Repetition Can Be a Form of Change

JANUARY 2020 — While I will cop to a mildly obnoxious habit of introducing references that almost always require an internet search, I will start this year-end letter off on the right foot by noting that the title refers to an Oblique Strategy Card by musician/producer Brian Eno and his artist collaborator, the late Peter Schmidt. Whether or not they would be amused or aghast that their creative game process is directly applicable to the financial world today is uncertain.

Despite Sauron and Einstein's failed attempts at unified theory, 2019 was simply the tenth year whereby interest rates were low and went lower, credit remained both cheap and plentiful, the economy was "good enough," and those who can print money re-dedicated themselves to a willingness to print money. The logical conclusion to this set of events is to buy and hold U.S. equities. Drop the mic—again.

Nothing "real" has changed in ten years despite all our collective work and consternation about this and that. While "Macro Investing" is a concept that has historically been a mess of practical application as far as getting it right, really good "Macro" is just beautiful simplicity to behold in the golden light of the aftermath.

And on September 20th, the Federal Reserve once again stepped up to the plate and committed to what is literally hundreds of billions of dollars of nightly support to the "repo market." For those not playing inside baseball, that is equivalent to a massive commitment to the highest quality indoor plumbing: it makes everyone happy, it smells great, and it produces wonderful year-end melt-ups in equity prices.

Quick performance note here because no matter how eloquent and thoughtful we can be, we know that the reader is always thinking, "great, but how did they do?" Spoiler—we had an excellent year relatively and absolutely in small cap, and less so in adjacent strategies where more conservatism was once again not in any way rewarded.

So we posit that until interest rates change, credit conditions change, and Elizabeth Warren/Bernie Sanders get elected, "things" aren't actually changing so fast, and despite our sense of history that something bad always happens to expensive markets, it's just hard to accurately spreadsheet and PowerPoint what it will be. While something that cannot go on forever eventually won't, things involving uncertainty, the future, and human nature can go on a lot longer than YOU have the capacity to imagine. We gave up trying about four years ago when we said almost exactly the same thing.

But CAUTION remains our operating mantra. While we have expressed—and continue to express—outright disdain for any variety of financial practices that seem very "top-like" in the world today, within our niche that we operate for most of our clients, we are judged on a relative basis and we have carefully been dancing with the "proper" dates. Fortunately, we had enough of our largest positions working a little harder this calendar year to compensate for the "mistake" with which we began the year—too much cash and "too conservative" in stock positioning. And while we can—and will—populate this space with interesting ideas about the future, bigger takeaways for us and maybe you, the reader, will be more related to "what we learned" last year. Avoiding making mistakes that someone else clearly made and therefore should not be made by you, is a solid use of one's mental time.

"80% of life is just showing up," but apparently investors aren't Woody Allen fans either. According to data from Refinitiv Lipper, investors have taken more than $156B out of mutual and exchange-traded funds as we approached year-end, the highest annual figure since the company started collecting data in 1992. This echoes many classic studies that show "investors" often don't earn what the markets are doing because of all those behavioral problems we bring to the game. It remains an interesting concept to ponder at the current moment: can money moving out of public equities be considered an anecdotal and contrarian positive? Or does that matter not a whit given the excesses committed in private markets, venture, and the leverage community?

What we also re-learned last year is just how much we—investors—are out-and-out lied to. I would define lying in the financial sense as something short of fraud but north of "we tried and just didn't hit the numbers," noting that a revision in that definition is possible, as I am not comfortable assessing legal definitions of securities fraud. As has been previously noted in these pages—and regularly reminded both at home and in the office—I am distinctly aware of how "old and cranky" can be a possible behavioral flaw in an investment approach. But having adopted the classic *Money Game* by Adam Smith strategy, we have "thirty-somethings" and now "twenty-somethings" on the investment team, even though their blood tends to run with value. But some of the crap we witnessed in 2019 that was espoused by what was formerly considered to be of "white shoe" reputation was stunning, in my opinion. And *we* don't even get to hear what nonsense pension plans and family offices are being pitched. As Buffett noted earlier this year in Omaha, "We have seen a number of proposals from private equity funds where the returns are really not calculated in a manner that I would regard as honest. If I were running a pension fund, I would be very careful about what was being offered to me." And speaking of Buffett, who badly underperformed last year, when was the last time you heard this much whining about his cash position? (1999 maybe?)

There are the "normalized" generalities of a bull-market cycle in things like "adjusted earnings" and the valuations and debt levels tied to these pronouncements—proof statements to follow sometime in someone's lifetime when the credit tide goes out. Our favorite credit quote of 2019: "I think of triple-C bonds a little bit like the bar scene in Star Wars," says Scott Roberts, head of high yield at Invesco, evoking a port described by one character as a "wretched hive of scum and villainy." Mr. Roberts adds: "Every single one is unique." This has arguably been the greatest and easiest credit cycle in history. When does "what happens next" matter? And on fixed income, is it not weird that people are buying negative yielding bonds with a guaranteed loss of principal and describing it as "safety seeking?"

