Fitzgerald, Goethe, Value

OCTOBER 2019 — In the midst of a pretty solid year-to-date for financial markets in general, and Cove Street small cap performance at large, we thought we would riff somewhat on topics that come to us as we chat with clients and their advisors, host C-level meetings with companies we own (or just watch for now), and review the musings of our ever shrinking peer group.

Let's start with the long deceased equine of "value management" at large, small-cap in particular, and offer up a preview of the upcoming "Cove Street Capital, a User's Guide." Many readers are at least kissing cousins to the fact that, roughly speaking and depending upon your day of measurement, "value" as a generic investment practice has underperformed by about 400 basis points (annualized) as of this writing since 2007. This relative futility translates into some pretty hard cash in the form of a 236% cumulative gain versus merely 115%[i]. That's real money that gets spent by clients, not just numbers stuck in an investment manager's relative performance presentation. Since mid-2017, it has even gotten worse: roughly 1500 basis points of difference between growth and value as measured by the S&P 500 Index.

Reasons why? The answer is naturally multivariate and we sum up here with these culls:

"Commoditization of smart beta has led to factor crowding and this has eroded the value premium."

Or, "fundamentals have truly changed that are enabling monopoly-esque growth companies to be inherently more competitive and sustaining, putting what might be considered "value companies" at a structural disadvantage."

Or, "…as more funds flow into passive or slightly active funds, the trading prices of their portfolio companies become ever more predominantly driven by the most active, most short-term, traders in the market. This, and the decrease in true liquidity resulting from more cash flowing to passive funds, adds not only to volatility, but also to the potentially greater disconnect between the views on portfolio companies as expressed by the market (i.e., the trading price) and the largely unexpressed views of the bulk of the remaining stockholders. In effect, the trading price may mean increasingly less about the long-term prospects of a company, and more about the short term prospects for a trading gain or loss, causing further misalignment between long-term holders and stock prices."

Or, "nothing has changed; this is just one really long and painful cycle that has been sustained by uncharted and unsustainable monetary policy and thus we repeat Ben Graham's paraphrase of Horace: *multa renascentur quae iam cecidere, cadentque quae nunc sunt in honore vocabula, (si volet usus, quem penes arbitrium est et ius et norma loquendi.)"*

We would argue for all the above to some degree. But, like most things in life, that is not a neat answer tied in a bow to deliver a few billion in new assets. To wit, in mid-September there was an odd week in which the value/growth performance dynamic had its biggest short-term reversal in measured history, and a Jefferies strategist (which recently became a former holdings for a number of unrelated reasons) breathlessly noted that $8 billion of new assets flowed into small cap stocks.

A fat finger in a world of trading minutiae? A legitimate canary in a coal mine? The dawning realization that crap like WeWork is the spawn of Theranos and much truly does stink in the world of what passes for Growth or Private Equity Orthodoxy? Difficult to say of course, but our point is that neither our phone did ring, nor our text beepeth.

Which brings us to...us. Since I was not on the proper side of the table recently to discuss how to best implement $8 billion in new client assets to effect take-private transactions, or buy my peer's stake of a 4-year-old take private deal, I thought I might give one viewpoint on how best to work with Cove Street. The historical argument might be as follows: we should give money to a small group of people with skin in the game, who diligently employ fundamental value principles in a concentrated portfolio format and who have achieved double digit returns over twenty years. This is called "playing the long-term alpha game" and in no way can be confused with playing the "beta game" and hiding out in modestly-weighted versions of an index that also has the benefit of absorbing billions more in assets. We know you are out there.

The primary argument against this seemingly simple idea is best summed by the technical financial term, "lumpy." We get it—we have 31 stocks, that pesky Russell index has 2000. I can assure you that there will be times when we look unusually different—and from time to time short-term results might suggest a really big mistake has been made in hiring us. (And that's when you *should* double up.) We of course argue that if you are complaining that active managers are often not active and thus are overcharging for index results, then a priori, you must accept the "lumpy," as it verges on fantasy to highly correlate with an index and at the same time beat it handily, net of fees. No lunch or a lumpy lunch.

