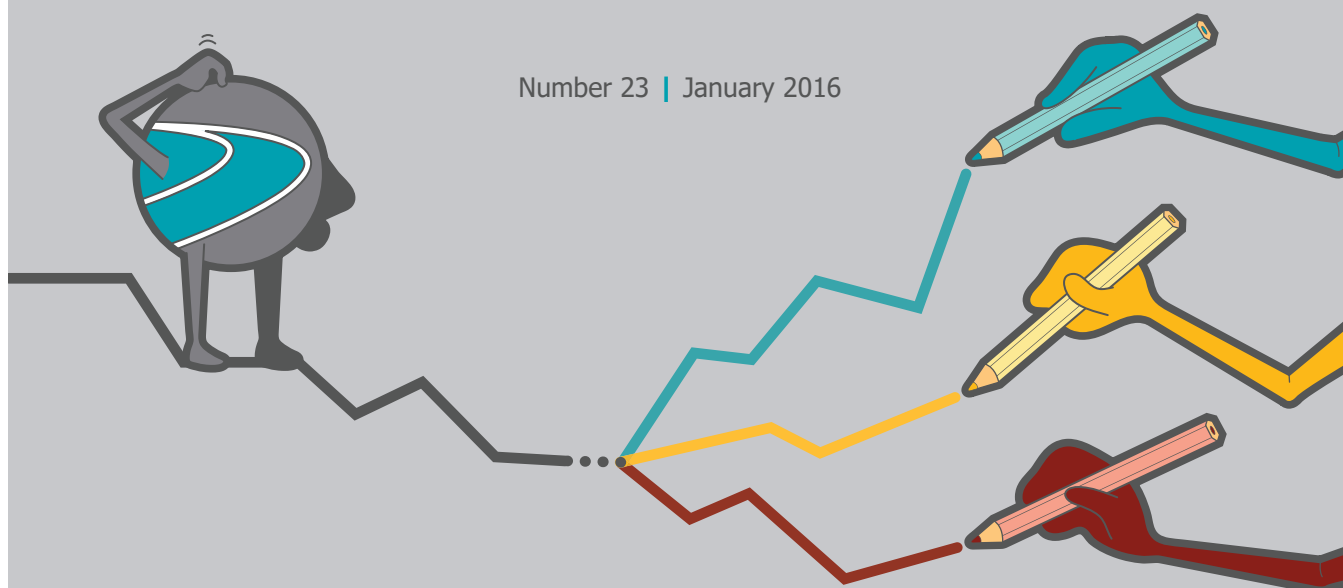
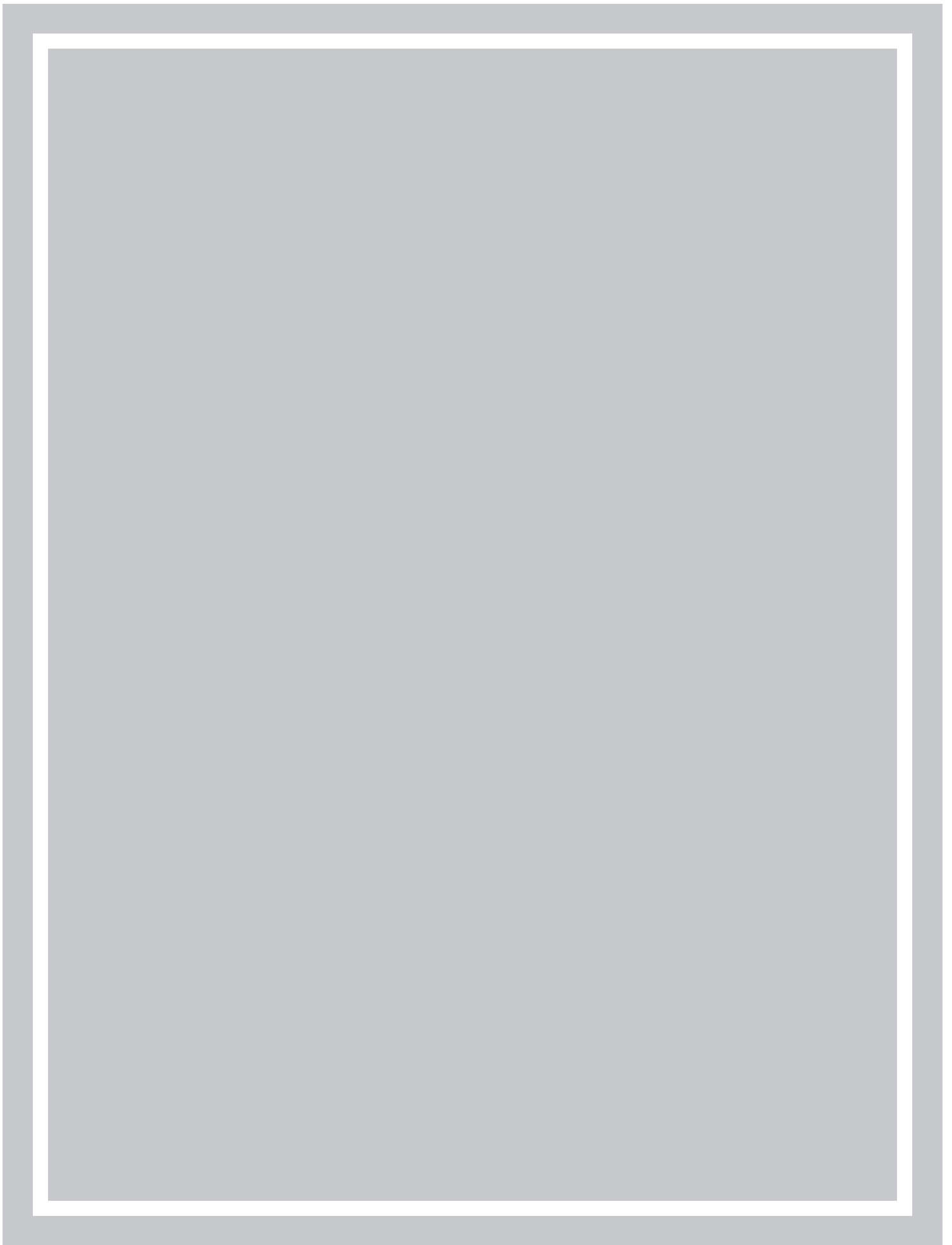