And I know everyone has a favorite "oilman" joke, but as the small and mid cap energy sector implodes on over-supply and poor economics, the stories coming out of the numerous bankruptcies demonstrate that what "well economics" were pitched to investors versus the reality of what is coming in is...wide. Very wide. (And side note: we think the energy arena is clearly the dog that's not hunting today, but it is fiendishly difficult to invest in small cap equities in the energy space. We are on the case nonetheless.)

I think our position has been clear—and early—about what constitutes "investing." Not included in that definition is the Unicorn Search out of Silicon Valley. Just look at how that has been translating (not well) into the public market for a variety of offerings like Uber (Ticker: UBER) and Slack (Ticker: WORK). But, we will just leave that as a recurring paragraph in our letters. Instead, what we want to focus on involves the white shoes.

Again, I am not a lawyer, but how hordes of people are not going to jail for the attempted IPO of WeWork is simply beyond me. And this is the point: while an IPO process seems like an antiquated concept in today's world, historically it has served a crucial role in investor due diligence. We know that we are being "sold," but in theory we have to imagine there is some sieve that shields us from even worse crap and someone like Goldman would have had to do SOME work prior to filing in order to screen out the most basic "lying" and "misdirection." And that is simply ignoring garden variety differences of opinion on a destined-for-bankruptcy business model.

While I would have initially pointed to Theranos as an OBVIOUS sign of a cycle top (if the market hadn't been up nearly 30% last year), WeWork now shares the billing. Besides the fact that no one is out there doing due diligence on pre-public securities, there is also the incentives reminder. The "they" who was pitching WeWork was really pitching the parent Softbank, whose largesse toward investees and investment bankers in 2019 was arguably unprecedented. Rinse and repeat: you are being sold every single day.

The last specific case to be cited here (and I assure you we can bore you for hours with more) is in regard to "spin-off" math and the accompanying B.S. we are forced to endure and dodge. In the day, large companies seemed to take the time to spin-off unwanted divisions with some sensible structure and presentable financials that could be the basis of future forecasts. And it was/is still a fertile place for investing—magic things can happen as highly incentivized people focus on a business that couldn't get the time of day at Parent Co. and apply competent elbow grease on an appropriate business model.

What we have seen a lot of recently are "grab-bag" businesses saddled with painful "transition service contracts." Either the resident Jeff Spicoli management team is dumped upon it or a team as new to the narrative as we are, that has no business throwing out grand projections that were concocted by the bankers seemingly a week before the roadshow. Honeywell, Resideo (Ticker: REZI, $30 to $12), Goldman Sachs. Again. (And since most third parties seem to enjoy picking apart our mistakes of commission, we would note: you have no idea what we researched and passed on. This was one of them.)

All of this should seem "old" to those who have been plying the trade for a few decades or people who at least have spent the time to read and understand that financial history cannot be absorbed through a series of tweets. And it habitually correlates with environments in which caution should be placed high on the list of priorities.

But, you could have said much of this a year ago, and 2019 was a year to make a lot of money almost indiscriminately. Which leads to us starting a look forward with, "what if something good happened?" This is actually a "process question" which we incorporate into our decision-making. Concrete fears are often easier to articulate and are more intelligently digested among the smart and chattering classes than is a simplistic forecast of "good companies bought at decent prices in what is still the most democratic and capitalist-oriented place in the world will compound at a high single digit rate." And yet, it is the latter group that has the infinitely better long-term track record. And under our internal learning curve, we have implemented an equal focus on "new insight" that is balanced with a traditional focus on avoiding doing really stupid things.

So reverse engineering a solid 2020 for U.S. equity investors, we might have the Trump Administration declare itself "done" and move its twitter focus from trade to almost anything else? The Democrats narrow the field to someone remotely middle of the road? The economy chugs along with enough growth to move corporate earnings forward without spooking the Federal Reserve? Europe and the U.K. put their Brexit nonsense behind them and add a point of GDP growth? China stumbles forward economically without their financial system blowing up and manages to sit on their hands in Hong Kong? U.S. Stocks remain the tallest "height-challenged" asset class in the world? And enough of what we own that is growing intrinsic value is partially recognized in the marketplace as the earth makes its next lap around the sun in order to bring smiles to our partners?

Certainly, some tailwind is better than none. But for Cove Street specifically, we will continue to point investors to the ongoing lack of curated attention in small cap land. As more assets are indexed, remaining practitioners are increasingly part of large firms who simply don't find it doable or financially practical to run smaller portfolios that can properly fish in our waters. In theory, the pay-off for "quaint" practices like fundamental research, proper attention to governance and incentives, and a longer-term time horizon is getting greater by quarter. These are the trends that are behind our back, and we have a stubborn team that is structured to take advantage of it. Our pitch: this is a multi-year opportunity and we have room.

