COVE STREET CAPITAL

You Didn't Build This Rally

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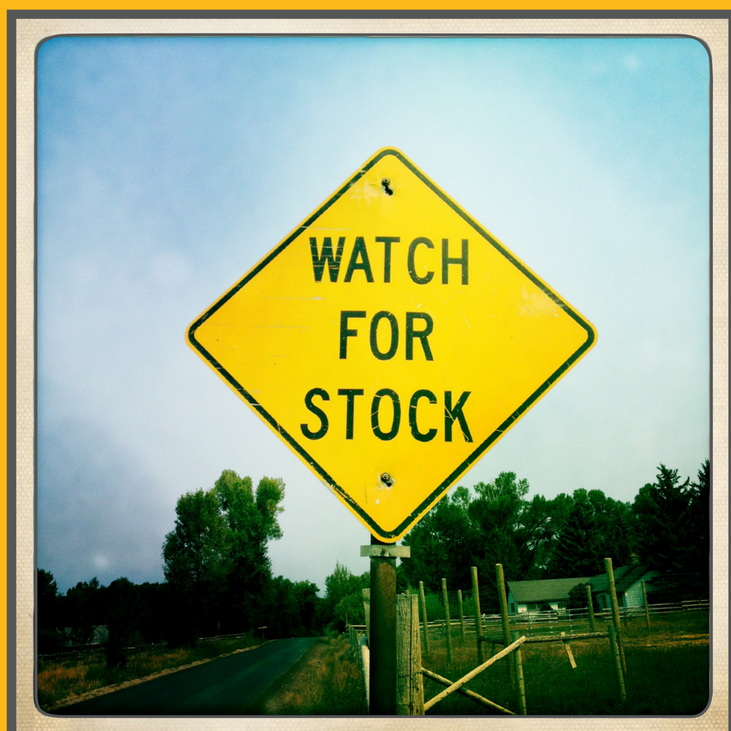

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SEPTEMBER 2012 — Among the many quirks of financial life is the lack of clarity as to the actual dates for the Federal Reserve's annual retreat in Jackson Hole, Wyoming. It's held "around" the last week in August, but presumably for security reasons the date is never on the Fed's website until the last minute. And if the Fed will list something as ridiculous as its interest rate forecast for 2014, then why not make this portfolio manager's annual Jackson summer trip planning a little easier?

Nonetheless, this missive is comfortably ensconced on the other side of Teton National Park, if you can call Mrs. Bronchick's annual re-creation of the tragic World War II saga, the "Bataan Death March," comfortable. (19.6 miles plus a grizzly sighting this year.) And, for those not terribly enthused with current Federal Reserve policy, no there was not a Ron Paul sash on the bear.

Why any of this matters is the issue at hand. It was precisely a year ago that financial market expectations swung 180 degrees within 48 hours as Federal Reserve Chairman Ben Bernanke turned the "drop $100 dollar bills from helicopters" metaphor into a reality of mainstream Fed policy via the quantitative easing program (QE2). The plan was very clearly designed to shove fearful investors into "riskier" assets, with the hope that the economy would then resume a wonderful path forward as we would all go out and spend based on the implicit recognition of the wealth effect.

However, with unemployment still over 8 percent and GDP growth hovering below 2 percent, it seems pretty obvious that there are other variables in the world that effect economic activity other than Federal Reserve policy. On the financial asset front, it is correct to say that Federal Reserve policy has manipulated asset prices higher in many sectors—whether this is a good thing or not is a relevant question. It fact, it is a slightly unnerving question given the financial market's "beta" to the most trivial and minor utterances of either Bernanke or his European counterpart Mario Draghi. But there is not a single economic or corporate activity that cannot be undertaken with the current level of interest rates or the availability of credit (sans a deeply underwater mortgage refi). Thus, additional moves by the Federal Reserve to lower rates, bend yield curves or tinker with bank reserves will continue to have little effect on economic activity as its actions are the financial equivalent of the third pint of Ben and Jerry's Mint Chocolate Chip—too much goodness is not a good thing. If anything, the current level of forced interest rates and the Fed's promise to keep rates low until at least 2014 is depressing economic activity by sapping the actual spending power of the "saving" community—an anti-wealth effect. We would also argue that the perception of persistent "tinkering" is becoming as counterproductive to economic activity as yet another Congressional scheme for a one-time tax rebate on washing machines.

At least Jackson Hole 2012 produced some belated self-awareness, however inadvertent, that Federal Reserve policy is veering from central banking to central planning, with the attendant unforeseen consequences. From the Chairman's speech last week, we have the following explanation from the "Making It Up as We Go Along Doctrine," the implications of which are legitimately scary:

> "As the Committee embarked on this path [sic post-2009 policy], we were guided by some general principles and some insightful academic work but—with the important exception of the Japanese case—limited historical experience. As a result, central bankers in the United States, and those in other advanced economies facing similar problems, have been in the process of learning by doing."

