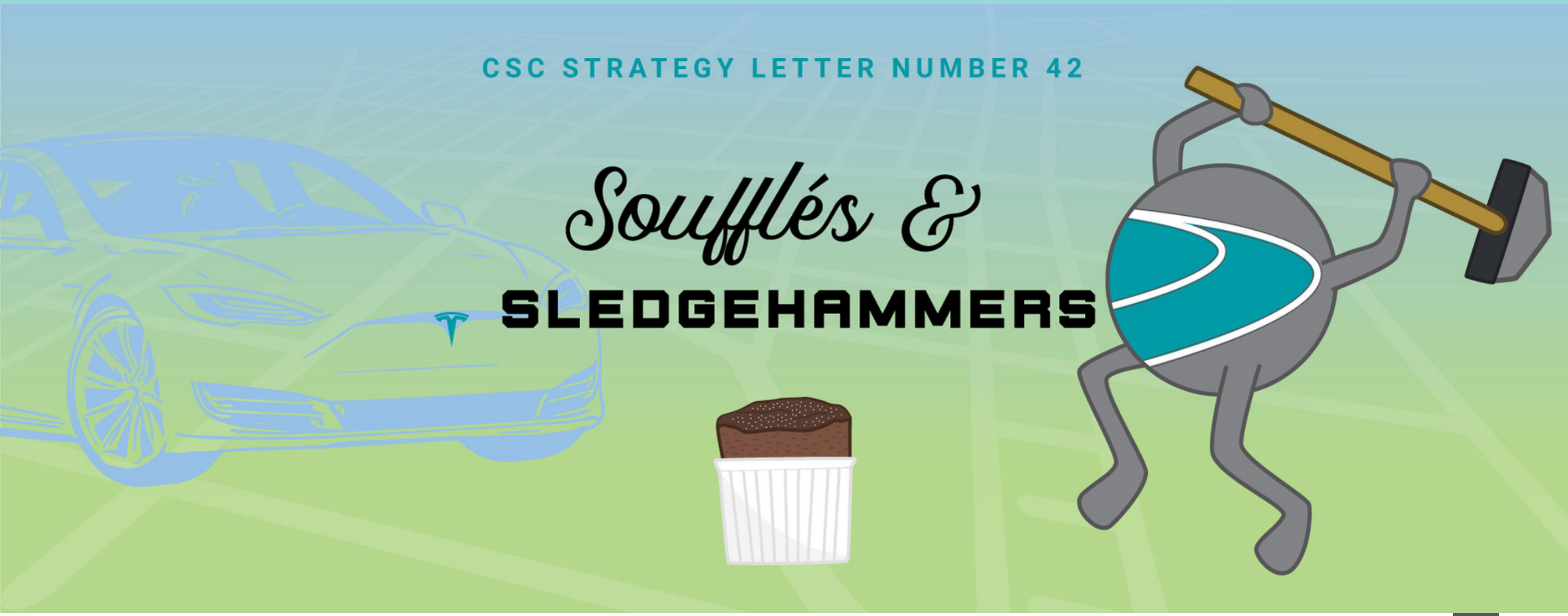
CSC STRATEGY LETTER NUMBER 42

Soufflés & SLEDGEHAMMERS



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As we have noted previously, one cannot practically ignore the celebration regarding our annual lap around the sun, although I think it's fair to say that there are roughly 7.5 billion people outside of Silicon Valley—or those who run large cap growth/tech funds—that are delighted to see 2020 declared over.

But people, business models, global issues, and viruses tend to generally pick up where they left off on most December 31sts, so the annual version of our Strategy Letter tends to be more fluid than are most. This space is generally dedicated toward "bigger thoughts" while the CSC blog has been branching out to focus more on specific ideas; and we would encourage all to sign up.

Do we really have to go through another soliloquy on the folly of "forecasting?" (If you need a hint on what we think of the annual prediction rigmarole, we sent many of you Phillip Tetlock's book, Superforecasting: The Art and Science of Prediction—a few years ago as a holiday gift.) Spoiler alert: it's hard to be right and it is usually embarrassing. In fact, there is an awful lot of common sense regarding a life and an investment view that suggests adopting a baseline case that assumes the next year will be "sort of like the last 20 years, but that you need to be on your toes and looking for disconfirming evidence." (Or a global pandemic.) Is it not odd that investing today has the contradiction that stocks are pricing in a "new era", yet investment turnover is higher than ever and thus investors seem to have a lack of will to see their predictions through?