# Waves in an Ocean of Guesses

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# Waves in and Ocean of Guesses

JANUARY 2016 — We closed out the year on a weak note after a number of attempts to snatch victory from the jaws of a difficult year. While our absolute numbers in small cap were flat but index-beating, our numbers in all cap were negative and not index-beating. We say this in the context of something we repeat every year at this time: the object is to compound wealth over a run longer than one lap around the sun.

We begin the new year with a fiendishly simple thought: with a high probability attached to a low-return world scenario, don't do anything stupid because it will have a disproportionate effect on your portfolio, the members of which en masse are not likely to make up for your whopper. I think good investing is less about the search for the new new thing than it is to be wary of getting clobbered in an old thing, whether it's being lazy on valuation or missing the idea that your "forever compounding Buffett stock" was merely an astute piece of timing that should be sold once its mean reversion is mostly complete. To say this another way without overtly repeating myself, I am going to work in a few paragraphs from a recent piece from Bija Advisors and its proprietor Stephen Duneier (plug included) that I think neatly expands on this:

"Not a week goes by that I don't find myself debating the claim that this environment is particularly challenging. To be honest, I feel like

I've been having this conversation since I started in the business two months before Black Monday in 1987. In my opinion, the current environment is no more challenging for generating alpha than it has been at any other time in history. What makes it unique, however, is that it is now far more difficult to generate beta and have it masquerade as alpha. Let me repeat that for emphasis. What makes the current environment so challenging, is that you can no longer deliver beta, including levered beta, and pretend its alpha. Rather than blaming the environment, the managers in your portfolio, the myopic investors, irrational policy makers, and liquidity dampening regulators, in order to consistently generate significant returns, to stand out from the crowd, you need to make fewer mistakes, be more patient, and think critically, creatively."

Ignoring the hedge-fund blah blah, this is another way of saying that investors have the means, the tools, and the motives with which to invest that are peeling off the layers of nonsense on which the investment industry has sold goods. Collecting large sums of assets and attempting to hold on to that fee stream with mediocre relative performance that is well-served in a bull market has made fortunes for people. IF we are in a low-return world, it becomes an untenable business model at best

and an unappealing intellectual offer to honestly stand before a client or prospective client.

After three decades of watching this unfold, I began Cove Street Capital 4.5 years ago with a slightly different mission that tilts the playing field in our favor: value, small cap, concentration, selectiveness in partner/clients, talent density, fortress balance sheet to support the mission and sustain through the inevitability of difficult periods, and the willingness to limit asset growth where it infringes upon our ability to generate returns. (We are not quite there yet...but there is not a lot of room.) You don't have to be a self-proclaimed investment genius if you are simply looking more closely in the right places. We spend a lot of time thinking through how we process information and make decisions, because our investment philosophy does not change—buy good businesses at reasonable prices and buy reasonable businesses at very cheap prices.