This paragraph is almost a microcosm of the current election. Either you believe private sector initiative and the collective wisdom of billions of people acting via free markets are the legitimate means by which human beings create wealth, price assets or allocate capital…or you don't. If you do, then you quite rationally should be wary of asset classes and equity themes that have been levitated by the best intentions of government officials. While we think what we own will be "weighed" over the long run by business model success, management's allocation of capital and movement from undervalued and underappreciated to grandeur and glory, we are suspect of short-term price movement in our favor for reasons that are broadly rather than specifically obvious.

What remains slightly more pressing in the front and center for investors is slowing growth in the BRIC countries, the recession and associated mess in Europe, and of course the thing we can actually do something about—the continuing mess and confusion surrounding fiscal policy and regulatory fiat. Here is some weird anecdotal evidence: I have seen at least three S&P 500 companies cancel their annual fall investor meeting because they don't know what to say to people! While it might not seem to be a big deal that 1.5 percent of the S&P 500 is wracked by indecision and thus holding back on capital spending and hiring, I would bet 100 basis points of GDP growth that the animal spirits of the rest of the S&P 500—much less the rest of the country—are being sapped by the laundry list of impending (or not) tax, regulatory or political changes. As a practical matter, it remains highly probable that no matter which party controls what after the November elections, there will be some sort of half-cocked fiscal compromise that will kick our fiscal problem can down the road until the sun rises again; thus, the financial world as we know it will not disappear.

So what is a poor investor to do? The answer of course remains fiendishly simple: think longer-term than 3 months, buy cheaply and safely, sell dearly, and do more work that results in fewer and better decisions. We seek to purchase stocks for which the valuation has been "systematically" depressed by macro fears but the underlying business or catalysts for change have their own drumbeat. Stocks may trade like commodities in the short-run, but they represent real businesses run by real people who are reacting to the same news "we" are and are mostly engaged in legitimate efforts to improve the wealth of their investors. I read articles in the *Wall Street Journal* talking about how portfolio managers could finally take a week off this summer because of the "low volatility" instead of feeling compelled to stare at a screen every five minutes. Seriously? I wish I had known that there really is some kind of gamma ray emanating from the Bloomberg screen that could help me ascertain the future or further understand business dynamics because I sure feel stupid after twenty-eight years of not receiving wisdom by staring at prices on a screen.

With all the professional hand-wringing and naysaying, we have had a pretty terrific year investing mostly in equities, with returns as of this writing ranging from low double digits to the low 20's, depending upon our strategy. As noted statistician Woody Allen has stated, 80 percent of this was just showing up (as many people obviously haven't given into the continuing outflow from long-only equities), but we have benefitted from a timely selection of "equity maturations" of companies whose return durations are always impossible to estimate. We can tell you the stock is cheap, we can tell you it has a great business, and we can analyze management's record of asset allocation, but our shrug is as good as yours as to when the value is actually going to be realized by other investors or an outside event. We have recently leaned into what has done particularly well, a strategy which suggests we have some additional valuation protection against any number of global political follies guaranteed to resume here in the fall.

On another note, we recently read with some bemusement—and almost some professional embarrassment—the ideas being espoused by Bill Gross of PIMCO that the "cult of equities" is over. Additionally, I learned that I should not catch my "spurious tail" (FooledByRandomness.com/SpuriousTail.pdf) in the door as I am supposed to be leaving the business of active money management. In relation to the aforementioned world's largest bond manager, it should be fairly noted that if you actually bothered to read his piece, he essentially said that while equity returns are unlikely to match the historical "6.6 percent real," he actually sounded more pessimistic about his own asset class. And, given the laundry list of S&P 500 stocks whose dividend yield exceeds the yield on the company's own 10-year bonds, and the range of outcomes for the return of a 10-year treasury at 1.5% (now there is a cult!), I will continue to take the bet that equities will outperform bonds over the next ten years—or even five or three for that matter. I still stare at the $1,000 bottle of 1990 Lafite Rothschild that was procured from a senior PIMCO executive the last time I took exception to the world's largest bond manager trashing stocks in favor of bonds. The bet was made in December 2008, a time which coincidentally was almost six years to the day that PIMCO was ruing its last Dow 5,000 market call. (It peaked at 14,000.) But we digress.

Waking up today and despairing over disappointing returns in the past is of course the exact opposite "feeling" that an investor should have—the only rational analysis is of the current valuation and the expected returns in the future. Equity returns were somewhat obviously too high in the ten years ending 2001, just as they are somewhat obviously too low for the ten years ending 2011. What is the "right" number for an investor's expected return in equities? Insert shrug here, but it is somewhat commonsensical and mathematically supportable to suggest mean reversion is tugging equities in the right direction—upward—and conversely, fixed income in the wrong one. It is crucial to remember that fixed income remains much more of an algebra game, whereas equity investing is a probability game, and the opportunity set stems from the fact that our brains are simply not well suited to the latter. (We sent some of you the book last Christmas!)

We enjoy repeating the mantra that the more people are focused on all the "big" things, the more opportunities are available on the ground. The idea that the pig finds the truffle in the field, not in the barn, is perhaps not our best visual but it holds up as practically accurate. The Cove Street investment process continues to find a healthy and eclectic mix of investable securities, both in our portfolio and on the new idea list, a fact that says much more to us than any articulately poignant macroeconomic statement.

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