Overall, we start with a baseline that stocks have positive returns 65%-ish of the time on an annual basis, that the economy sort of grows in the 2.5% range, that we are not always 94% consumed by thoughts of pestilence and death, and that the present level of alcohol consumption is likely unsustainable. And that most business models and companies providing somewhat essential products, and not grossly over-encumbered by debt, are likely to "bugger on" in the words of Winston Churchill. We then make a mental note to shade our baseline for the possibility that we might be in one of two extreme cycle positions (things are generally awful and cheap, or things are good and expensive) based upon decades of reasonable historical research and thus shade accordingly. Eat and drink reasonably, get sleep, and have an investment process that can maintain some sense of rational balance in the face of "absolutely crazy things that cannot possibly be modeled on a spreadsheet."

I have been told I should start thinking of summing up all thoughts in 140 characters if I want anyone under 60 to read Cove Street Capital output. So, let's get directly to a few thoughts for 2021 before thinking a little deeper about the past year.

- Most investments in most asset classes are "highly valued" by any measure that uses anything but a 1% interest rate as its hurdle rate. We repeat the idea (despite the fact that it has been incorrect for some time) that it does not take much to knock something off a high step ladder. But as consistently proven over the last number of years, a 1% hurdle is a low bar and is a powerful motivation for putting money to work in apparently nearly anything.

- While we will discuss this in further detail below, there has rarely been a more obvious, career -threatening/don't want to be first-mover investment opportunity in my career. Specifically, right now is the time to employ a strategy that leans as hard as one can against "large cap/growth/tech/private company in all the above" and leans into "basic cash flowing—often small cap—businesses that publicly trade." (AKA: Smaller Cap Value.) As noted above, putting a finger on an absolute return number for any given year, or two, is a game you fail simply by entering. But, what about a relative return call? All day right here. While we don't "idealize" one month of massive changes in relative performance (although we will take it), we do think this is a multi-year comeuppance. There is simply a planet-sized gap in trailing—and future—relative returns between what has been hot and what has been forgotten.

- We have a disciplined, patient process, we pay attention, and we are smarter than we were last year. As such, we firmly believe there will be things to do that we can't pretend to have our finger on right now. There are literally several hundred new public companies that have become public in a world of near nonsense or zero adult supervision. Disappointment breeds in these waters and represents a new well of future ideas.

- The world of COVID "brain" will continue to recede. We are not negating the individual losses that are targeted sadness, but in the comprehensive historical review of global decision making, 2020 will rank as a more man-made tragedy than the tragic inflection point for mankind. The collective "we" are not changing remotely as fast as the world can blog. Endlessly. At all hours. While we lost money and faith in "cyclical vs secular" in the case of movie theaters, having exposure to a return to social interaction is a bet that will pay off.

- What comes to mind when you think of low interest rates, seemingly unlimited and unencumbered credit, a revival of vaccine-induced human spirits, and a corporate cash flow high? M&A. Hopefully expensive, record-setting multiple M&A focused on smaller companies where strategic synergies are plentiful and corporate costs can be eliminated. We have a list of legitimate targets if you are a CEO lacking initiative and imagination.

That is about all we can offer in the barrage of New Year blather. As we turn to some material thoughts about the prior year, it might be easy to infer a distinctly negative tone. Part of that is derived from our own failures and the hard fight to keep that bottled up and thus not let it affect decisions for the future. But yes, there are a lot of things that bug us that seem completely unsustainable, but yet seem to be sustaining for something longer than the proverbial "short-run." And we kid ourselves not: to proclaim, "oh, we have problems, but don't worry, not in what we own" is a frame of thought that has proven not to be helpful when it comes to capital preservation. (A quaint notion that has relevance every seven years.) But we will say it directly: there is an absolutely NUTS, year 2000-like, tech bubble-esque disconnect between a thoughtful investment process defined by people—long dead—in a book in its 6th printing and the current fervor for what can almost be called "cargo cult" investing. As defined in Wikipedia: *"a millenarian, (millennial?) belief system in which adherents perform rituals which they believe will cause a more technologically advanced society to deliver goods. These cults were first described in Melanesia in the wake of contact with allied military forces during the Second World War."* By investing in a concentrated and curated list of businesses that are mostly getting more valuable every day, or whose reasonable and boring estimate of value is so divorced from the price of its public securities, we think we can do a lot better—absolutely and relatively.

