COVE STREET CAPITAL

The Old Normal

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JANUARY 2019 — The beauty of having a Cove Street blog is that you can flog your thoughts all the time and not be tied to the quarterly rat race. On the other hand, you can also get very busy and involved with investing and not write at all. And frankly, I was tired of saying the same damn thing...as in "I am not sure why what we own is not moving and why so much that is silly is ripping." Subconsciously invoking my inner Lincoln, it seemed better to remain silent and be thought a further fool than to speak out and remove all doubt.

But clearly some things have changed in a big way in the back half of the year, including our relative performance, notably in small cap. More succinctly, the perception of risk has moved from a Star Trek-esque distance probability to something more tangible and current. Which, again, is how it usually is: gradually and then suddenly things change. Us? Not so much. The mixed metaphor du jour for clients has been: when you are standing on your tippy toes on a 10-foot ladder, it doesn't take much of a push to knock you down and the fall could be very unpleasant. But when you tend to buy pancakes, there is simply less distance to the ground—although we are familiar with the mathematical concept that no matter how much a stock is down, it can still go down another 50%. It remains a universal mystery as to why some stocks move on the week of September 14th versus the third Thursday of October, and thus we endeavor not to pay much attention to the short-run, no matter how much it seems to mock us. Over the year, we simply bought more of what hadn't moved, resisted temptations to create activity for activity's sake, and fortunately enough "other people" came around to our viewpoint and bid some of our larger positions up. Not all of them, but enough.

A couple of other things have helped both absolutely and relatively. We have had three takeovers at premiums that were to our liking, for the most part. And we have maintained a distinct "no" posture toward small and mid-cap banks that was quite unhelpful for most of the post Trump election era. As any small cap value manager understands, the comparative benchmarks have a huge weighting of financials. But one thing you learn over 35 years is not to compound missing "something" early by doing something stupid late. Non-money center banks are, to a large degree, levered bets on undiversified commercial real estate, and a number choose to grow by diversifying badly outside of their core geographical competence—see Bank OZK. Oh, and a flat yield curve, legitimate secular disintermediation through technology, the high probability of current over-earning due to minimal reserving and the ever-present jack-booted thug of financial regulation. We can…and will do better. Unless they continue to do worse and we will tiptoe for a look at some point.

As is becoming needless to say, credit conditions are the thing to watch in 2019. LIBOR rates going up 150 basis points is not the driving factor in the creation of miserable environments—losing access to credit is what really hurts. We abstain from interest rate forecasting other than to reiterate that we continue to believe the bottom was made in the summer of 2016 and rates will move irregularly higher over a long time. But we have seen credit spreads widen, we have recently seen deals changed or dropped at the last minute on both sides of the ocean, and we have seen the first peeps of protest at what has arguably been the most lenient and largest availability of credit offered to some of the shrewdest and most undeserving people in the history of financial markets. The willingness to extend credit is a fickle thing and difficult to model. And it is another "thing" that tends to change gradually—and then hard—all of a sudden. The tide will go (or maybe is going) out one day. One can and should be wary of areas and entities that have definitely benefitted from nearly free credit for a lot longer than at least we would have thought. And guess what Mr. CFO: somehow the market "knows" you need to finance or refinance in some upcoming timeframe, and that there is no 11th commandment that says the credit window will be open when you need it. You know who you are, we know who you are, and we should all know better.

It has taken only the specter of credit problems in the last month to truly crush any variety of cyclical stocks with some leverage, thus creating some interesting things to chew on now. We operate on the basis that posting on Facebook has not eliminated the concept of a business cycle, and we have had a big and favorable economic cycle for a long time. While no one calls tops and bottoms consistently, it pays to think about generally where one stands in a cycle, and we certainly ain't at the bottom of one. As value investors, we have often dismissed macro as something that doesn't matter "a lot" as it relates to our Buffett and Graham paradigm and our focus on Business, Value, and People. But we are acutely aware that we have spent much of the last 9 years with generally decent macro, and the unprecedented benefit of lower rates and low cost of capital. And thus it is not easy to stand in the mirror and say "bad macro" won't matter. And bad macro once again has proven itself to be independent of political party.

Oddly, we could use some economic slowing and lessening inflation pressures. Lest anyone forget, the US economy under-grew for 8 years in a policy world of flat to lower rates and last I checked the stock market put up some very reasonable numbers. So it can be argued that knocking some fairy valuation dust off stocks deemed cyclical is not an end of the world scenario. But cyclical stocks are hard, because cycles are hard. They look statistically inexpensive just when they really are expensive and buying them after a fundamental crushing is a gender-neutral difficult mental process. We now have a nice laundry list of what might be characterized as "growth cyclicals" that we have accumulated over time. We have estimates of value for these names and we will step up when they get there. And then, most likely we will be 20% early.

Interestingly, something to note that is different now than in any number of other cycles (because every cycle is different) is that there is a LOT that was and still looks expensive to any time period except that of three months ago. In periods like 2000, there was a lot that was silly and a lot that was legitimately inexpensive and out of favor. Median valuation levels are higher than capitalization weighted levels in both large and small cap indices. The "traditional defensive" companies—Consumer Staples and Utilities—are neither cheap nor seem defensive given the "new world" of direct selling (i.e. Amazon, private label, distribution changes). And owning the 8 large cap tech stocks held by every hedge fund and stocked in every index and ETF known to man is not a defensive strategy, as recently demonstrated. All and all, it has been a fairly solid and systemic crush in the fourth quarter with little escape.

