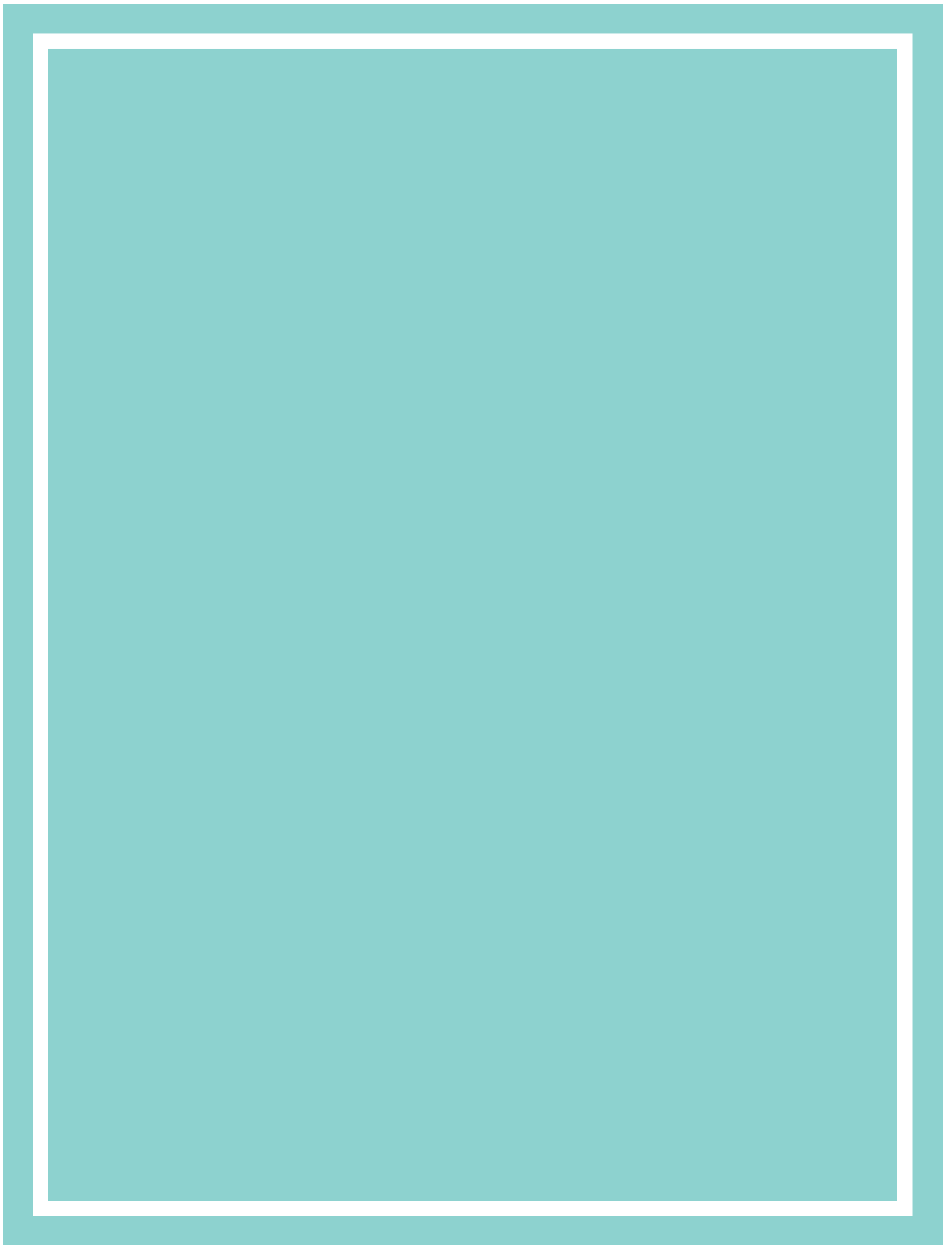
COVE STREET CAPITAL

The Slow Investment Movement

Number 2 | August 2011

"We embrace a slow-cooking theory of investing. It is literally more enriching to shop carefully and put the roast in the oven for four hours, affording the time for thoughtful and productive activity, as opposed to celebrating the ability to go to a fast food restaurant every two blocks."



The Slow Investment Movement

AUGUST 2011 — If there is a conclusion that can be reached after an analysis of the last 45 days of volatility, it is likely that many investors are too busy "doing something" to be able to glean any insight.

Culling from a variety of sources, the average holding period of stocks in a mutual fund is down to four months. The average holding period of an exchange traded fund is less than a week. The average security holding period of a hedge fund or an investment bank engaged in high frequency trading (HFT) is measured in microseconds. My submission to this popular compression of time frame is that while I usually wait about halfway into a Strategy Letter to subtly self-promote Cove Street Capital's investment philosophy, this time I will get right into it.

It is particularly in times of duress, financial or otherwise, that I often go back to the "classics" (check out **CoveStreetCapital.com** for a list) and reassure myself that, yes, buying a dollar for 60 cents is an eminently decent way to go about life and intelligently build capital; that stocks are not pieces of paper trading at magically determined prices, but represent ownership of real businesses that are run by real people; and that if you own a decent business run by decent people with a decent balance sheet, time is on your side and in fact you get paid for being patient.