Adding to these concepts is something which we have always considered important but spent more time on 2019. There is a large amount of room between owning a passive 2000 stock portfolio and specifically selecting securities upon which plan A is to "actively" call for management change and/or a pursuit of strategic alternatives. To wit, we spend a lot of time trying to understand who is running the companies in which we invest, how they are incented, and who—if anyone—on the Board has skin in the game and can act as appropriate oversight for our interests. This is the big "G" in the ever-popular ESG trend and if one really stops to think for one minute, it is likely the only letter in the acronym upon which most can agree. (We will have a separate piece shortly on ESG trends that you should find interesting, baffling, and just sad in many cases.)

As we began 2019, we identified ten companies in our portfolio that still had staggered boards, which essentially means there is not an annual election of directors and only two or three come up for a vote each year. Now there is a good counter example for everything; my father-in-law smoked his whole life and lived until 93, and Google, Berkshire, and Liberty have done pretty well with controlling shareholders. Accordingly, there is no exact math that highly correlates investment success with an annual election of directors. Let's face it: properly judging that a company will generate 20% free cash growth for five years in a stock selling at ten times free cash flow will make us a lot more money than a governance change.

But our painful experience is simply that in far too many cases, many directors just "mail it in" for $150k (or a lot more) per year and are thus not terribly engaged in things that are important to us: weighing in on vanity acquisitions, real pay for performance structures, and intelligent capital allocation. We are not sure if it's worse in smaller cap companies, but clearly there are less people paying attention in our world. And there is basic human nature: we act differently if we know people are watching. And an annual election of all directors seems to us a solid way of creating an environment where people might pay more attention to our investment if things could change for them in a year. And oddly enough, we are entirely in sync with the broader governance world and its cops on the beat—the notorious proxy advisors—as 90% of the S&P 500 has de-staggered.

So, we paid attention. We quietly approached our ten companies with a well-reasoned letter that articulated our rationale and provided a number of examples. We also pointed out that this initiative was not designed to build up Cove Street as an activist. It was a real chance for the Board to get in line with common practice and claim the public credit for being more shareholder oriented. And voila, we have it in writing that eight of the ten have or will announce de-staggering proposals in the 2020 Proxy. One gave us a clear "Heisman" and, given the existence of a very high inside ownership, it is also a vote that would be difficult to win. The other is a work in progress for 2020.

We think these are longer-term steps that will result, on the margin, in improvement in results. These are also some of the things that involve "judgement" on our behalf, versus the notion that companies shall be treated equally as numerical factors whose past experience can be relied on for future results. Judging management, the staying power or change implied in returns on capital, and a sense of the catalysts for a change in trailing data are things that are difficult or impossible to be screened on, machine learned, or magically captured by artificial intelligence. That is where we spend a lot of our research time and is our "edge" versus a passive portfolio. And yes, we have definitely become more "active" over the last decade in our quest to deliver value for clients within a timeframe that is acceptable. (Seven years is our answer.) And it's one reason why we think we can make decent money in 2020: a number of projects and catalysts in our largest positions—internally and externally driven—seem to be lined up for resolution this year. That is not always the case. And we can be early, as previously noted.

So we conclude. Our biggest sense of the future is always derived by an analysis of baseline history and what we are expected to pay for any future above and beyond this baseline. While ten years is one helluva baseline from a career standpoint, we remain somewhat incredulous as it relates to any asset valuation that maintains much of its balance on near-zero or negative interest rates. And a 30% increase in valuation in one year that is not coming from a big negative the year before is simply borrowing from future returns. While we are curating within a world that is much more overlooked, we remain extraordinarily wary of changes in credit conditions, events that tend to be the canary in the solar field. Said again, the extension of credit is as ephemeral as youth or clouds, and it has an enormous ripple effect on the attitudes of investors toward risk and risk assets. Not to mention what seems to be a legitimate second derivative change in the willingness of nearly anyone to throw money at anything in venture capital: disappointment in recent IPOs and the slow unraveling in Softbank with WeWork being the first tick.

As noted in a recent interview with legendary Silicon Valley-er, Benchmark's Bill Gurley, "I've never been around a group of people where risk is forgotten so quickly…as markets go up, VCs lose their aversion to risk slowly, eventually taking a tremendous amount of risk. When markets bust, risk aversion comes on immediately, like overnight, boom!" He continued, "The vast majority of returns are right at the end of the cycle. So, if you get conservative and pull back, you'll miss out. The best way to protect against the downside is to enjoy every last minute of the upside."

But doesn't the client eat the downside while the fund mints fees on the way up? And is Chuck Prince laughing out loud?

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