Our view for the upcoming year remains remarkably similar to most years. We come in the office looking for inefficiencies in public stock markets of which we can take advantage. Inefficiencies occur from fairly obvious and consistent places that remain remarkably unchanged over decades:

- fears of the short-term;
- the inability of large funds to practically take positions in smaller companies;
- the difficulty of organizations to structure themselves in a way that compensates its people to do actual research into smaller companies...and be willing to hold these companies in the face of short term issues; and
- the fear of acting with conviction in sufficient size in order to make a difference.

At heart we are a research shop, and thus cannot help but view the trillions of dollars wandering around indexed products as a gift that keeps on giving. I find it fascinating that actual movies are being made which essentially condemn the practice of bundling underlying assets into unanalyzed packages to be sold to investors as a criminal act. Think hard about what an ETF or index fund is or isn't. Yes, the latter is low fee, and some are low turnover. It is entirely appropriate to index large sums of money in very liquid asset classes and call it a day, but we will remain old-fashioned. Doing some work before making an investment still makes sense to us.

I have recently come to believe that economists are like painters—their work gets more valuable when they are

deceased and time can be taken to truly evaluate the good idea versus the daily drivel shoved at us by *The New York Times* Nobelists. In thinking about the year ahead, I pulled this 2005 quote from Douglas North, a Nobel winner in economics who died this year:

“The perpetuation of open-access societies like the United States in a world of continuous novel change raises a fundamental institutional dilemma at the heart of the issue of economic development and of successful dynamic change. By uncertainty, we mean that we do not know what is going to happen in the future and that condition characterizes the world we have been creating. How can our minds make sense of new and novel conditions that are continually occurring? The answer that in fact has proven successful in the case of the United States and other open access societies is the creation of an institutional structure that maximizes trials and eliminates errors and therefore, maximizes the potential for achieving a successful outcome—a condition first prescribed by Friedrich Hayek many years ago and still the prescription for an adaptively efficient society. Such an institutional structure is derived from an underlying belief system that recognizes the tentative nature of our understanding of the world around us.”

We have been buying cyclicity and have not been proven terribly early...yet. Any stock that has an element of cyclicity—pick your poison: agriculture, mining, energy, Brazil—has gotten pretty well-crushed. Some of this was deserved because no matter how wonderful a business it may be, if its 20% geared toward one of the aforementioned sectors, you WILL have a bad time somewhere in any given five year period. We are utterly convinced that a properly identified cyclical problem is inherently a buyable issue as an investor and we have stepped up to the plate in a number of what we almost call “growth cyclicals”—a partial list of which includes Franklin Electric, FMC, Raven Industries, Colfax and USG. (Ok less so USG.) What is notable is that these are mostly businesses for the long-run, with excellent balance sheets and some nice secular growth trends behind them. In other words, what we would call our classic “Buffett values.”

I will note that the lead CSC portfolio manager has not always executed this line of reasoning in prior economic cycles, as the temptation to buy the cheapest, most-cyclical stock early in a downturn proved to have a high

disaster ratio and generally avoiding this temptation is one of the key things that has helped us this year. We do have a growing list of “Graham values,” a number of which have had sickening declines this year as investors are properly spooked by leverage on top of a cyclical, iffy business model. Buying a stock that has doubled to \$6 on a balance sheet fix (down from \$40) that still has a value in the high-teens is a better bet than guessing as to whether they will be around next year in the event of a true recession. Let someone else be the hero that picked off the bottom.

Energy remains a topic that still requires either three minutes or a week to discuss, either extreme of which is problematic. It remains a near universal truth that when enormous hordes of institutional money runs to and fro, it usually pays to be gingerly on the other side. Suffice it to say that gingerly did not in any way pay off in 2015. We continue to look for opportunities and the fortitude to find survivable pockets of an industry that defines notorious cyclical. Singed fingers and intellect are currently suggesting that industrial companies that have and will continue to sell widgets to energy companies might be a more viable way to preserve capital and position for an inevitable and huge upside...in someone’s lifetime.

We will throw in a few thoughts about “China” because we didn’t get our Letter out until the second week of January and it seems hard not to. It’s a big, messy country that is suffering the inevitable comedown of the “a group of smart people from good U.S. colleges with the proper political connections know what is best for us” theory that seems to capture people’s imagination from generation to generation. (Federal Reserve and Bernie Sanders alert.) This has nothing to do with the financial crisis of 2008, which people seem to bring to the table every 2% move in the Dow, since there is much more insularity in their financial system and reserve holdings. Chinese economic and political issues will continue to exert pressures on global economic demand, with particular emphasis in commodity areas, which again people forget benefit everyone but the commodity makers. A billion people and their insatiable demands for middle class “necessities” and political freedoms are not going away. If they truly crush their currency, it “may” cause a modest inflation uptick in the U.S. But the math of the world economy is simpler—U.S. demand for non-U.S. goods dwarfs that of Chinese demand for non-Chinese goods. A fat and ugly recession in the world will be headquartered in the U.S., not China. We would be happy to buy U.S. stocks on fears regarding China.