But…cue music…stocks fluctuate. And they do so well in excess of their underlying fundamentals. Not surprisingly this is because of people and their behavioral problems—and the often dysfunctional environment in which they work and for whom they work. For reasons that must originate in the deep, reptilian origins of man's conscious/self-conscious internal babble—because I remain dazedly confused as to why—stocks remain ensconced as Giffen Goods in that they are more highly prized when they are priced high, and they take on scales and sulfurous qualities when they drop. This is the old normal and it is what one should expect a lot more of in the years to come. And to restate the painfully obvious, a "Value Restoration Project" like the one we are now at least partially in, is good—to a point of course—for the long-term investor.

Greed is changing to fear, and opportunities are being created for future gains. While not in any way immune to near-term pain, we are reasonably positioned to profit from it over the longer run. (We would be even better positioned if those of you who have "diligenced us" for years stepped to the plate with fresh cash.) The easiest "edge" for any investor is the time arbitrage of accepting other people's near-term fear and investing with a long-term time horizon.

We would suggest that the time to worry about a fundamental downturn is when things are going great. When a stock goes from $55 to $23, someone else has done a lot of worrying for you and that's when it pays to start looking. Headlines declaring that a stock or market is in a "bear market"—mysteriously defined by someone probably long dead, or if not, something that should be immediately put out to intellectual pasture—is arguably the dumbest idea that "finance" can come up with. Why does "down 20%" constitute something important? Annoying and unwanted for sure, but completely irrelevant. If anything—it is probably a clue to start looking at a stock, not the beginning of the time to start worrying.

"To be a successful investor, at minimum, you have to survive. Surviving on the good day is not the issue. You have to be able to survive the bad days. The idea of surviving on average is not sufficient. You have to be able to survive on the worst days, so you have to adjust your portfolio so as to limit the risk so that you can survive on the worst of days…If you do not have conviction and you give up on the bad days, then, by definition, you do not participate in the subsequent recovery."

That Howard Marks-ism is both an investment philosophy and process, and not a bad credo for an investment firm itself. As we are half-way through our 8th year as a firm and my personal 35th year as an employed investment person, I will note the following:

1. While money is the outcome of being right as an investor, if you do it solely for the money you will not last or be successful for your clients. (That does not preclude you from being highly successful for yourself in the short-run–cue hedge fund music.) This should be highly absorbing and fascinating work…borderline fun.

2. We have endeavored to be as transparent and straightforward as humanly possible. I have found this combination to innately limit our potential client base, but it has/should prove(d) to attract the "right" clients.

3. The firm is Cove Street Capital—not Bronchick Enterprises. There are people here who think they can do this better than me. I share that opinion two days a week, though I will never tell. You should get to know them.

4. We punch way above our weight in all things not investing—compliance, operations, trading and technology—for our firm our size. I am thankful to be cocooned by them.

Going forward, here is what you won't see from us. You will not see public expressions of moral anguish as we close down a multi-billion hedge fund and state, "In previous periods, weakness created opportunities but as we survey the outlook for 2019, we are concerned that we don't see those opportunities," XXX wrote in the letter. "Both the political and economic outlooks remain confused and without clear direction."

Really? The future is always highly visible to you and no one else and thus you can put on investments with clarity? But today we woke up and found it confusing? Oh…you forgot to mention in the letter, but Bloomberg was kind enough to note in the last paragraph of its piece, that the fund was down 42% through November in a "Global Balanced Fund." It is perfectly reasonable to say you have had enough of billing at "2 and 20" and the yacht is now finished. But to quote Fitzgerald, "it takes genius to whine appealingly."

It will also be unlikely to see from us elegant solutions to the world's uncertainties in regard to Federal Reserve policy, trade wars, the direction of oil prices, Chinese economic conditions, the Middle East, Brazilian currency issues or myriad of domestic political weirdness.

The future remains uncertain. What we will reiterate is an interesting value proposition, pun intended. Thoughtful and active value investing is evergreen, and the less people professing to do it, the better the returns will inure for those who remain. The lower your cost basis, the better your returns will be going forward—new money is rewarded. The fewer the sell-side firms and the larger the size of asset managers, the more opportunities abound in the small cap space. Idiotic compliance rules like "we will not even custody stocks with a market cap less than $300mm" further enhances the opportunity set. Asset management industry consolidation means larger asset pools—which is simply death in the small cap performance derby and continued opportunities for us.

Naturally, we have to execute for you. What you will see from us is something that rhymes with what you have seen in the past: a focus on carefully researched investment ideas; better combinations of Business, Value, and People; people working very hard to make fewer mistakes; and thoughtful patience. It remains a very simple process: work tirelessly to position yourself to "see" the good idea, have the intellectual and financial fortitude to buy as much of it as you can prudently stomach….and then just be right. Our goal remains simple: delight clients, have fun, make people money.

Our best in 2019 to you, and your family and friends from everyone at Cove Street Capital.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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