COVE STREET CAPITAL

Metastability?

Number 18 | September 2014

"Successful investment in public markets needs some volatility in which to take advantage of short-term silliness in terms of both buying and selling. Long-term investors actually hope the market goes down from time to time in order to create opportunity."

Metastability?

SEPTEMBER 2014 — The recent and well-publicized decision by the California Public Employees Retirement System (CalPERS) to eliminate its hedge fund program is very interesting for a variety of reasons, not all of them obvious. To reiterate any number of themes previously explored in these letters, being a "hedge fund," as literally interpreted in today's investment management industry, means absolutely nothing. In reality, CalPERS saying it is sick of hedge funds is the equivalent of a single person saying that he is sick and tired of dating mammals—a little more specificity would be helpful. A "hedge fund" is a euphemism for an alternative compensation scheme, not an investment strategy, and it is often a compensation scheme that has been glommed onto many investment strategies that can very well be replicated through lower cost and often passive means.

There are certain investment strategies that can only effectively be implemented within a longer-term, "locked-up" partnership structure—Botswanan private equity comes to mind. Real estate, oil and gas, certain private equity structures…and concentrated small and micro cap might be others. In other words, these are illiquid, information specific, less trafficked areas where asset size must be limited and for which higher fees may be warranted given the inability to "scale." CalPERS is keeping plenty of these, a fact that doesn't seem to be getting a lot of press. What the current roster of thousands of partnerships, not to mention thousands of shuttered attempts, have basically proven is that trading in liquid debt and equity securities on the long and short side in order to provide "competitive returns in up markets and outperform in down markets" is not as easy as it looks, net of high fees or not. Additionally, many strategies can mostly be replicated by some simple version of a balanced asset allocation that even bank trust departments have conceptually mastered for over half a century. Throw in a "fund of funds" fee on top of that and the disgust factor rises proportionately. (More on this below.)

CalPERS, like many large funds, is also somewhat an innocent victim of its own size, as the history of many such funds has shown that their entrance is simply the death knell of the asset class outperformance they were seeking to capture. Even if hedge fund managers did outperform a market index on a reliable basis—definitively proven not to be the case—it would not solve the problem of fully funding the pension obligation, which, by the way, is the goal that seems to be forgotten in many an investment management meeting. The top 300 pension funds in the world have assets of somewhere around $15 trillion. Total hedge fund assets are around $2.9 trillion. If all the money in the world went into hedge funds that then outperformed an index by 2% annually (which would put them in the top quartile of long-only active managers), it would boost overall pension returns by about 40 basis points. It is simply an impossible task whose successful outcome almost doesn't matter. But oh those fees.

Getting back to the real world, we then have the issue of "timing." Very large piles of money tend to be on the wrong sides of asset decisions due to the sheer battleship-like structure of decision-making—by the time they get there, the opportunity set may be gone or constrained—and then whatever is left gets trampled anyway. I would also note that while being sick of high fees and feeling bamboozled by the nonsense du jour of the investment industry are symptoms that can be practically and correctly treated, a lot of the current whining about hedge funds also stems from a naturally occurring phenomena: a fund that practices hedging will likely underperform a long-only index in a very strong up-market. In fact, hedge funds' whole sales pitch is to provide some uncorrelated, absolute return mix that lies between equity and fixed income. Even assuming reasonable fees and full transparency, throwing in the towel on a "hedged" investment because the manager is underperforming the long index might be…questionable timing. Throw in the Alibaba IPO and Bill Ackman's attempt to lock down permanent capital with a European equity offering and you have another excellent set of anecdotal contrarian signs.

As a firm with a small cap focus, we have seen plenty of signs of "toppiness" in the last few months as we continue to trade right around zero for the year as far as performance…and that is not underperformance. Even if you do not recall what we said at the beginning of the year—that small cap performance HAS to be tougher this year after a stupendous 2013—then you might have noticed the unrelenting headlines of "Small Cap is Over," "The Most Overvalued Asset Class," or "Bubble in Small Cap." And in a prediction that was actually correct, small cap has materially underperformed its larger brethren this year. The enquiring mind then asks: so what and now what?