This was definitively not the case in 2020. In broadly reviewing the year thus past, let's just get the "it was really disappointing" out of the way. There are simple mathematical facts about compounding capital that get really unpleasant when you have the start of a year that we did. Disappointment two: in print and through a series of really interesting and mostly short-term unrewarding calls and Zoom meetings, we "begged" for more money in March/April. We got some, but we didn't execute "well enough" on being mostly right, as it turned out the correct strategy was buying every $2 leveraged stock that didn't go bankrupt. In fact, 70% gains from the bottom turned out to be underperformers. A professional investor can dim the lights, pour a glass of Whistle Pig and provocatively cover himself with Berkshire Annual Reports. But as Keynes noted, successful stock investing requires some sense of who are the other judges in the beauty contest. A blind focus on "just the business model" takes a LOT of fortitude and ideally permanent capital. We have the former...the latter is a wish list. And clearly, Elon Musk looks a LOT better in a bathing suit than does Mark Dankberg, the CEO of ViaSat.

So, putting together a series of good and bad outcomes doesn't help in the short-run and can burn a nice hole for a while in what was a good long-term track record. We have a culture of transparency and have always had problems stomaching the veneer production of the investment industry. When we stink, we stink, we own up to it, we get smarter from it, and we adapt and move forward. (Doesn't take the sting off of course.) And watch it with the Whistle Pig.

We see a lot of things coming from all directions as investors, but a key ability for an investment process is to properly identify "critical variables" from the rest of the chaff and be right on their interpretation. With that, here are some brief comments on what were the most pressing topics of 2020:

COVID

We might suggest "we" are not following the science; we are following the scientists, or some of them, in a world that has some distinctly unhealthy attitudes toward the traditional scientific process. In general, the scientific process does not close down dissent but it tests hypotheses and pivots accordingly. A conceptually terrifying unknown has morphed into a human management process problem in science, health, and economic policy, to name a few. Just as the analysis of the history of human decision making in the management of prior "big things" (wars, depressions, financial crises, and geo-political changes) has produced a treasure trove of examples of incredibly poor decisions and outcomes influenced by well-meaning people, this one will be a doozy and lead to some incredibly interesting books in X years. The world—investment or otherwise—has muddled through 2020 by gaining knowledge about something that NO ONE alive has ever seen before (what we are often witnessing as investors is much the same). But when does trillions of dollars of spending to fix an economic problem that in many ways we have created start to matter on global finances? What are the after-effects of trillions of dollars of bonds being issued at negative interest rates? Is MMT really going to be adopted as official Federal Reserve policy versus simply a tacit acceptance? We are generally bullish on investments that benefit from a return to the "baseline" of the human condition (socialization, travel, globalization) from a macro-like basis, but we don't think we are getting paid at large to accept the risk that global policymakers have created a series of political and economic conditions in response to COVID that have some unpleasant and lingering side effects. Doesn't "winging it" deserve a little caution somewhere?

Value Investing

Let's start off by saying we hate labels. And the investment world is tired of hearing the same arguments in favor of value. I know we are. And if Berkshire Hathaway can buy Snowflake on the IPO, then what can't one do? We have never practiced a discipline that seeks to buy just the cheapest stocks. Or the ones with the most historical balance sheet assets trading at a discount to book value. Or just focused on "trailing metrics" and ignored future possibilities. It is this simple: the value of any investment is the current cash flow divided by a discount rate plus the present value of future value added. So, an investment can be all current income and zero future value—like a bond. It can be the value of the current cash flow and a negative future value—value traps, secular problems, capital allocation disasters, etc. It can be a negative current value and an enormous future value—early Amazon. It can also be a current negative value and a negative future—Nikola and a lot of newly public things priced at dozens of multiples of revenue. Value investing has always included analysis of all the above and is a philosophy that requires a respect for both math and that practitioners make judgments about the future. To quote the great Bezos: "math based decisions command wide agreement where judgment based directions are rightly debated and often controversial."

We have always divided potential opportunities into Grahams and Buffets. The former consists of deeply discounted current value with question marks about the future, and the latter is made up of "really good businesses with staying power that provide essential products and services." That is the see-saw-like lens from which we view the world. And as Woody Allen famously noted, "being bi-sexual doubles your chance of a date Saturday night." You get the idea.

We see no evidence whatsoever that value investing, the practice of buying things for less than they are worth, is dead. With the advent of global computer processing power, it is clearly harder to add value by buying a basket of hundreds of statistically cheap stocks, because that game is known and is being played in size. The academic arguments for smaller cap "value" investing were documented, and then crushed in the last ten years by quantitative methods and indexing.

But, don't ever forget that humans run the machines. Over $100 billion of assets has been taken from public "value" and allocated toward venture capital and "alternatives." We remain convinced that human behavior ensures the inevitability of cycles as it relates to economics and corporate performance, as well as the reactions of market participants to these developments. As someone named Munger neatly encapsulated, since the future is uncertain, the investor must "invert" the present. How much are we paying for a certain view of the future and does that make any rational sense? That is precisely today's problem: for every great idea that will legitimately be the next great idea, there is a LOT of absolute nonsense...and a lot of that has recently become public.

