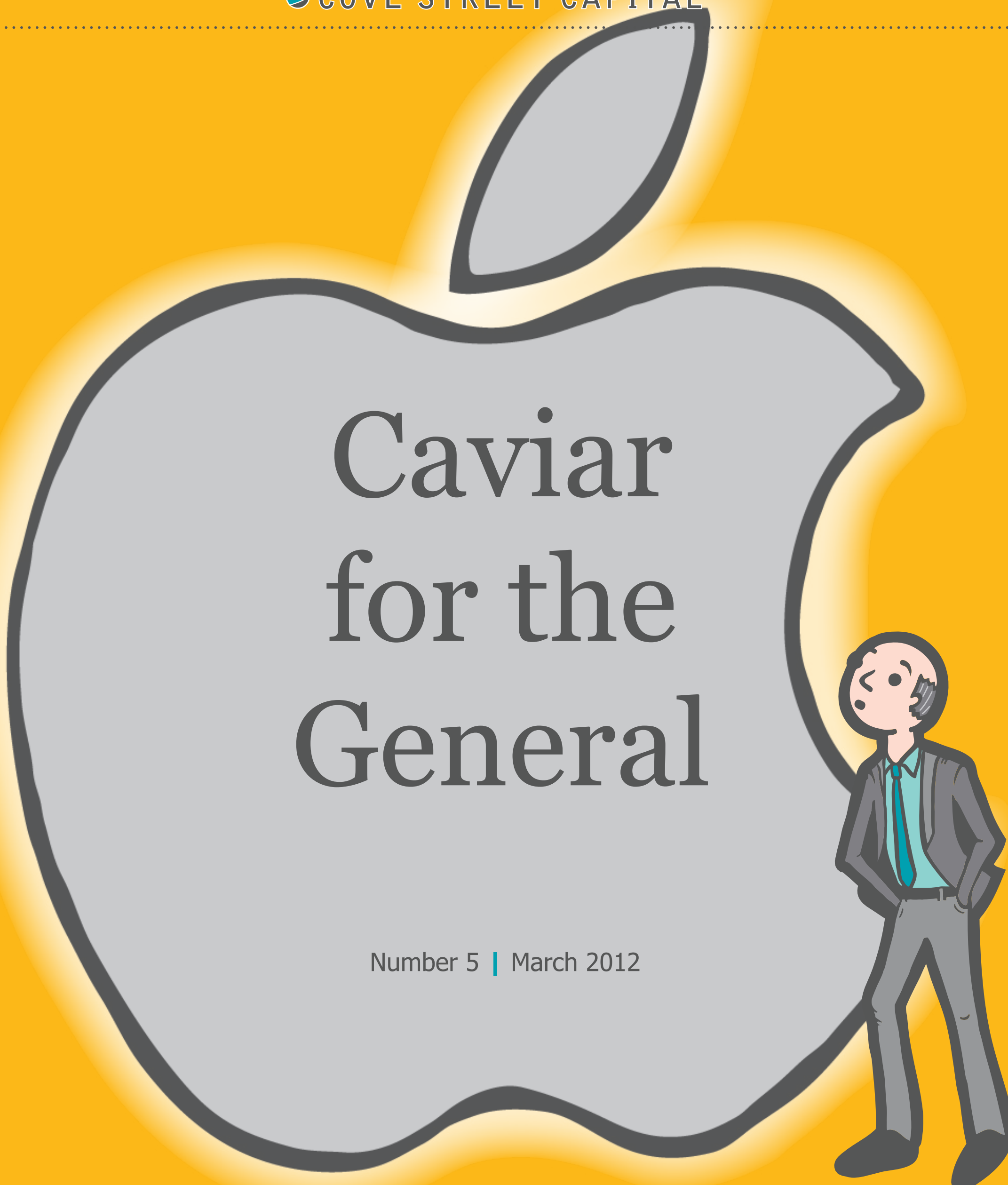
COVE STREET CAPITAL



Caviar for the General

Number 5 | March 2012

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Some Things Really Do Change

Dear Client:

We were pleased with our performance for most of the first quarter until we were informed that due to a variety of apparently obvious issues, industry convention has removed the S&P 500 and the Russell indices as comparative benchmarks in favor of Apple, Inc. Therefore, we will take a defensive tone in light of our terrible underperformance as of this writing: + 15% versus + 44% for the Apple benchmark year to date. We are actively reviewing our research process and in the absence of any immediate improvement in relative performance versus the new benchmark, we will consider adding Apple to our portfolios at any price, as any number of small cap, large cap, growth, value, dividend, domestic, international, high yield, and hedge funds seem to be commonly doing. We appreciate your patience during these trying times.

Management

(Sent from my iPad)

MARCH 2012 — Without going into the litany of behavioral finance problems that have glued our cognitive abilities and rendered us unable to recognize the merits of a company that has appreciated 7-fold in 3 years, we would simply note that we are operating under the innate suspicion that Apple's current profit margins and growth trajectory are unsustainable and thus the stock is simply not as cheap as it looks. The history of "hot" consumer products and brands, electronic or otherwise, suggests a highly competitive market with rare instances of long-lasting dominance. There are countless companies, representing hundreds of billions of dollars of non-Apple market capitalization around the world that are intently focused on doing "something" to participate in Apple's markets and margins. There are also some 11,000 or so other investable companies that trade in public markets where the glaring heat of attention is somewhat less radiantly beaming and might possibly offer sources of unappreciated value.