"So what" stems from the one conclusion that anyone can reach: speculating on results in any one year is not the way toward covering a pension liability or establishing residence on your own private island. Successful investment in public markets needs some volatility in which to take advantage of short-term silliness in terms of both buying and selling. Long-term investors actually hope the market goes down from time to time in order to create opportunity. The "value restoration project" as Jim Grant coins it, requires either the passage of time, during which good businesses compound and catch up to a flat price, or more simply a price decline. We have cash, we have what we think are "good" clients with a long-term focus and patience, and we are prepared, to paraphrase Charlie Munger, to throw a fast spear into the water to catch the fish before they swim on. These opportunities don't come as often as one would like, so you have to be there and be ready. (Which is why we are actively encouraging new money today.) We are seeing more opportunities today than we saw in the beginning of the year and that is a good thing. We think we will see more and better opportunities going forward. Just as short-term, excellent performance steals from intermediate expectations of future performance, lousy interim numbers create higher return expectations for the intermediate future. We are getting there.

Before moving on, let's briefly reload some key factors. Returns from investing in small cap value remain one of the VERY few statistically significant abnormalities of long-term performance. Why? Because there are thousands of stocks from which to choose and many of them have characteristics that lead to opportunities: information inefficiency, institutions remaining deathly afraid of illiquidity, shrinking—or absent—sell side coverage that leaves many publically traded orphans (the ongoing gift from Elliot Spitzer) and the general behavioral biases of both managers and clients toward favoring brand name quantities with minimal uncertainties. While we have a pretty good long-term record in strategies that involve large cap stocks, the easier pickings have been and will continue to be in small cap. It is the gift that structurally keeps on giving.

Which brings us to the gloomier but essentially accurate essay entitled *The Rise and Fall of Performance Investing* by noted industry consultant Charles Ellis. It is a serious piece and is seriously worth reading and thinking about. I will assume you have plenty of free time and thus will not summarize the entire piece for you. But his key points are:

- Too much information, too much technology, too many smart people, and too much money are chasing performance, making it simply harder to achieve than in the "good old days."
- Investment management fees are too high.
- Cheap passive structures are highly available and should be used much more often than they are.
- Our "industry"—on both the manager and client side—is structured poorly; high turnover, short-termism, and poor incentives are all factors that reinforce "The Losers Game."
- Our own behavioral issues remain a problem. Specifically, sticking to a rational plan in hard times is difficult, making rational decisions in committee structure is hard, and the human tendency to want to be better and try harder can often be counter-productive.

Umm…we mostly agree…with some only modestly self-serving caveats. The first is noted above—the abnormal performance of small cap value—and you can add to that investing in concentrated portfolios of larger-cap names and the ability to extract return from "time risk" assist in tilting a very flat playing field in our favor. While of course we think we are better than the average fishermen, we know we are fishing in a better than average pond. Additionally, what is somewhat intuitive to us, but is apparently not a widely shared opinion is the following: if more and more people are abandoning active management and blindly buying 2000 stocks for proportional representation, the benefit that accrues from perceiving differentiation in value as well as company fundamentals, should be increasing. While we are a long way from inuring to the benefit of being the last guy standing, directionally we think it is working in our favor.

We remain cheerfully bearish on fixed income and slightly less so on equity markets. The combination of volatility and confusion produces opportunities and since we have had a lot less of the former, we have seen a lot fewer of the latter. Not much of this has changed this year... but things do change—sometimes for reasons we can "see" and sometimes due to factors we can't. We remain utterly convinced that Federal Reserve policy is our greatest known unknown and we remain extraordinarily skeptical that the Great Monetary Experiment will end with a purely beneficial outcome. This quarter's favorite term is metastability: an unstable and transient but long-lived equilibrium that is not the system's natural state of least energy.

In CSC news, we welcome Dean Pagonis to the Cove Street Capital research team. Despite being yet another UCLA MBA, Dean has a very interesting background in think-tank research and has a great sense of dogged determination to ferret our critical variables in valuation and business fundamentals. He is already making me work harder.

We would also remind interested parties to sign up for the 'Weblog' on our website for shorter form or very specific topical issues like *Buyback B.S.*, *An Activist Too Far* and a variety of other pithier thoughts irregularly gathered from our team. Please see CoveStreetCapital.com/Blog.

—

Jeffrey Bronchick, CFA
Principal, Portfolio Manager

Visit our weblog at CoveStreetCapital.com/Blog and sign up to receive commentary from the CSC research team.