are looking at remain well above their February 2016 lows, a period that in our view (and as previously noted in prior letters) represented a true buying opportunity. Stocks down 10% from recent highs on Brexit chatter is not the end of the world, nor is it a real call to action.

But since we run concentrated portfolios within a vast universe, we still see under-appreciated value in both our portfolio and in a select few fresh faces. We still like our housing-related companies. We think agriculture and related companies are good values. Yes, we like Latin American media assets. We have reloaded positions in E.W. Scripps and VeriFone, both of which were successful investments that have retraced their paths to value status. We have a new pair of aerospace distributors that have fallen in the wake of fears that Boeing is not only at the top of a cycle, but also is getting meaner and nastier as it relates to its supply chain. We like Williams Sonoma in the ever-hated retail sector. We like large U.S. banks and Leucadia—still. These are ideas that have all be reached through a thoughtful and bottom-up basis. They are not conclusions necessitated by "There is No Alternative Asset." There is always an alternative to doing something stupid.

Before we conclude, here are some random (even Twilight Zone-esque) topics and events we are pondering halfway through the year:

- **Jim Bianco:** "Economic forecasting isn't easy, but you could flip a coin and get it right more often than the Fed has since the recession ended seven long years ago this month. The indisputable fact is that the central bank has consistently overestimated the stimulative effect of its monetary exertions. The Fed keeps saying its policies are "accommodative," and while they have contributed to higher prices in stocks, real estate and other assets; they aren't accommodating faster growth or broader prosperity."

- **Interest Rate Weirdness:** "Japanese government bonds virtually aren't functioning as an asset class today," said Kazuo Sato, head of finance and investment planning at Japan's biggest private life insurer, Nippon Life Insurance Co. "We are living in an age when we cannot secure yield unless we improve our asset management and diversified investments." If you think about it, this concept can be extended to include investing in an ETF made up solely of dog grooming, juice bar, and fitness studio REITs.

- **Gold:** In a world of negative interest rates, is it a high yield investment? It is the single best argument I have heard for considering something I have never put into a portfolio.

- **More Interest Rate Weirdness**: Bayer is attempting to buy Monsanto for $62 billion, using a lot of debt. The European Central Bank—sans the U.K.—is openly buying European corporate debt as another method of providing economic stimulus. Ergo, unregulated pools of freshly minted money are enabling takeovers?

- **The New York Times in Charge**: While France is on strike to protest the government's attempts to renegotiate the 35 hour work—a policy universally hailed as the critical variable behind a general 10.4% unemployment rate and 24% youth unemployment—the U.S. Labor department issued new regulations mandating that most salaried workers earning up to $47,476 a year must receive time-and-a-half overtime pay when they work more than 40 hours during a week. The previous income cutoff for overtime pay, set in 2004, was $23,660.

- **Please Short Me**: In a move that would make even Michael Dell cringe, Elon Musk is using Tesla's cash that he doesn't generate from operations—but has to raise from investors just so he can hit his own production targets for Tesla cars—to buy Solar City, the money-bleeding company being run by a family member. All of this is being done under the synergy heading: specifically that every Tesla buyer wants to be cross-sold a solar power deal under the same roof. The world's most infallible man noted on the deal announcement conference call that "I just really want to emphasize that I have zero doubt about this." In related news that we didn't write about on April 1st: Tesla is also contemplating buying Whole Foods, since it is self-evident that Tesla cars, solar power, and organic food are naturally synergistic.

Five

As someone who has been married for 26 years and has worked in money management for 32 years, I am not sure how I feel about celebrating only the 5th anniversary of the founding of Cove Street Capital. But five comes before ten, which comes before twenty—so here we are.

My first inkling is simply to say thank you. We now manage $1.1 billion, an almost a four-fold increase since our inception. This has been achieved in a world that has not been terribly kind to those who cling to the quaint practice of actively investing in publically traded equities on a long-only basis for a simple management fee. We have consciously partnered with a high class set of clients, a strategy that was one of the key tenets of our founding. In other words, we have been and will remain selective in who we work with. Cove Street was not founded to be a "growth story;" it was founded to be a performance and professional service story. There is NOTHING in our future that could hurt us more than to accept more assets than we can intelligently manage. Good performance can bring more money, and too much money can bring poor performance. We still have room to grow…but we will continue to be careful.

My second thought is to say thank you to the Cove Street people not named Jeffrey Bronchick. Five years ago, we coalesced around the following internal self-analysis:

> We are a highly motivated, entrepreneurial, and open ecosystem. Every member of the firm understands DHM and the importance of its ordering—Delight Clients, Have Fun, Make Money. The atmosphere is highly collaborative and ideas flow across rank and job description, enabling "failure free" expression. The best thing a human being can do is help another human being know more—personal growth is encouraged and compensated. Resonating themes include: unwavering ethics and devotion to clients first; independent work with full accountability; ownership mentality; a focus on what is the "best way," not "this is how it has been done before;" and submission of rank and seniority to best ideas and best practice.

I am proud to say that we are still working every day to live up to that ideal, as my short-comings, attention deficits and lack of knowledge within any variety of specialty areas in money management, client service, operations and trading are regularly pointed out and confirmed by the outstanding people around me.

I am not sure what the "right" number of people is to run a successful firm, but we have the "right" people who want to work hard, work collegially and who were willing to give up short-term dollars to be "long term greedy," as Warren Buffet is so fond of saying. Sixty-four percent of our employees are equity partners and I look forward to improving on that number.

Lastly, I have never had as much fun in my life. I was lucky enough to recognize early in life that managing money is an endlessly fascinating preoccupation that also happens to pay well and it's indoor work with no heavy lifting. We have built a structure that enables creativity and thought within a disciplined process. This is a construct that I think will continue to attract the "right" people and "right" clients in our quest to deliver proverbially lumpy outperformance.

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