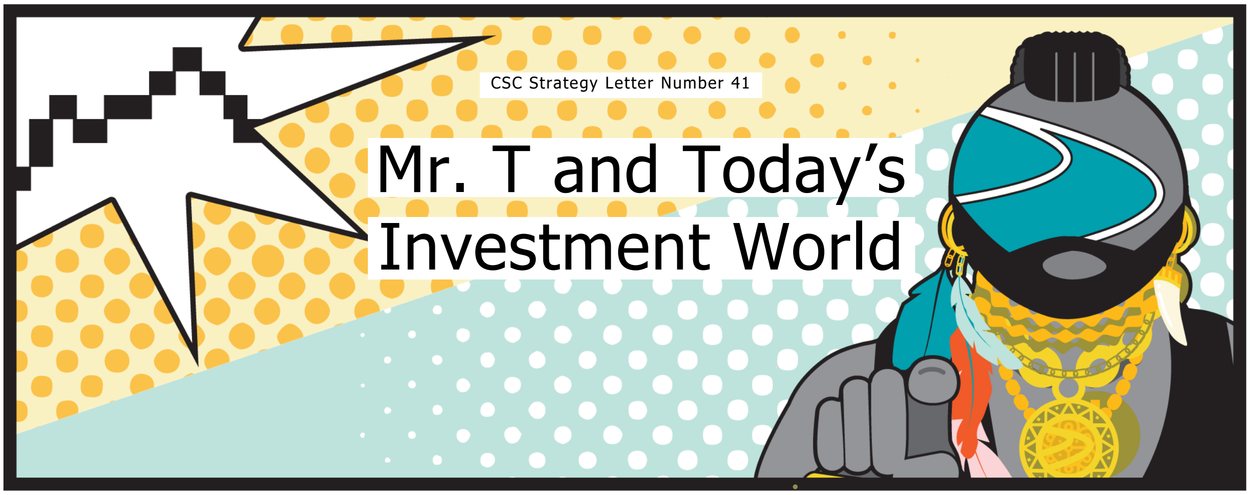

CSC Strategy Letter Number 41

Mr. T and Today's Investment World

SEPTEMBER 2020 — It would be correct to say that a number of us have had a little more "alone" time on our hands over the last 6 months and it is also correct to note that the online world provides many chances to waste said time. Which brings me to Mr. T of A-Team fame, who for completely nostalgic and personal family reasons, comes to the fore at particular times with his "I Pity the Fool" meme.

Translation, yes, we are still practicing the art of value investing, a discipline that has succeeded in demonstrating this calendar year that skepticism and prudence have not proven highly remunerative. But it's certainly been a heckuva lot better than Q1. We have picked up absolute and relative ground slowly versus everything but a large cap growth index. But that too seems likely to change—based on history—and it could happen faster than one would expect.

So as we enter the fourth quarter, we remain EVER incredulous on many fronts as to what is happening around us, and while one is always contemplating change, rethinking positions, and attempting to make money free of marketing labels, we don't see a lot of intellectual reasons to completely swap out an investment process and philosophical underpinnings that have "centuries" of demonstrated success. Pay a fair price for a great business, buy decent assets at distressed prices, find people who are stealing with you versus stealing from you, think long-term, don't over diversify, don't spend all your time doing what everyone else is doing, don't panic at the bottom of the cycle. And now back to our regular programming.

While we will point to some versions of communal insanity or outrageous anecdotes that should be screaming caution, we will also point to the annoyance that it is our largest positions that are watching paint dry, and thus we are borderline bullish on our own relative and absolute performance, a circumstance that is not always the case. (Visit our website Thoughts tab—CoveStreetCapital.com/Thoughts and read our March 2020 piece on Viasat (Ticker: VSAT). And then re-read and ask yourself—I am passing on this to invest in Nikola?) And then pass it to your largest fund friends.

We see an enormous bifurcation between "stocks that are moving" and "undervalued businesses that happen to be publicly traded." (Yes, I know it must be fun to hide problems in a privately marketed fund.) As such, we have been steadily upping our commitment to said investments. We would like to further up the commitment, but we need a little help from new and old friends. It remains a historical fact that the best environment for value investing is where other's interest in value investing is at negligible levels. I hereby confirm we have arrived at this station.

To wit, I present another relevant blast from the past. A very long time ago, this writer worked Sunday nights for TheStreet.com at its inception —naturally writing a column entitled "The Value Investor." And, I got mail. This was January 5, 2000. Things changed shortly thereafter.

