COVE STREET CAPITAL

# Big House, Small Doors?

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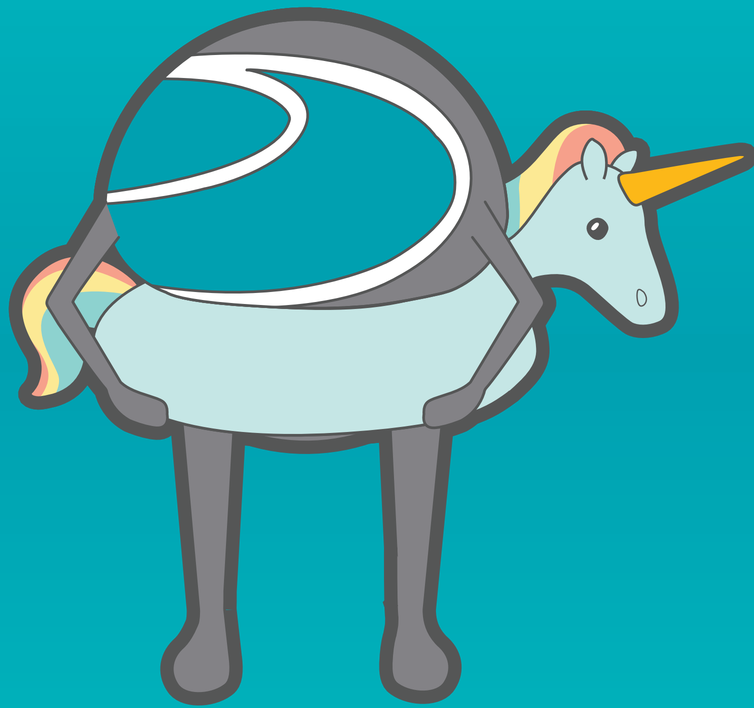