We should expect more volatility and that is not a bad thing. The concept of “micro-aggressions” seems to have snuck into the financial world and there is

commotion over market moves that in the past would not have disturbed a feather. Our desire for a mindful, considerate, and paced life full of meaning is simply impractical in financial markets, and I think Federal Reserve attempts to tighten the cone of life’s innate variability have been as foolish as the presumption of the Chinese economic miracle. Things have, can, and should move 10% and 20%—and occasionally more—in the short run without resorting to massive rethinks of financial strategy. We run long-only, non-levered portfolios that are ideally designed to be the buyer of last resort in messy markets—it is the current mess that creates the return opportunities going forward. And if someone is not calling us dumb from time to time, we are off-piste.

In other notes about the New Year, we have whined about Federal Reserve policy plenty of times and we are tired of it. The part that remains important to us is not the level of interest rates that we are being manipulated to, it is the availability of credit issue. We continue to think, and now we are actually witnessing its unfolding, that any move by the Federal Reserve to attempt to move rates higher would curtail the desire of the marginal buyer of “yield” and thus end the free money era as it relates to credit availability. There are numerous second derivative effects as the high yield market and bank loan market tighten in an environment that has been clotheslined by Dodd-Frank and Federal Reserve bank regulation. If there is follow through from the 4th quarter, this would affect stocks—and not in a good way.

Concluding on the Fed and the necessity of attributing the Strategy Letter title, we throw in a living economist. Alex J. Pollock is a resident fellow at the American Enterprise Institute in Washington and former president and CEO of the Federal Home Loan Bank of Chicago from 1991-2004. “Since the Fed does not operate on knowledge of the future—that being impossible—it relies on academic theories. Its theories and ideology change over time. They are waves in an ocean of guesses.” We remain of the opinion that the Fed has a highly-educated academic view and that it has no idea what it is doing. They are not really “raising rates”—they are attempting to get out of the manipulating rates game that has garnered little for the economic system except punishment of savers and the sufferance of rational capital allocators. When a trend has lasted essentially 33 years, there are bound to be issues with the adjustment period.

But life is obviously not all about the Fed. If it were, we would have 102% employment, the Dow at 50,000, and Obama with a 98% approval rating. There are plenty of other problems in the world—take your pick. But we simply cannot have cheap stocks and good news at the same time. Uncertainty about any year to come does

not mean high risk per se and more often than not it is the opposite that is true. It's those unknown unknowns that hurt. Statements like "After a Tumultuous 2015, Investors Have Low Expectations for Markets" and "Not a lot of things to get enthusiastic about, says one investor" are anecdotally good things despite your innate desire to choke someone for their sober inanity.

On a closing but most important note, "management" recognizes that the assets of an investment firm are its people, and our people democratically created this reality statement for our firm:

We are a highly motivated, entrepreneurial, and open ecosystem. Every member of the firm understands DHM and the importance of its ordering—Delight Clients, Have Fun, Make Money. The atmosphere is highly collaborative and ideas flow across rank and job description, enabling "failure free" expression. The best thing a human being can do is help another human being know more—personal growth is encouraged and compensated. Resonating themes include: unwavering ethics and devotion to client first; independent work with full accountability; ownership mentality; a focus on what is the "best way," not "this is how it has been done before;" and submission of rank and seniority to best idea and best practice.

If we do this correctly, we will attract and keep great talent in every aspect of our firm and produce corresponding excellence in every aspect of our relationship with you. While I think we have gotten this mostly right to date, we are taking the next step.

We are delighted to announce that Ben Claremon, Paul Hinkle, Kelli Manthei, Eugene Robin, and Mathew Weber have become partners of the firm, joining me and Daniele Beasley in our quest to fulfill our mission stated above. Their contributions and responsibilities span from investing to trading to client service to design. They have demonstrated the "relentless passion" that I consider to be the critical DNA of our firm. We...and our external partners (clients) should be grateful to have them and look forward to a long and mutually prosperous future together.

Best wishes for a happy, healthy, and prosperous New Year.

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Jeffrey Bronchick, CFA  
Principal, Portfolio Manager

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