January 5, 2000 — Mail From a Reader

"I am a first-time visitor of your column and now I understand why I haven't read

you before. Your top 10 picks make a sloth's movements seem like a cheetah. I think molasses is more fluid than your picks. Sure, if I was a multimillionaire I could manage to live with and accept a whopping 20-25% a year, but I'm not and I would like to double my money within the next 100 years. Start getting on the bandwagon. In about seven to eight years when this bull market is over, I'll start looking at those world-changing insurance companies. Go Albertson's (Ticker: ABS)."

We have gotten some signs in recent months, but nothing this juicy as to flag an immediate change in fortune. And that is the question: when? From bitter experience, I can tell you the answer is not likely to come from us and I sincerely doubt it will come from you. Under the heading of being somewhat right versus precisely wrong, you should be leaning into what you know you should be doing. (For example, putting money to work in our space.)

It remains amazing to us that 3 days of growth/tech stocks falling constitutes a major financial news cycle. But apparently, this is increasingly passing for a workday in the investment world? *"What do you do when you just don't know?"* says Mr. X, who is a European PM at a major firm and whose name I am blotting out here for his sake, but who nonetheless felt good about being quoted recently in the Financial Times. *"It shortens your investment horizon. If you don't know what's going to happen next year, then you focus on what's happening right now."* No, that is not what you should be doing, despite the risk of client/career potholes.

And why is it perfectly accepted "convention" that the same private equity firm that is blowing up Fund 1 with 11x levered assets can now go out with a straight face and successfully market Fund 2 with a pitch that there are all these great opportunities to buy the disasters we created with Fund 1? But yet, a small cap value manager who deals in misunderstood, lightly traded, and lightly analyzed public companies that got smoked in Q1 is basically told to "talk to the hand"? If it was difficult to raise money with great performance—and it's patently difficult to raise money when things don't look great in the short-run—can someone explain to Cove Street's Mr. Business Development, Paul Hinkle, when is a good time?

That concludes our whining and we move on. Here are some of those promised "things and anecdotes" that seem to us to be important, but apparently are not to many others. It is important to note that these "macro thoughts" percolate, but that is very rarely how one makes money. If we diligence a company thoughtfully and carefully, and the price embeds most of the known unknowns or dislikes, you step up and put money to work. Repeat. Like in 1999/2000, there are a fair amount of very interesting values and business models that simply are not getting the time of day because they are either Small Cap or in the "wrong" sectors. There is oddly a lot to do today despite what we talk about below.

The problem child list:

☑ **The Election** — For the record, the writer is a registered independent and did not vote for either of the two major party candidates in the last election. For the purposes of this Letter, let's just say the politically incorrect thing and state that we are just in it for the benefit of our client's money. That said, in less than 60 days we are either going to get more of the same (zigzagging nationalism and favoritism, and dangerous mercantilist trade policy with massive government spending) or as heard on the other side, *"It's way past time we put an end to the era of shareholder capitalism. The idea that the only responsibility a corporation has is with shareholders. That's simply not true. It's an absolute farce. They have a responsibility to their workers, their community, to their country. That isn't a new or radical notion."* That seems pretty much like zugzwang, a new word in these parts, which is a chess term for a compulsory next move in which no matter what you do, you will find yourself in a worse position than you are in today.

☑ **Ceaseless stories about the adventures of the Robinhood trading site and "trading bros"** — led by Lead Bro, David Portnoy, who spills gems to his millions of Twitter followers like:

August 25, 2020 — David Portnoy on Twitter:

"Why do I like stock splits? Because you get double the stocks. Two stocks are better than one especially when they go up."

Or:

> June 9, 2020 — David Portnoy on Twitter:
>
> *"I'm sure Warren Buffett is a great guy but when it comes to stocks he's washed up. I'm the captain now."*

Retail trading as a percentage of NYSE equity and option trading volume is near record highs. Private equity firms are selling stock hand over fist. To Whom? On what side of this trade should we be?

☑ **Stock Splits** — Seriously, go get a pizza, practice cutting slices and tell me how you will cure world hunger.

Attention finance committees of public companies: you have been whining about short-termism and your shareholder base. Why do you want to make it easier for people to day-trade your stock for zero commissions and use leverage?

☑ **What in the world is Softbank?** — Tech stock options trade with a $50 billion notional value? Whim-based investment of billions in venture capital at outlandish valuations? Funded by selling its actual cash flow producing assets? A public company with no adult oversight?