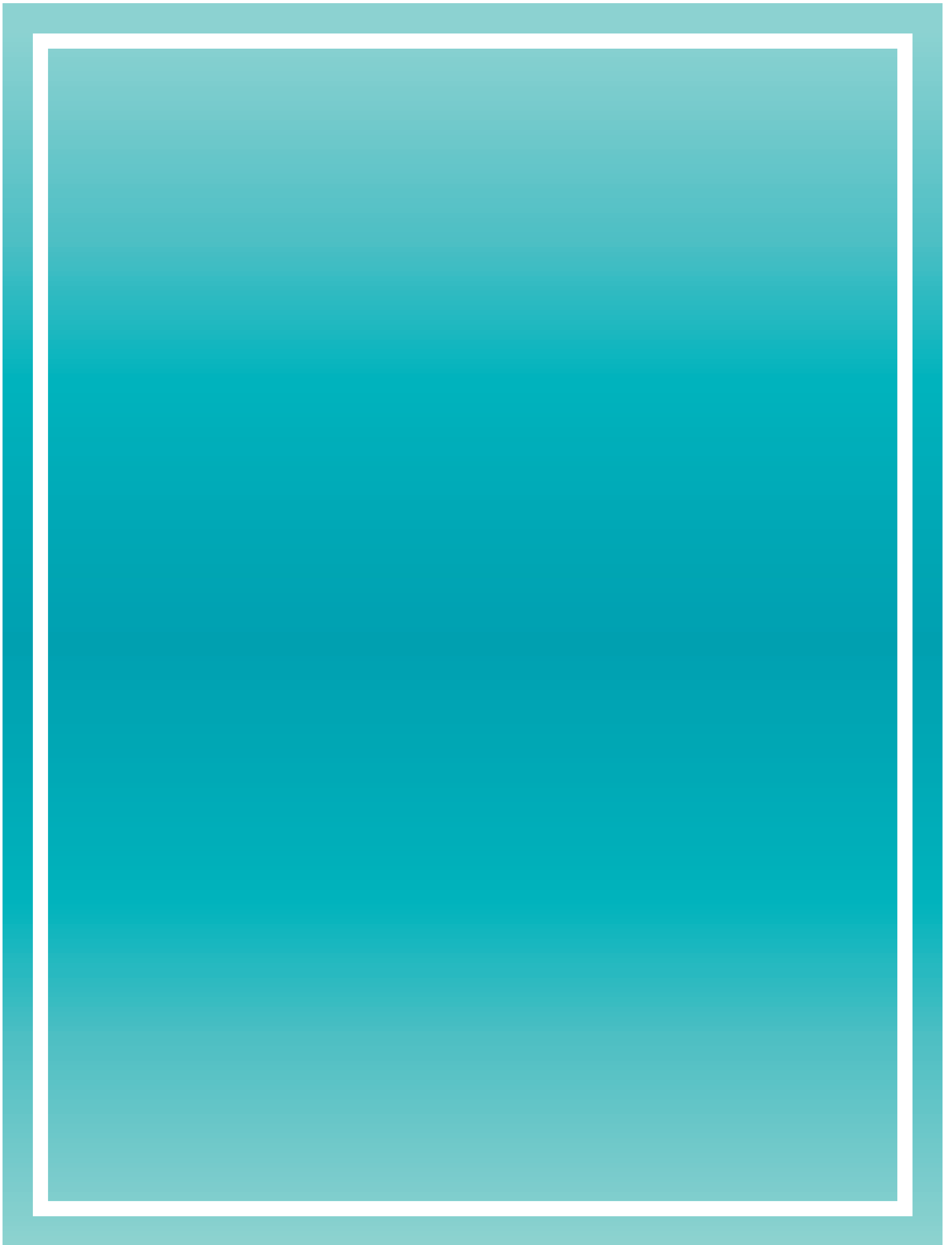

# Big House, Small Doors?



JULY 2019 — Since the investment "industry" remains a place where financial history goes to die, we thought we would properly attribute the aphorism "Don't Fight the Fed" to the late Marty Zweig, who some of a certain age would recall as the "the guy who called the 1987 crash." He also coined "Don't Fight the Tape," which is the caveman version of the academic literature behind the momentum factor.

Regardless, regular readers know where we are going with this. The drop in the 10-year Treasury from the 2.50s in April to its present perch of 2.03% as of this writing is pretty much all it takes to drive all other asset classes higher, as we have seen again. We managed to put together another excellent relative and absolute quarter in our Small Cap portfolios despite "everyone else" catching up in the last few months. Our All Cap strategy is presently unable to escape the fact that relatively little in large cap value is doing well enough to keep up. Labels, timing, interim suffering. In the former, we are leaning into winners. In the latter, we are leaning into what hasn't moved.

While we might feel a bit sheepish about beating the dead horse after the year at Santa Anita, the fact remains that the implications of the current state and duration of near zero interest rates is the single largest elephant to consider as a long-term investor. All of this has been said before, but since nobody listened the first time, it must be said again. Thank you Andre Gide. Whether you are referencing the mammoth increase in capital allocation toward "private equity" (which is simply a leverage and credit game rather than some superior form of investing), the idiocy of what is being funded at what value in Silicon Valley or simply the knee-jerk reaction of gold and bitcoin to a probabilistic bet that the Federal Reserve will heel under Twitter, lower rates remain the underpinning of a lot of obvious and not so obvious financial activity. Throw in the massive securities purchasing by central banks across the world and you have the uncharted territory of $12 trillion of sovereign bonds with negative yields and corporate borrowing just behind it. I ask you, good citizen of the world, what human endeavor, short of self-amputation, cannot be justified with a negative interest rate hurdle?

