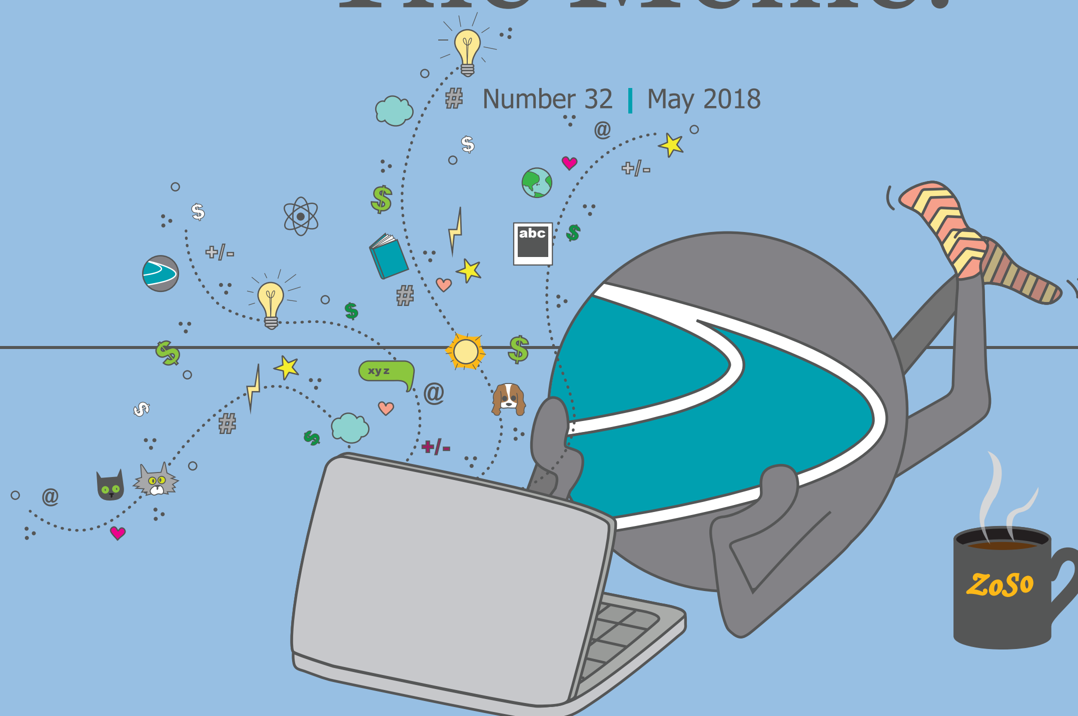
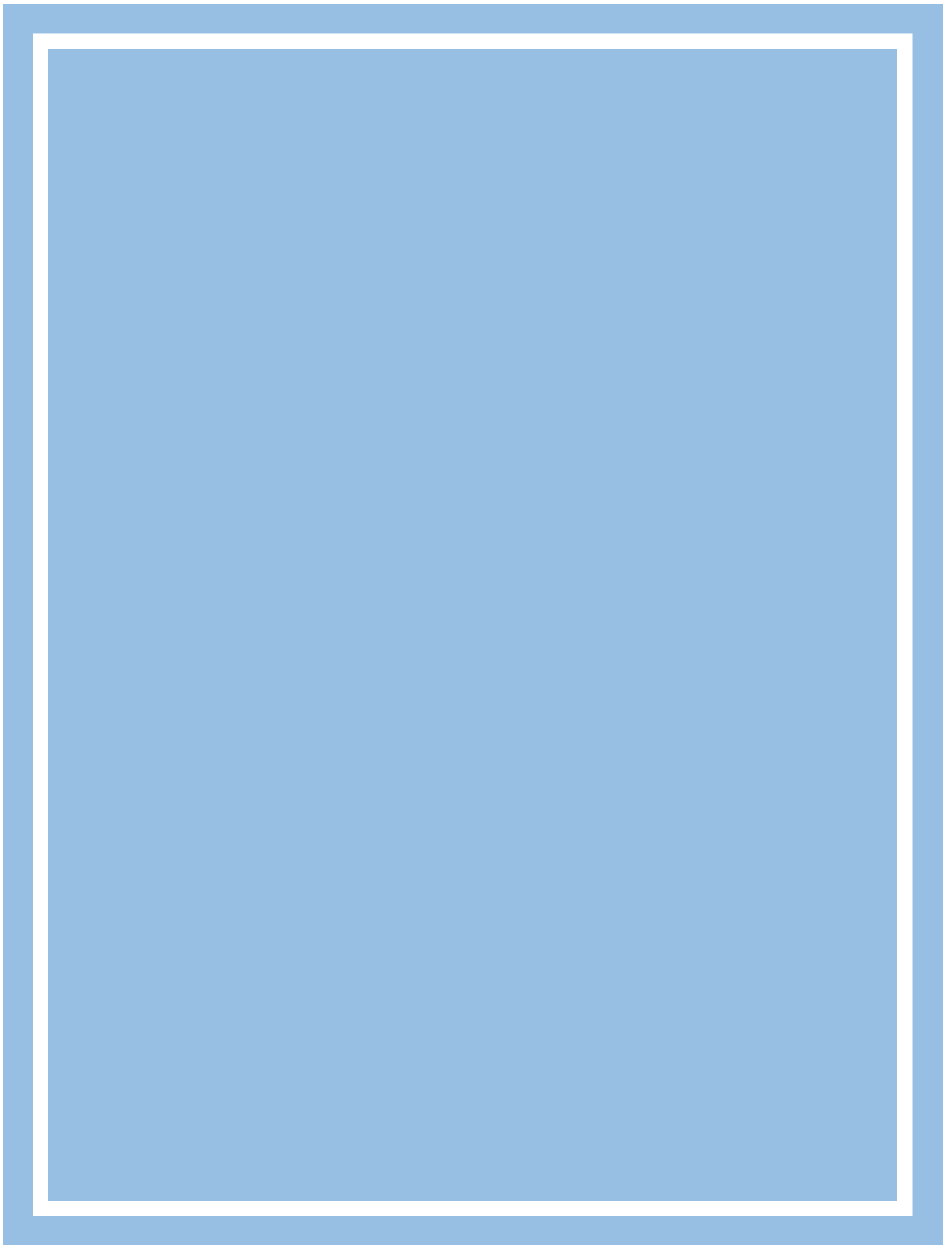
As Good As It Gets? The Meme.