The ability to technologically receive the fire hose of global information and then react instantly to what is often a mere shadow of a possible reality is not necessarily what I would call a gift. It is a distraction at best and a wealth destroying curse at worst. As noted 20th century social scientist Herbert Simon said, "A wealth of information creates a poverty of attention." Additionally and academically, a new paper called the "Dark Side of Trading" by the trio of professors Ilia Dichev, Dexin Zhou and Kelly Huang, neatly confirms the obvious: more trading volume equates to more stock volatility. This is a drone aimed at the Wall Street convention built on the assertion that more liquidity leads to a lower cost of capital. Like many good ideas before it—such as chocolate or family vacations—too much of a good thing runs smack into the inevitability of declining marginal utility, and in this case, becomes clearly unproductive and self-mutilating. I am forewarning the next CEO who visits our office and utters the idiocy of "we split our stock or sold more shares so that our investors can have more liquidity" that it won't go well. Do you really want to offer investors the ability to "hook-up" with your company as if you were attending a party of drunken co-eds?

So we embrace a slow-cooking theory of investing. It is literally more enriching to shop carefully and put the roast in the oven for four hours, affording the time for thoughtful and productive activity, as opposed to celebrating the ability to go to a fast food restaurant every two blocks. That's a metaphor and recipes are available upon request. Reacting to daily headlines is

the antithesis of successful long-term investing. In fact, recent bouts of nearly mindless volatility afford the patient investor the ability to buy more of good things that are currently owned, as well as the chance to upgrade portfolios with businesses that one always wanted to own but couldn't stomach the thin air of high pricing.

What have we done in the past few weeks? Knocked off another dozen 10Q's; updated models; talked to 15 management teams about businesses and business conditions; and tirelessly debated current holdings and possible new ideas. What we didn't do is glue our eyes to CNBC, hang on the political trial balloon of the day or despondently sell down 500 points or excitedly get back in 24 hours later up 400 points. (We have outperformed in a down market, an outcome which beats the alternative but crowing about losing less money is never our real goal or in good taste.)

Contrary to some surprisingly real concerns from very legitimate investment committees I have stood before in the last few weeks—not to mention my macro friends at Bianco Research—individual stock investing is not "done," value investing is not "passé" and investing for the long run is not a quaint convention. This "theory" is "supported" by the recent increase in price correlation between industry groups and individual stocks as technical trading and frequent index realignment stemming from flows in and out of exchange traded funds seemingly makes individual analysis futile. We strongly take the counter position—that mindless volatility creates enormous opportunity for precise analysis and that investors get amply paid for near-term volatility. Finally, for those more academically-oriented, equity correlations have a high propensity to mean revert—i.e., high correlation tends to be followed by low correlation and vice-versa.

The last 45 days may or may not be a signal of an imminent double-dip recession, but there has clearly been no new evidence that the chattering classes of economists, politicians, or financial writers have discovered any new ability to predict the economic future. If anything, the very recent past is just another reminder of the ability of consensus opinion to ferociously shift on a dime as it has done any number of times during the past decade and thus, why is the latest swing worthy of any title other than "trade du jour?" Why shouldn't a rational value investor be leaning into this current ill wind and buying the specific value that is being run out of town on a macro "risk-off" trade?

We all fear the last crisis—2008. The fact that most of us fear it is why it is likely not to happen again. Been there, done that. Seriously. The biggest risk an investor faces is often not the one seemingly barreling toward him—it's the risk no one sees. Our financial system, contrary to the nonsense regarding Bank of America at the time of this writing, is comfortably overcapitalized and would be considered grossly overcapitalized if it was not for the egregious greed and self-aggrandizing of our state attorneys and all those who voted for Dodd-Frank. The rest of corporate America is generally sitting on comfortable balance sheets with strong access to nearly free liquidity. The higher likelihood is that the biggest risk we face is a long and Japanese-like freeze.

Which brings us to the elephant in the room. Investors can price the probability of a recession, the very real possibility that corporate profit margins are at generational peaks, severe swings in commodity prices and any variety of specific industry factors. What cannot be successfully discounted are the vagaries of political economics. The INEVITABLE dissolution of the European Union as we know it? Tax changes or not? QE3 or not? Stimulus or not? Healthcare revolution or not? Infrastructure Bank or not? Gulf of Mexico drilling or not? Vegas or not? Trade agreements or not? Dollar depreciation policies or not?

The following is not a political statement. The United States has created the greatest wealth in the history of mankind. It has also afforded the greatest luxury of liberalism, both on a federal and private level. Either we embrace the idea that private wealth creation is the engine that will enable successive generations to prosper or we will learn to embrace 9% unemployment. The people of this country are calling upon its leadership to intelligently reform. The call has been mostly falling upon deaf ears. If I recall my Old Testament, the Egyptian pharaoh endured ten plagues before relenting to let the Israelites leave for the Sinai. With a downgrade from Standard and Poor's, an earthquake in the Washington DC area, and Hurricane Irene, I can only wonder what's next.

Fear is contagious and spreads quickly, while confidence builds slowly. (We paraphrase from Mr. Buffett—"The Oracle of Irony"—who is in the midst of passing on, tax-free, what is likely the greatest chunk of private wealth in the history of the world.) Publicly-traded financial assets remain one of the few "things" in the world in which the reaction to a lower price for the same good is typically revulsion and the desire for less. My naivety still suggests that a reaction to a 20% off sale at Tiffany's or the Porsche dealer would engender a slightly different reaction. We remain skeptically and selectively bullish on equities, particularly vis-a-vis return free risk alternatives.

In Cove Street Capital news, we are celebrating our 59th day Anniversary as of this writing and all is going well on both the investment side of the house as well as in operations. Our first new institutional account is on board and we will have fully verified GIPS compliant performance track records for our strategies ready to be published by the end of the quarter. Our 'Weblog' is live at **CoveStreetCapital.com/Blog**, and it will house our Strategy Letter archive, a running list of shorter, poignant investment thoughts, as well as links to interesting content not of our own making. Please subscribe to keep up-to-date on our thinking.

—

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.