To wit, let's take the German 10-year Bund at a negative 0.33% yield. When it comes to positive yielding bonds, if you assume there will not be a third World War involving Germany with an associated 1000% pre-war inflation, then no matter what interest rates do, you are eventually going to recoup the capital you have laid out at maturity—at least on a nominal basis. It's just a time game and somewhere around the 7th year, you will mathematically recoup your capital as your reinvestment rates on interest received increase. There is a few thousand years of history to support those statements. Now, what the heck is a negative yielding asset? There is NO time horizon by which you will recoup your capital because, if you hold to maturity, you are guaranteed to lose capital. Your only argument is that you will lose less than the alternative bad ideas you are being pitched—like Theranos. Or WeWork.

As noted recently in the Financial Times, *"Investors have continued to pile into negative-yielding government debt*

*even though it locks in nominal losses over periods of a decade or more."* And quoting a named portfolio manager whom I cannot name here based on my basic sense of decency, "*many Eurozone bonds looked like good value compared with even more deeply negative interest rates on excess cash deposited at the ECB, unlike in the US where longer-term yields have dropped below short-term interest rates. Twelve months ago people were talking about interest rates starting to move higher. It now seems as if everyone has given up. No one is expecting rates to go above zero on a five-year view."*

So all risk and no reward is the world of fixed income, unless your world is simply about an arbitrage with an actual or quasi-sovereign entity. At least in equities, you have X probability of upside. Which again brings up our point endlessly repeated here – why are we utterly complacent as a world and somehow allow a small group of unelected officials at institutions with awful track records to set interest rates on trillions of dollars versus letting the market set them? (Note to self: watch middle-age crankiness creep.)



What makes all of this more odd is that it can't be studied. There is a future with a resolution but there is no way to outwork or out-think your fellow investor. Negative rates are a topic upon which anyone can opine. Baseless opining, as we all too well know, is fun with alcohol, but it carries with it unlimited capacity which nonetheless seems to fill itself. We are officially in the longest US economic expansion since 1854 (when they started counting such things in earnest) and yet the US Federal Reserve signaled that it was leaning towards lowering rates due to "uncertainties" in the economic outlook and muted inflation. We conclude that these bizarre circumstances have produced a world of credit, leverage, and nonsense that will prove dangerous at some point in someone's life. To throw in the obligatory, and likely last generational reference of this Ben Graham paraphrase, it is not necessary to know a women's exact age to guess whether she can vote, nor do you need to know a man's exact weight to guess that he is overweight.

One other large risk that we would highlight has indeed been on slow simmer for quite some time. The issue is liquidity, the most ephemeral of friends. But, let's not forget the wisdom of the aforementioned Zweig, Citibank's Chuck Prince, and Jim Cramer. You can imagine them asking: "So what? None of this seems to matter right now." The Financial Times has done a number of fascinating and frightening pieces in regard to specific investment managers who either deliberately hid the actual illiquidity of their fund holdings and/or fooled themselves into thinking that backward looking measures of risk and liquidity would be relevant. It's like the HBO mini-series on Chernobyl, where hitting the AZ-5 button completely shuts down the reactor, unless of course nine other things haven't quietly gone wrong behind the scenes.

Modern finance and the "sophistication" of the institutional money management industry—and the regulatory bodies that watch it—have demanded the functional equivalent of the AZ-5. Compliance teams, risk models, the SEC, Morningstar, and the consultant community all ensure that things go according to a well-documented plan. But the history of mankind and PhD concocted schemes and models suggests things don't always go according to plan.

Pulling from a variety of FT pieces, first we have investment manager GAM, which suspended its star bond manager Tim Haywood for what still reads as a hazy transgression, and then had to close his funds for redemptions after the stampede of demands for the return of funds and a suspension of liquidity. The FT also called out Neil Woodford, a UK money management legend, for having a variety of illiquid positions. That led to a lovely avalanche of redemption requests which of course cascaded into the gate closing for investors and the usual round of recriminations. Now on the hunt, the FT then took a shot at the holdings of the H2O investment managers' Allegro fund at Natixis, producing the predictable panic of outflow and a multi-billion dollar drop in Natixis market cap. Dutifully, Morningstar lowered its rating AFTER the fact.

