COVE STREET CAPITAL

Idiosyncratic Risk ...and the Other Kind

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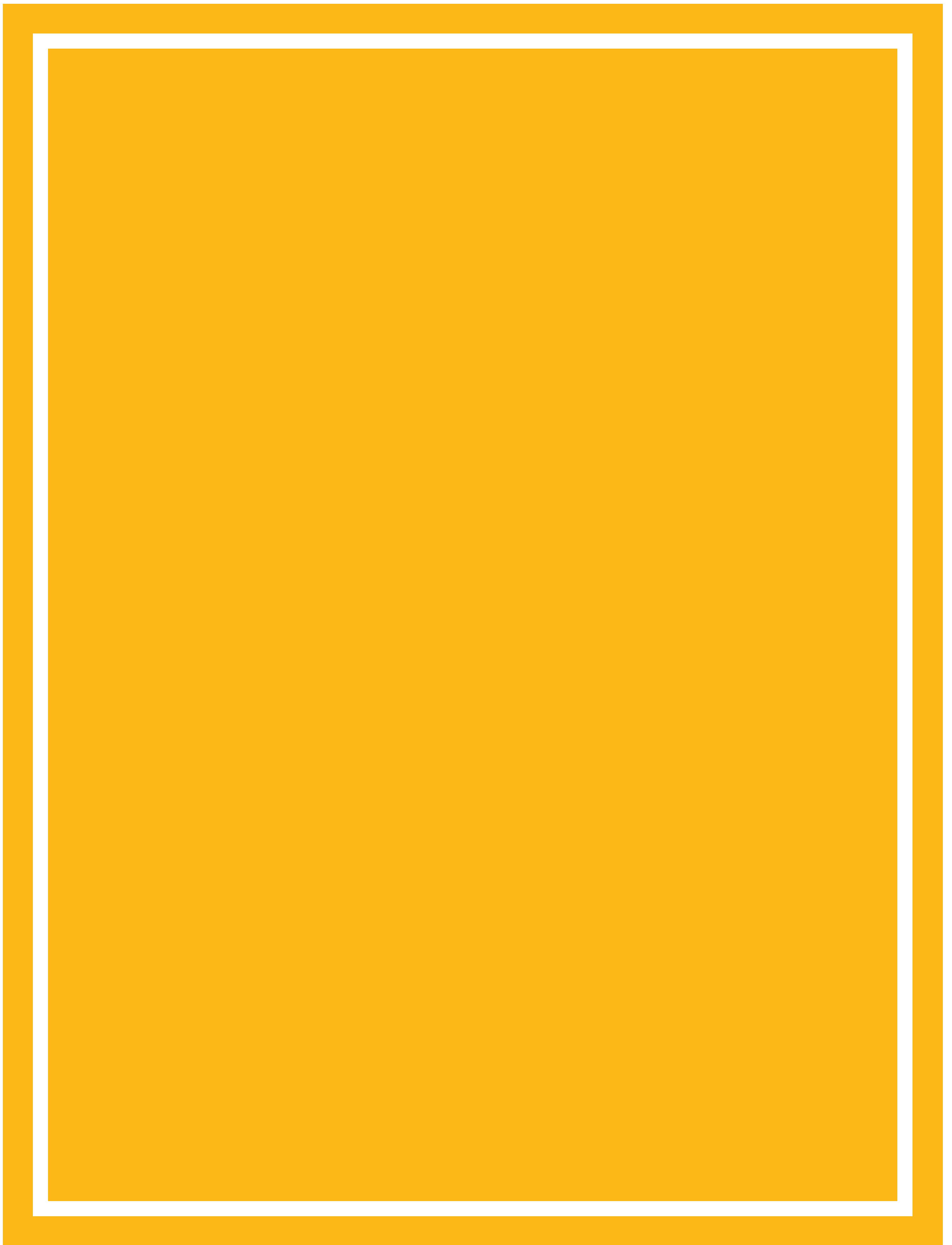

Idiosyncratic Risk ...and the Other Kind

NOVEMBER 2012 — If the recent election demonstrated anything of relevance to an investor, it should have been the beginning of the end of the tyranny of the "catalyst." The day before the election, an investor could have legitimately been worried about any number of micro, macro, domestic, or global issues. And yet the sun rose, work was attended to by those who have jobs, markets opened, fell, and closed, and the collective attention moved to the next "perceived" catalyst—the so-called fiscal cliff. Calling Roseanne Roseannadanna.

Operating in constant fear of day-to-day catalysts is in many ways exactly the opposite of how life on "Main Street" really works and how investing should be pursued. Barring very specific events, such as the expiration of a tender offer or the date of an important court ruling, investing in equity securities has no time clock, two minute warning or even a regular season. The end of a fiscal quarter is NOT a catalyst, unless of course the investment committee is about to fire you, at which point it can be argued fairly convincingly that you are in hope and prayer mode anyway.

Cove Street Capital is very fortunately not likely to be at the receiving end of some unpleasant news given very solid absolute and relative performance across all strategies. Our efforts have been unusually well-rewarded since the market bottomed in March of 2009 and we would be lying if we didn't acknowledge how pleased we are, but we smile with a hint of uneasiness.

Our stocks have clearly done better than "average" (or the "averages"), a fact that means with no changes in the portfolio, there is less of a margin of safety relative to the point from which we started. Said another way, the expected return from current prices is less than it was a year ago; hence, there is a diminished probability of further outperformance to the degree we have experienced.