Number 32 | May 2018



“So the question is posed, “at what interest rate does the stock market begin to have a problem?” While a 3% ten-year Treasury yield seems to be tossed about like the Holy Hand Grenade of Monty Python fame, the vague answer is distinctly Hemingway-ish: “there is not a number, but gradually and then suddenly” there is a problem. To be continued.”



As Good As It Gets? The Meme.

MAY 2018 — I love our last letter and I would encourage you to go to the CSC website and re-read it. Or don't and therefore what follows will seem fresh and interesting.

While Buffett—in his most recent shareholder letter--was talking about the world of private equity, his sentiment can be equally applied to the public markets: "prices for decent, but far from spectacular, businesses hit an all-time high. Indeed, price seemed almost irrelevant to an army of optimistic purchasers."

We agree with the narrative, and we wish we had registered the "As Good As It Gets?" meme. But despite our acknowledgement that there is no shortage of things that bug us about the world, nonetheless we find ourselves for the first time pretty much fully invested in accounts that want us to be fully invested.

Yes, that statement might be a nice anecdotal "top" with which to pound us in 18 months if the market craters, but it also reflects a bottom-up set of movements that seems to be the result of the return of "normal" volatility relative to calendar year 2017, which was absurdly abnormal as far as its lack of volatility. Specifically, we have seen a widening spread between "things that are working and doing well" and equities which have a few scabs or scars. And that leads to theoretical investment opportunity if we are correct in properly identifying scabs as temporary wounds versus scars that indeed represent secular problems.

We have also been "sizing up" certain positions as a natural response to the idea that we cannot find a lot that we like, but we are starting to like certain things a lot more on a relative and absolute basis. These choices have been more focused on companies which fall more to what we call the "Buffett group," stocks that we gingerly and quietly ask to go down so we can buy more.

Aside from the normal zig and zag, and bottom-up work, we remain centered on three big things. (There is a fourth but we tend to ignore him.)

Valuation en masse across many asset classes remains historically inflated by almost any measure, stemming from a sustained period of near zero interest rates.

We are arguably (as we continue to argue) at a generational inflection point in inflation and interest rates, and recent numbers on wages and unemployment, and the giddy deployment of lower tax rates begin to more forcefully make their way into government statistics. Inflation, however measured, was north of 2% in the last batch of statistics. Earnings report after earnings report note the need to raise prices to offset a cornucopia of pressures. Wages are going up both legislatively as well as in the private market – the Wall Street Journal notes that certain cities are paying people to move there and work. Tariffs and quotas of some sort and in some form have been passed or are in motion. The Feds are expected to borrow 4.2% of GDP next year according to the CBO, the most since the end of World War II in 1945, after adjusting net issuance for the Fed's "QT" Treasury sales (the Bernanke era would have seen greater growth in public debt relative to GDP were it not for the Fed's asset purchases).

A brief paragraph from Grant's Interest Observer asks, "Does the uptick in measured inflation and the fast-deteriorating fiscal picture portend a higher interest rate regime?" And answers: "not necessarily, we can infer from the work of Paul Schmelzing, history professor of Harvard University and visiting scholar at the Bank of England. Schmelzing conducted an analysis of the sovereign bond market going back to the 13th century, specifically utilizing the so-called risk free rate cobbled together from the world's most credit-worthy borrower in each era. As documented in the November 17, 2017 edition of Grant's, Schmelzing "concludes that fiscal deficits don't matter, at least not in the setting of bond yields [and] that the average real rate of interest since the year 1311 stands at 4.78%."