☑ **Snowflake is not a new James Bond movie.** — It is an IPO that like all excruciatingly hot IPOs was allocated to the largest commission paying accounts. Or a famous person's personal account. We fit neither, but we are also not part of the group that bought the first tick at 2x the offering price. Now when I was riding my horse to work, a giant spate of initial public offerings was a sign of "enthusiasm" that eventually burns out into over-enthusiasm and a host of losses. We actually have a screen set-up to look for "busted IPO's 12 months later." It's near empty. Per the news site The Information:

> *"One twist the coronavirus pandemic has brought to capital market activity is the emergence of remote initial public offerings," said Adena Friedman, chief executive of Nasdaq. Gone, for now, at least, are the two-week-long in-person road shows that have traditionally accompanied IPOs. Virtual road shows, Friedman said, can be carried out in just "four or five days" from investors' living rooms. "We now are seeing IPOs come out into the market almost every day of the week," Friedman said in a rare interview as part of The Information's Women in Tech, Media and Finance conference."*

The interesting twist to this was that one postulated reason pre-COVID why active public equity investing was dying a slow death was because of the shrink in the number of public companies—partially due to the explosion of private equity and partially due to actual and perceived regulatory burdens. Not so much.

☑ **Special Purpose Acquisition Companies or SPACS or blank check companies.** — As of this writing, 78 SPACs have raised a combined total of almost $31 billion in the U.S. according to Bloomberg, by far and away a record. We have looked at doing one ourselves a few years ago, and dropped the idea. Very dumb apparently. Roughly speaking, you put up $2mm for $100mm raised. You "earn" 20% of the equity if you close a deal that gets voted upon by your shareholders. It has proven to be an ingenious way to bypass a lot of regulatory and legal scrutiny to go public. I am sure LeBron James is just waiting to get this pesky basketball thing over with so he can attach his name to one.

☑ **As of this writing, 13% of the Russell 3000 sells for over 10x enterprise value to revenue.** — If you include companies that have no revenue and show as N/A, the number is 31%. In another blast from the past, we have the famous Sun Microsystems CEO, Scott McNeely quote/paraphrase in the aftermath of Dotcom mania:

> *"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero*

> *expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

Now, that math or logic is not 100% correct, and there are wonderful exceptions to the rule. But never as many as we would like and it sure isn't 13%.

☑ **After a 30-day recession/credit closure in March, it's back to the races for the funding of the "zombies."** — Per a Leuthold/Financial Times study, 15% of Russell 3000 has not covered its interest expense from operating income for 3 consecutive years. While these numbers are not "COVID Adjusted," the leverage ratio for the median high yield issuer in the most leveraged quartile of high yield indices is 11 times EBITDA. That is high—and 100% dependent upon access to refinancing. We would argue from history that planning to do so is not a 100% done deal, despite the Federal Reserve's $50 billion (and counting) investment in corporate debt and ETFs. But it sure as heck is working like a charm now. *"Market valuations are entirely fabricated—or synthetically generated—by all the central bank liquidity and do not reflect the fundamentals of the securities they represent"* said one Oksana Aronov, head of Market Strategy for Absolute Return Fixed Income at JP Morgan Asset Management.

So there are those who think they "know" and are comfortable with their forecasts of the future, technology trends, and feel like "I've got an incredibly charismatic guy doing this." And there is the "not sure about the future" group, which clings to outdated concepts such as uncertainty, risk management, margin of safety, and that there are a lot of things in life and the future that just weren't in the spreadsheet or pitch book.

I would like to say that when we are buying a business with a financial history that can be studied, we have signposts that suggest where their publicly traded stock should be. And when economic things happen or the stock price moves erratically around some reasonable assertion of fair value calculated and recalculated in a variety of ways, we sort of know what we should be doing in response.

When you are paying a dozen multiples of brand new revenue with zero profitability, it seems to us that the air pockets of disconnect when something goes wrong, or takes longer than you think, or simply doesn't produce results in a linearly positive fashion can be enormous. And you are not sure what you can rely on or what to do. So, yes, we are likely not your place for your 50-bagger. But we think we are a place to invest in businesses where more often than not, we are paying prices with either downside resiliency or some sort of "realness" for price recovery in the aftermath.

Julius Caesar noted in Commentarii de Bello Civili, *"Inusitatis atque incognitis rebus magis confidamus vehementiusque exterreamur."* ("The unusual and the unknown make us either overconfident or overly fearful.") Nothing is perfect and as a firm, we are not as resistant to change and rethink as some paragraphs in this Letter, or its predecessors, might have suggested. But we have a North Star as far as an investment approach and as a culture of people. From time to time, discipline can seem like an anchor. But as we have all seen, things change. And as we saw in March, you need to be prepared and "be there" when it happens.

Best Regards,

Jeffrey Bronchick, CFA

Principal, Portfolio Manager

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