Naturally, we comb the equity markets for other opportunities to match the excellent risk/reward tradeoff we were seeing a year ago. In that context, the most positive thing we have to say is that we are finding them. To reiterate—and this is incredibly crucial—successful long-term investing must be based upon what the company is going to do, not what the stock market is going to do. Nonetheless, any good value investor usually feels the opposite of how a client feels: when we perform well, we get nervous and sense fewer opportunities and when things are miserable, we feel the excitement of searching for bargains. (Insert CSC Plug—Please do not hesitate to call Paul Hinkle, our Director of Client Portfolio Management if you would like to discuss this process in further detail.)

But on the subject of the economic continuum, what has also not changed is the preponderance of bad ideas that continue to be based on ideological grounds. Running trillion dollar annual deficits financed with short-term debt at interest rates artificially held down by another

arm of government does not represent prudent or lasting policy. Crushing the rate of return on saving—and distorting the evaluation of capital allocation by artificially holding down interest rates—in order to drag unwilling participants toward "risky" assets is a morally repugnant way of attempting to cure the profligacy of public sector finance. Raising taxes in earnest and cutting government spending in jest does not engender confidence in the business community. It does not matter how many times government officials tell us otherwise, an economically dumb idea remains an economically dumb idea and we are all the worse for it.

2013 Drag From The Fiscal Cliff

— CLIFF NOTES —

Potential calendar-year fiscal impact, 2013	Likelihood of fiscal drag occurring	$bn
Discretionary spending caps	High	84
Health-care law taxes	↑	21
Payroll tax cut expires		116
Bush tax cuts for wealthy expire		45
Bush tax cuts for middle income expire		150
Tax extenders expire		30
Extended jobless benefits expire		25
Physician payment cut		20
Sequester	↓	85
Alternative minimum tax not patched	Low	94
Total		**670**

Source: ISI Group

— FISCAL 2013 IMPACT, ANNUALIZED DOLLARS / PERCENT OF GDP —

Category	Amount	Description
Spending cuts: **$136 billion** 0.8% of GDP	$87 B / 0.5%	Across-the-board cuts in domestic and defense, discretionary spending
	$35 B / 0.2%	Expiration of extended unemployment benefits
	$15 B / 0.1%	Reduce Medicare doctor rates
	$24 B / 0.1%	New taxes from Obama health-care law
Tax increases: **$532 billion** 3.1% of GDP	Tax Cuts that Expire:	
	$87 B / 0.5%	Other tax provisions
	$127 B / 0.7%	Payroll tax holiday ends
TOTAL spending and taxes: **$668 billion** **4.0% of GDP**	$295 B / 1.7%	Income tax rates to rise to pre-2011 levels; alternative minimum tax reaches into middle class

Source: The *Wall Street Journal* (numbers are rounded)

On a related note, the so-called fiscal cliff is perceived as deadly not because of some draconian set of spending cuts, but for the associated tax increases.

So let me see if I understand this. "Tax increases on the wealthy" are a precondition for fiscal health in one argument but they are deadly if wrapped in a "Fiscal Cliff" scenario?

None of this is new news, and people from both sides of the political aisle have proven themselves capable of going to wire on important decisions before reaching a slightly less than awful agreement. And recent history suggests that it may take a few down-400-point days in the Dow to focus the Washington gestalt. But I imagine that somehow the entire 236-year American experiment in democracy and capitalism will not disappear by January 1st, despite its recent tarnishing.

As a value-based investment manager, we are keenly aware that it is one thing to have an opinion on the political-economic world and quite another to act on it. This understanding remains in the minority as the year to date "count" shows over $200 billion in new money flowing into fixed income or "low volatility" funds and a net outflow from equity vehicles north of $75 billion.

Our outlook is based upon the relationship of price to value on a security by security basis. We see little in fixed income that fits any reasonable definition of a comfort zone. We see plenty in the equity side, where we try to assemble a set of business, value, and people combinations that possess diverse and idiosyncratic risks, the biggest of which is that the market's price for a business overvalues its long-term earnings power. "Systemic risk," like the nonsense we are all forced to live with in the political capitals of the world, can be scary in the short-run, but it can also be laid off very simply and inexpensively by holding cash until you can sleep at night. It does not require modern portfolio theory or 2 & 20 fees and leverage. I think there is a lot of confusion regarding the perceived risks in equity investing versus the risk in portfolio allocation. An inappropriate appreciation of the latter can hurt, but even when you have that down, an obsession with what is not knowable, impossible to influence or related solely to price movement will paralyze your ability to successfully invest in the long-run.

A recent example highlights some of the reasons why we think we can make a living investing in public markets. In broad daylight, Liberty Interactive (LINTA) recently completed a transaction whereby a tracking stock (Liberty Ventures — LVNTA) was issued to its shareholders. The idea was that LINTA's main asset, QVC, the global home-shopping network, was being undervalued due to the presence of "other stuff." This included nearly a dozen non-controlling stakes in public and private companies and a variety of admittedly complex tax schemes

concocted by the John Malone Libertarian Brain Trust. (Bless them.) All of this information has been public knowledge for years and any variety of PowerPoint presentations have been produced to help make sense of it, to only partial avail. The market capitalization of LINTA the day before the spin-off was $10.3 billion. As of this writing, the combined value of the tracking stock and LINTA is now $12.5 billion, a 16% uptick in valuation if you remove the $328mm new cash raised in the process. Nothing fundamentally occurred other than the pie being sliced differently, a process that enabled less involved investors to see flavors they appear to like more. No politics, no Europe, no China, no Middle East.

While it is practically impossible for John Malone to run all the companies in the S&P 500, there are pockets of undervaluation and good businesses that are being run by management teams looking to create value in the midst of the same weird environment in which we all live. We are going to continue to try and find them.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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