We spend a lot of time on these issues because we are a small cap manager. While taking advantage of other people's fear of illiquidity is a long-term performance driver, like chocolate and every other good idea one runs into, there is an inflection point at which the marginal utility of goodness not only decreases but also goes negative. We try to minimize the size of the bucket of our illiquid names and gate the portfolio from additions to this bucket until the current holdings are "resolved." We have only one Paul Hinkle as our client-facing partner as an attempt to more carefully choose our partners who understand the mission. We also invest in publicly traded securities which at least have a "screen" bid versus who knows what nonsense goes on within the quarter-end valuation comedy show in private equity.

But nothing is perfect, and things and people change. We can argue that ten years of near-zero interest rates have led the investment community into a "desperate" search for yield and return in increasingly illiquid assets. We would suggest that our industry is living in a much bigger financial house with much smaller doors than many realize.

We can argue that the massive move into passive investment vehicles is eliminating the swing buyer of securities who traditionally could take a contrary view to the mess du jour. We can argue that regulatory changes and intense investor dislike for capital markets activities (see our go-nowhere position in Jefferies) means a historically important risk buffer for liquidity seekers is gone. Take a look at recent behavior in Q4 2018 to see how quickly things change and how quickly portfolio "marks" are inflicted at the merest hint of 3.5% Treasury bonds or a Tweet. All these ideas and examples represent opportunities if you have the capital, if you are prepared before the event so you can keep your head and be greedy when others are fearful, and lastly, if

your firm has the culture and intellectual stamina to step up—carefully—to take advantage of the gifts before you. Cue the music: that's us!

So we have turned "cheerfully bearish," a position you take when you are so sick of hearing CEOs say they are around "cautiously" optimistic. We recommend careful asset allocation, and there is nothing wrong with an asset, at least in the US and at least for now, that has a plus sign in front of its yield. Our attention has been driven to more economically sensitive companies as that is where the fear and uncertainty still percolate.

We are long what are apparently the two biggest contrarian bets on Wall Street: Active Management and Value. As Irving Janis noted, "The more amiability and esprit de corps there is among the members of a policy-making group, the greater the danger that independent critical thinking will be replaced by groupthink, which is likely to result in irrational and dehumanizing actions directed against outgroups." Who is having more fun than a group of PE guys on G5s discussing the need to limit the size of their new PE Fund to $25 billion? Who is losing assets faster than value managers? (FYI: the only real assets we have lost have been from a handful of clients who gave us the "high five, great year, now we are rebalancing.") I will take the bet that we will make more money for you in returns, but take less money from you in fees than the aforementioned group. And yet which group of managers is under fee pressure? If you complain that active management doesn't work because managers are greedy and run too many assets in a closet index fashion, then how is the solution to demand near-zero fees in a manner that effectively eliminates an entire class of asset managers who have committed to limit asset size and do fundamental work—preconditions to the success you are looking for in the first place?

The great paradox of the Efficient Market Hypothesis—EMH—is that it requires a lot of people NOT to believe in it. It works if there are enough people left still doing fundamental work and trying to beat the market to make stocks somewhat efficient. Then you simply index a somewhat efficient pool of securities. Passive investing en masse leads to fewer people paying attention and that in itself creates mispriced securities to which you are then tethered in the index. You are welcome.

In closing, if there is one thing that seems to be missing from the toolkit of "many" in the finance business and certainly in the academic finance/policy maker world (and doubly certain in the political world), it is any sense of financial history regarding how things work and why we have gotten here today. I give up on trying to make people read. But one Daniel Peris' *Getting Back to Business* is a recent book by a Russian History Professor turned money manager that offers a nice and readable history lesson of how "we" got here today. It's worth reading if you don't know your investment history, particularly if you are coming from the client side. It is something to do with your feet in the sand this summer.

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