We have a curated portfolio of 30-ish stocks, with our top ten representing 50% of the portfolio in most time periods. We don't need a monster tailwind to succeed, but I think we are going to get "some" help over the intermediate period. It is a classic heuristic mistake to conflate the concepts of what is difficult to conceive with that which is not possible. As Sir John Templeton put it, "To buy when others are despondently selling and to sell when others are euphorically buying takes the greatest courage but provides the greatest profit."

Our favorite 2020 marker of our thoughts? In an interview with Pensions and Investment Age on or about October 14th, retiring industry legend and value quant Ted Aronson, stated:

> *"Our recent performance sucks," says Mr. Aronson. "And our record over most of the last five years has been so sucky that even if we outperformed mightily over the next five, we would still have—at best—a drab return looking back over those 10 years." He concedes that he may be getting out of the business with "the exact wrong timing" and that the exit of a firm like his might well signal that value investing's long-awaited comeback is imminent. Even so, given AJO's recent results, Mr. Aronson says he had no choice but to give clients their money back."*

The decision, by the way, doesn't make a lot of sense unless you want to enjoy a $1 billion net worth in a low tax state and make your own branded whiskey. Yes, avoiding an awful entry point really helps your compounding math, but isn't there something aggravatingly sublime and desirable about nailing a bottom?

Tesla, Bubbles, Bliks, and Indexing

Well, what is a bubble? An eightfold increase in a stock in 9 months? Incredulously implausible assumptions to justify any valuation? A near religious focus on narrative rather than some baseline of math? The ability to take that $600 billion-ish market cap and buy the next NINE largest automakers and still have some spare billions of change?

What is a Blik? To paraphrase one R. M. Hare, a deceased English moral philosopher who held the post of White's Professor of Moral Philosophy at the University of Oxford, it is an unfalsifiable conviction that cannot be unseated by the presentation of empirical evidence, and counter-arguments are continually offered in the face of new and countervailing evidence. He was arguing that the existence of God is innately meaningful for a LOT of people and thus is crucial to understand a person's view of the world. I am arguably stretching wide here as I tie this together specifically with investing, but in subtly attaching Hare's ideas to a lot of things with which we are dealing, he presented his well-known thought experiment:

> *A certain lunatic is convinced that all dons want to murder him. His friends introduce him to all the mildest and most respectable dons that they can find, and after each of them has retired, they say, 'You see, he doesn't really want to murder you; he spoke to you in a most cordial manner; surely you are convinced now?' But the lunatic replies, 'Yes, but that was only his diabolical cunning; he's really plotting against me the whole time, like the rest of them; I know it I tell you'. However many kindly dons are produced, the reaction is still the same.*

Now, while "Eric Clapton is God" was quite popular in the late 1960's, and it seems plausible from time to time that many, including plausibly Musk himself, view Musk, as at least a demi-god, what is incontestable is that there is a VERY LARGE value placed on the present value of Tesla's future. And any variety of counter-arguments—like the math noted above, and the distinct lack of actual manufacturing profitability versus the profits from selling environmental credits—are met with statements like "well, Tesla is not a car company, it's a battery company, it's a software company, it's a…." If we were on the Board of Tesla, we would advise selling $100 billion of stock at elevated prices, not $5 billion every once in a while. The man himself is "in tweet" using our headline analogy.

While this page is in awe of an economic system and a country that enables truly great entrepreneurs and visionaries to turn the existing world upon its head, that does not necessarily mean I want my billions of indexed dollars to wake up last Monday and own Tesla as one of my largest positions, AFTER a 9 bagger.

It is often noted at Cove Street that every good idea, such as the benefits of eating chocolate, has an inflection point where it stops being a good idea. Indexing large pools of capital in liquid markets is a good idea. But, isn't the level of self-reinforcement in today's financial markets via quantitative strategies and indexing arguably at that point of one too many chocolate bars? It is hereby argued again that there is going to be a helpful tailwind behind a "short large cap and growth" and a "long small cap value" strategy.