Here is our solution. Index 70% of the total allocation and give us 30%. You net lower your fees, you eliminate the inevitable whining about us when we look dumb for 18 months as you gain some "beta at the right price," and you have the satisfaction of actually hiring a firm built for the challenge of generating performance and actively practicing active management. Even better, we are more than willing to commit to a performance-based fee structure, despite its rarity in long-only worlds. We are also positioned for an LP structure, if transparency and daily pricing are not critical variables.

This also solves for something we have always been willing to say: "we are not the fund flow guys." While we like a tailwind of asset flow as much as does the next sufferer, we are not the perfect "play" to capture a growth versus value trade for three months. We make people happy when enough of our top ten positions are in valuation realization mode and often that has little to do with fund flows and more with the specific and often eclectic self-help reasons at work. While we have "factors" running through holdings, stuff like satellite launches, rising interest rates, wet and cold winters, the cessation of Swedish interference, and some acknowledgement of the legitimately long tail of broadcast media are a lot more important to us than is the 9th strategist at JP Morgan advocating small cap value for the first time since 2009. Not that it would hurt!

To be fair, let's discuss when to fire us. Here is a quick list: we blow through the asset size we told you was optimum for our strategy; we have people leaving in droves; the Founder has a second wife, a third home, a plane and is in the opening band for the final Rolling Stones tour; we sold a majority stake in the firm; and/or we walk into your office with 76 stocks in the portfolio. Any combination I would suggest is a sign that something is different here. The worst reason to fire us is that we have done the job on both an absolute and relative basis for 20 years but, what the heck happened on a relative basis in the 18 months ending June 30th 2018? And you also know who you are.

We argue that in a world of silly, value investing is an antidote. In a world where investing firms are legitimately going away—or are about to—we are a firm that has staying power. In a world where competing groups of the world's smartest people are raising the largest funds in history to pay the highest multiples in history with the most lenient credit profiles in history, nosing around for a handful of good businesses at reasonable prices amidst the abandonment of 2500 or so investable small cap public assets is arguably a legitimate idea. Especially when you consider that 81% of 2018 IPOs are showing GAAP income losses, a trend which is certainly no different year to date in 2019. Throwing in another Graham quote, "Weighing the evidence objectively, the intelligent investor should conclude that IPO does not stand only for "initial public offering." More accurately, it is also shorthand for:
It's Probably Overpriced; Imaginary Profits Only;
Insiders' Private Opportunity; or Idiotic,
Preposterous, and Outrageous.

The temptation to do today what one should have done four years ago is overwhelming. And yet, are we *actually* seeing quiet signs that the zeal for subsidizing losses for the suggestion of future value is reaching end of cycle? That what was achievable over the past decade with this strategy is simply insanely expensive and mostly unachievable over the next decade? And that this may slowly be reflected in financial markets?

All of this brings us to Fitzgerald's famous and very relevant quote on cognitive dissonance. We see a fair amount of things in which to invest and we cite the issues above. We are "leaning" into better pockets of cyclicality fear, but are wary of burying ourselves upon the first down-tick. We have picked around a few non-US companies that trade here in sufficient volume, as the math is pretty clear that having 90% of your bond market trading at negative interest rates surprisingly has not been as much of a boost for equities as one would think.

But, the world at large remains just plain weird to us. If financial markets have to rely on the Federal Reserve to maintain orderly REPO markets for the most creditworthy asset in the most liquid market in the world in an excellent economy, just what the heck might happen if things became a disorderly mess? Most financial messes seem to come from a combination of over-valuation, leverage and crowding, a mix that seems to explain a lot of what we see in the world in which we live. When might we have a problem? It is often noted that credit problems happen for companies or countries slowly, but investors seem to recognize it seemingly overnight, or in the case of the par-buying investors in 100-year Argentinian debt, about 18 months later.

Said another way, we remain cheerfully bearish. We lean into specific opportunities regardless of the nonsense headlines du jour, and that is the way we have found to add value. But as Goethe noted, *Der Worte sind genug gewechselt, lasst mich auch endlich Taten sehn!* "Enough words have been exchanged; now at last let me see some deeds!"

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[i] Data reflects the S&P 500 Index.