That would be a 6.7% ten-year bond, an outcome I can assure you would be a problem for stocks. As always, see Hoisingtonmgt.com for the devastating counterpoint argument.

Further, we are seeing a distinct change in policy at the Federal Reserve—and other global central banks—from one of quantitative easing toward one of shrinkage. Seinfeld jokes aside, this remains an experiment that has never been conducted and one cannot help but stare at the statement, "if quantitative easing was so good at raising asset prices, what can one conclude if it goes in reverse?" On a related note, I believe for the first time in my generation the Federal Reserve is not being run by an academic but a lawyer and investment banker who has been on record numerous times about the dangers of the "Fed Put" and "moral hazards". He seems on a gut base to understand that life is not perfect and that people who do dumb things with their own (and others') money will from time to time be punished badly. We will see.

So the question is posed, "at what interest rate does the stock market begin to have a problem?" While a 3% ten-year Treasury yield seems to be tossed about like the Holy Hand Grenade of Monty Python fame, the vague answer is distinctly Hemingway-ish: "there is not a number, but gradually and then suddenly" there is a problem. To be continued.

Arguably more important than the absolute level of interest rates is the availability of credit. Credit spreads remain extraordinarily tight by historical standards, and credit standards remain as low as this writer can recall—even when compared to those at the top of any previous cycle. But, interesting things seem to be happening on the margins. Bloomberg notes that several prominent debt deals, including those by American Greetings and Coty, have faced resistance from investors for the first time in an "anything goes" high yield market, as the pretense of "terms and conditions" has begun to hit a hard spot. This is particularly relevant for so-called "trapdoor" clauses, which enable tricky financiers to sneak assets out of a lender's reach and of course borrow more against them. Who doesn't love Private Equity and their lawyers?!

The topic that naturally follows is, "how can one protect one's capital in more difficult markets?" Cash is certainly one way, but that is not an option that is always available to those who play in the long-only institutional world. And something that we wonder is if enough of the sponsor world thinks about the following: if active management is supposed to prove its worth in a down market and escape the jack-boot suffocation of the passive movement, and yet we are expected to be 100% invested at all times and also not deviate from index returns over the short-run, then...I think you see my point. Doing something far less stupid than what is currently popular or highly represented in the index on the basis of past performance will help to some degree, but one can assume that if the money that has poured into passive decides to pour out, there are not many stock symbols without the CASH moniker that will help much in the short-run.

To pull Ben Graham down from the shelf one more time, "the risk of paying too high a price for good quality stocks—while a real one—is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low quality securities at times of favorable business conditions." So we are being careful.

And so what is a quality business? "The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you must have a prayer session before raising the price by 10 percent, then you've got a terrible business." So says Mr. Buffett. Our observation is that an entire generation of business executives has seen decades of prices generally going down and thus a critical variable to success was cost-cutting and holding pricing to less than the decline in costs. That game appears to be over and the ability to raise prices is something that in our view (and Mr. Bezos'?) remains "aspirational" at this juncture. To wit, from a recent earnings call:

> "...we had several competitors in certain segments that were slow to the party that made it a little slower and tougher. Clearly, over the last 90 days, and if you follow our competitors' calls—as we listened to them just like you do—people certainly have begun to recognize that you know it's paramount to be protecting their business and raising price. So definitely more disciplined over the last couple of months, not only by large multi-nationals, but in many cases...we have good local competitors as well. And I think it's finally worked its way through the supply chain where people who might have been trying to take advantage of short-term share graph that kind of stuff...we're seeing less of that."

We would also throw into the good business mix the question, "Would anyone give a %*$# if they went away tomorrow?" That question has kept us out of a lot of retail mistakes but has buried us in some impressively long and unprofitable investments in things such as Avid Technology and Wesco Aircraft. This matters in a world with more volatility, because you must truly understand the nature of what you own when the price is going against you, or risk either a terrible mistake or just jerking yourself and your clients around by buying high and selling low on the whims of the week.

A good investment process captures "the known unknowns" and then establishes positions based on the best decision possible, risk-weighted. Good asset allocation takes into account the "Swans of Unknowability" and for the small group of accounts we have that ask for our opinion, we are defensive. But for the rest, sometimes there is no amount of work to be done that substitutes for the passage of time. In other words, "we will see." The fiendishly simple task is to buy securities whose prices already discount a very well-known probability of lack of success, and thus we pay little for the "what if something good happens?" scenario. We have a boatload of positions that annoyingly check this box, and to date, not enough "something good" has happened. And when it doesn't happen, results flatline and that is pretty much where we stand year to date. (And frankly over last 18 months as well.) Nothing awful, but little to distinguish ourselves.

Yet.

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