And lo and behold, there is a solution, and like all solutions, they seem to come from someone who was at least accepted by Stanford: Robinhood! "Democratizing" access to Wall Street and investing by enabling commission-free trading in fractional shares with a gaming style app and a promotional campaign that seems designed to captivate every junior high school student pretending to be doing his online schoolwork. Yes, we all want lower costs, a chicken in every pot and .125 shares of Tesla at a $21 cost. But it is really hard to see how "having fun" on an app that is trading 40 times the volume of Charles Schwab on a daily basis is a solid basis for "intermediate-term" investing success or financial planning for Robinhood's exploding and mostly millennial client base. Anyone who has invested for a reasonable period of time understands the enormous time commitment surrounding the attempt to NOT do dumb things in an environment that seems to incent you to do more in shorter periods of time. And that's just in the "institutional" investment world. Clickbait investing is just another one of those uncomfortable signs of a world where the "next new thing" doesn't seem like a good thing for your capital. Oh, and if there was ever the sign of a definitive top, Robinhood is odds on to do a big IPO in 2021.

SPACS and IPOs

There is no love for investment banks on these pages. But a quaint theory that may or may not be disabused by the WeWork fiasco, is that the aforementioned banks represent some sort of speed bump between companies/promoters and potential investors. Getting sued and publicly embarrassed are solid reasons for performing some due diligence. On the other hand, we understand how ticked off a company would be if its IPO was priced to gift an 85% return to the bank's largest commission generators. Enter the SPAC, which enables near due diligence free entry to public markets, and gives the promoter 20% of the consummated deal. This anti-IPO structure was enough to raise north of $70 billion in 2020. That's all money with a two-year time horizon to make a deal. While nearly anything seems easy in a world of near-zero interest rates and covenant free credit, doing smart deals is not an easy thing to do on a good day, much less on a strict timeline, in size, and in perennial competition with strategic buyers. So one tends to overpay, and the performance, en-masse, of SPACs post-deal close has not been promising. Of course, there are spectacular successes just as there exist superstars like Lebron James and Patrick Mahomes. And Charlize Theron. And yes, there are interesting twists for SPAC buyers pre-deal that can create interesting investment opportunities; whether it's the collection of "free options" or similar to what we saw in 2010, the ability to buy securities from forced sellers at discount pricing to the SPAC cash, or simply to be able to say no to nearly anything the sponsor has in mind for risk-free return. We suggest massive amounts of capital flowing into such a space tends to ruin the original premise and diminish future success. But that's just cranky experience talking.

Favorite Anecdote:

Softbank is the genius of the East. They raised $100 billion dollars for their "Vision Fund." Yes, you can get bailed out by a few Alibabas, but arguably they have been the poster child for torching investor capital in venture capital-related schemes, seemingly on the whim of its founder. (Remember WeWork?) They are doing a $600mm SPAC that includes wording that strongly alludes to buying one of Softbank's *existing holdings. In the world of ESG, which apparently is going to be "the thing" (and something we will address directly in future writings), that is a conflict of interest violation that stinks worse than Tokyo Bay at low tide.*

The Federal Government, the Federal Reserve, Spending Money, and Interest Rates

It is correct to say that we have a two party system and "someone" has to be President. And yes, over the long term things like democracy, rules of law, robust capital markets, and scientific and technological development tend to override the proclivities of whomever is the current occupant of the seat. But, as a country, we wade in some serious uncharted water as far as our willingness to take on debt, the decreasing returns on economic growth from each round of spend, and the high probability attached to the abandonment of "rational economic thought" that, with fairness to the incoming administration, is akin to bringing in Mariano Rivera to close out a process that has generally been getting increasingly inane for a few decades. There are plenty of government agencies that can address the issues regarding climate change and an evaluation of policies that could conceivably make sense. Does it really have to include the Federal Reserve? Again, near-zero interest rates enable a lot of dominoes to be set up, including raising and spending trillions of dollars at near-zero cost on...pick your poison. (We would vote for at least one damn bridge.) While difficult to imagine, is it possible to conceive a world where these costs begin to rise to levels where someone begins to care? (Cue the inflation bogeyman).

Say what you like about the soon-to-be former President or the soon-to-be new President, if lower taxes, an attempt at less regulation, and a directional sense of "pro-business" ideology was pretty good for the economy and equity investors at large, what is the effect of its stated opposite? Is this a Blik? Or just a restatement of the notion that nothing matters but zero interest rates?

In conclusion, we go back to work in the New Year, literally or figuratively. We have mostly experienced a history where good investing tends to be a minority sport and in order to earn returns you should concentrate on something different from what most people are doing. Mostly. Irrespective of fancy words and the tables and stats to back them up, our real world is mostly culled from the late Henry Singleton, the Teledyne owner and operator: "My only plan is to keep coming to work every day. I like to steer the boat each day rather than plan ahead way into the future. I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible."

Jeffrey Bronchick, CFA

Principal, Portfolio Manager
Cove Street Capital, LLC

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