All of which somewhat reminds me to note the passing of Walter Schloss at the age of 95. Schloss' approach came to define "classic" value, a discipline developed working under Ben Graham for 9 years. He was reported to have put up a 16% annualized rate of return over decades by investing in obscure and out of favor value equities. When asked, "What is the secret for keeping itchy clients invested in ideas that were always highly contrary to the fads of the day," Schloss responded, "Don't tell them what they own."

Moving on to one other random piece of annoyance that is occupying our mental time—we present "Non-GAAP" adjusted earnings. While the SEC is running around planting wires on investors on this year's version of the Soprano's, mini-thefts are occurring every day as our nation's finest companies are reporting earnings that make Swiss cheese look like the Hoover Dam. Our point is simple: there are enormous liberties being taken in the reporting of earnings with enough re-definitions of GAAP numbers to make Mr. Webster spin in his grave. Here is a very partial list we have seen this quarter: contingency and integration actions, stock compensation, refinancing fees, acquisition costs, disposition costs, write-offs of obsolete equipment, legal expenses, executive severance, executive hiring, plant start-up costs, plant closing costs, downsizing, restructuring, intangible amortization, gain/loss on sale of assets, intellectual property write-downs, and income tax-related adjustments.

While we are as interested as the next investor in "disclosure," and understand that there are truly one-time costs or benefits that we parse in or out to deduce the elusive "real cash flow," what is going on here in many cases is obvious "painting the tape" earnings management. "One-time" costs laid out every quarter are not one-time costs—they are part of a myriad of operating costs that develop under different guises when operating a real world business. And in a world with so much passive ownership that doesn't bother to do any work whatsoever—and semi-passive owners who rely heavily on database driven entries—management teams are getting away with it. I don't have a problem with an appendix that lays out anything reasonable people may consider to be unusual costs experienced during a quarter. As an investor, I just resent being talked to in "adjusted terms" and it certainly irks me that what is being taken out of the earnings numbers also has an impact on compensation discussions. Our conversations with a variety of management teams suggest the "but everyone's doing it" phenomenon is strongly in place. As I noted recently to one CEO, I would be very happy to manage $50mm of assets for your pension plan and be paid a performance fee net of any 3 stocks I would like to exclude from the calculation. I am waiting by the phone.

On another note, as Abraham Lincoln was once quoted, "it is better to be silent and thought a fool than to open one's mouth and remove all doubt." Thus we begin our updated take on what is going in the world. As noted above, we have enjoyed a riveting upward movement in a number of current positions, as well as some others we had been watching on the farm team. Yet such market levitation is the bane of value investors. We, of course, want our efforts to be vindicated in the shortest possible time or at least before the onset of a debilitating mental disease that prevents us from fully appreciating the resounding applause of our clients and peers. But while we recognize and expect lumpiness between the growth in company value and the growth in the market price of a stock, immediate success makes us uneasy. To restate, our primary goal is not to maximize returns and whoop it up on a quarterly basis; it is to generate superior returns through a process that takes less risk and achieves our goals over the long-run.

This is of course fiendishly simple for investors who carefully monitor stock prices armed with a reasonable estimate of intrinsic value and are willing to lean into the trend du jour. That strategy has produced some cash in our small cap strategy, as once again we remain unmoved by the truism expressed by so many that a perfectly rational sale should necessarily coincide with an immediately compelling purchase in an equal dollar amount. We have an interesting and eclectic idea list, but we will maintain our disciplined purchase habits. We remain very mindful of the severe and long-term headwinds represented by fiscal policy at home and in Europe; we are cognizant of commodity sensitivity and of an emerging market economic slowdown; and we are properly weighting the persuasive argument about the sustainability of current corporate margins and returns on capital. We also consider the possibility that the Federal Reserve has its metaphorical head stuck so far in the sand as to render it difficult to have any sense of what the "real economy" may or may not be doing.

But what really intrigues us is the continuing apathy of investors at large toward equity markets. Mutual fund statistics from Lipper and Associates showed a $60 billion outflow from equity and balanced mutual funds in the fourth quarter of 2011, with only a partial and modest reversal to the tune of $11 billion in the first two months of 2012. A variety of statistical work that we have read shows that while ETF trading is going crazy, the actual inflow of investor dollars into equity ETF's remains muted. Our institutional marketing efforts suggest a very low level of new, long-only equity related searches among asset allocators, continuing the slack pace since the 2008 crash. The 2012 CFA (Chartered Financial Analyst) Institute survey of its members concludes, "investors remain terribly concerned about the prospects for market performance and ethics in 2012…there is very little to cheer about in 2012…only 41 percent of members think equities will be the top performer in 2012." Similarly, we see continued high interest in "hedge funds," portfolio insurance strategies, and the staggeringly counterintuitive desire among pension funds to embark upon a "liability-driven investment" scheme at a time when interest rate levels are as low as they have been in a hundred years.

The stock market as measured by the S&P 500 is up almost 30% over the last 6 months, and has doubled from the March 2009 lows and yet most investors remain underinvested. This is a definitive conundrum at odds with at least hundreds of years of financial history. Despite this temporary risk aversion, we remain convinced that stocks remain a unique species: the higher the price and less compelling the value, the more they seem to be desired by investors. In addition to the number of reasonably valued assets that can be found in financial markets, this represents an anecdotally strong underpinning for a reasonable intermediate future in our opinion.

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