COVE STREET CAPITAL

Lots to Fear or Fear Itself?

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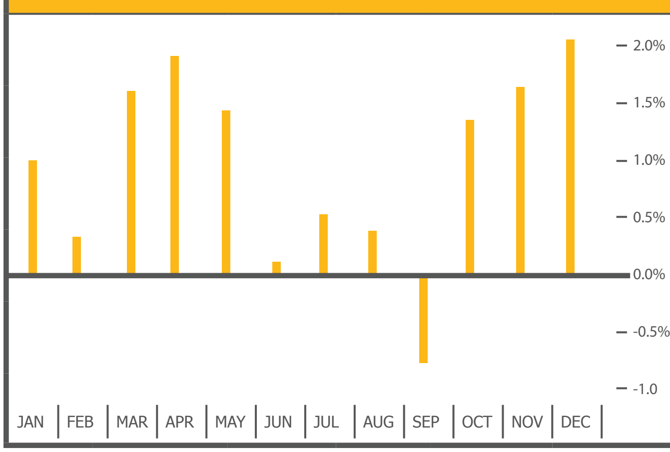
APRIL 2012 — We are getting in our April Strategy Letter with no time to spare because we are busy boarding up the office and putting white sheets on the furniture. Isn't anyone who is anyone selling in May and Going Away?

Frankly, after the strength of our first quarter and the impending specter of $2 billion in spending on political ads directing drivel at loud volume to our aging ears, selling now and going away until November 10th has some promise as an idea. My inability over 25 years to find clients who will continue to pay fees during an 8 month hiatus remains an ongoing flaw, but our phone number is still listed. For your entertainment pleasure only, I have included the following two charts, which clearly suggest that seasonality as an investable capital allocation concept is statistically as ridiculous (the official term is "insignificant") as it might seem to you intellectually. And if you do discover a neat timing concept, remember to NOT tell anyone and don't forget it requires both an ingenious buying and selling ability to make it work. Good luck with that.

Big Bars and Headlines — But Little Movement



Source: Bianco Research, LLC

S&P 500 Month-to-Month Results since 1950

Month	Average % Gain	Winners	Losers	Average % Winner	Average % Loser
May	0.2%	35	27	2.8%	-3.2%
June	-0.1%	33	29	2.6%	-3.0%
July	1.0%	33	29	4.1%	-2.6%
Aug	0.0%	35	27	3.1%	-4.2%
Sept	-0.6%	28	34	3.3%	-3.5%

Source: Wealth Wire

With "indexed" equity markets up 30% in the past six months, a value investor comes to several current and obvious bottom-up realizations. First, there are certain stocks in the portfolio that have more than reached reasonable approximations of fair value and should be sold or reduced. Second, the non-owned market of stocks clearly reflects fewer obvious pockets of value. Our conclusion: more caution is warranted. Just as we leaned into the headline mess of last fall and bought equities, we are leaning the other way and making sales of fairly valued securities and practicing patience with the redeployment of proceeds. We are hopeful that the current earnings season produces instances of the usual shortsighted nonsense and we will be able to contrarian our way into some interesting opportunities. I think Michael A. J. Farrell, Chairman, Chief Executive Officer and President of Annaly Capital, did a nice summary on his company's recent earnings call:

> "Risks continue to evolve in the market, with an emphasis on sovereign weakness, slow economic growth, central bank activism and the implications of proposed regulatory reforms. Against this background of potential challenges to global financial stability, we continue to see the benefits of being conservative in our business. It enables us to maneuver through these markets to deliver attractive risk-adjusted returns to shareholders, protect our portfolio and maintain our flexibility to take advantage of investment opportunities as they arise."

What he said.

Yet, I remain unconvinced of the hellish, depressive Japanese model scenario analysis, which was neatly pounded into me again with cheer and aplomb by Prem Watsa—the CEO and investor extraordinaire of Fairfax Financial—at his annual meeting in Toronto last week. While any futuristic outcome can have some probability of occurrence attached to it, I continue to think that investors remain anchored to the 2008/09 financial debacle and thus continue to underweight the possibility of any variety of good things happening. This is not limited to, but clearly would include a Romney electoral victory, an outcome that promises at least stasis in the amount of government meddling in the economy on every front as well as a rollback of the frightening onslaught of tax increases in 2013.

Using the housing market as another example, our well known problems have been very visible for going on five years and thus have been/are being quietly dealt with, at least in the private sector—or whatever remains of it. Yet the overwhelming chatter remains the "housing crisis" with scant attention being paid to the possibility of silent improvement on the supply-demand side. As a country we have been constructing housing units for at least three years at a rate that can be very reasonably argued to be hundreds of thousands below the yearly required replacement level of 1.2mm to 1.3mm units. The "demand under-hang" gets little mention in the wake of the oppressive headline of foreclosure supply over-hang. I can tell you as a FACT that in this sand state, housing has bottomed. Multi bids are the norm on most anything inhabitable, and the real estate mafia is organized, raising money and eager to bid on nearly any sized portfolio. Naturally, there remain some lingering obstacles in the way of this healing and they are dually headquartered in Sacramento and Washington, but they are being chipped at every day. (Yes, we are invested in and continue to evaluate further investments in the "housing food chain.")

Currently, big fat problems like the European financial circus, the U.S. election and the uncertainty of where the wobbly spiral of the Chinese economic elephant will come to rest are legitimate concerns that will impact our own economic growth. However from a completely contrarian perspective it remains difficult to see material downside in U.S. equity markets. Morningstar recently updated its numbers to show that in the 12 months ending in March, stock funds oriented to domestic equities showed an outflow of $121 billion while bond funds attracted $191 billion. April data shows another $18 billion going out the door, the highest number since comparable data became available in 1996. The history of mankind is the history of fear and greed and those emotions are inevitably correlated with important tops and bottoms in financial markets. If the stock market can rally 30% in the face of this suspicion, anxiety and distrust, what will it do if the economy can grow 3%, and unemployment is 5.5%? Our answer: a lot better than fixed income securities, which remain the single largest "bet" an investor can make over the next ten years (allowing a lot more leeway than prior asset allocation pronouncements on this page if you are paying attention!).

Adding to my confidence but not necessarily my timing, it is now public record that our fine U.S. Treasury is considering adding "Floating Rate Notes" to its quiver of questionable ideas on how to continue to float our government's appetite for spending. It seems VERY hard to imagine that with century level lows in interest rates, selling more short-term notes, much less floating rate notes, is a superior financing strategy than selling 30, 50 or even 100 year bonds to those who seem desperate for "duration." If the administration wants to punish the One Percent, I can think of no better idea than to sell them long maturity bonds.

On a more micro-level, the drumbeat continues for stocks that reflect investor desires for "quality, dividends, transparency, liquidity, and immediacy." While these are all wonderful qualities, they don't always line up to create a successful investment as price tends to reflect this self-evident goodness. Conversely, value today is often in the messy, the illiquid or simply a recognized opportunity that investors are having problems "timing." Insurance, natural gas, messy conglomerates, and anything to do with Aubrey McClendon, Rupert Murdoch or those who sell against Apple seem to fit the bill. There remains a reasonable amount to do in equity markets, albeit it would be nice to see a dip first, which is likely to be the exact recipe of why we are not seeing much of one.

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