CSC STRATEGY LETTER NUMBER 44

Don't Get Rugged

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Be forewarned – we are going to empty the quote bin this quarter. Let's start with one Robert Smith, the Financial Times reporter who is getting the credit and proper accolades for exposing the Wirecard fraud in Germany, a fiasco that burned billions as a public equity investment:

"Smart people often get conned, because they don't like to admit they don't understand something," is Smith's explanation. "The comparison to 2008 is often an overused cliché in finance, but it fits in this case." Back then, another low-margin, "blocking-and-tackling" corner of finance—mortgage securitization—became a sexy profit center overnight, as sophisticated investors, afraid to admit to not following the logic of certain derivatives, sat mute through math-heavy presentations promising riskless returns in "real estate." Then and now, a few key questions by a few key regulators would probably have burst the bubble early, but too many were too invested in the party. "It's amazing how far a little common sense goes," says Turner. "And it's also amazing what happens when there's no common sense at all."

Yes, we like that last statement. And while we own businesses that happen to have publicly traded securities, representing our primary form of participation, we cannot help but be appalled at what is going on around us that seems to pass as day-to-day normality. (Unless of course you want to Stonk our portfolio for a few weeks.)

It is a fact that "we" come to work every day and see the doyens of the financial press: *Bloomberg*, *The New York Times*, and *The Wall Street Journal* (ok, throw in the *CNBC* blather too) matter-of-factly discuss Reddit-based meme stocks in a manner as commonplace as "bond prices went down as interest rates went up" statements. As Buffett (hasn't that guy been canceled yet?) noted in the 2021 Berkshire Hathaway annual shareholders meeting, "The degree to which a very rich society can reward people who now

know how to take advantage essentially of the gambling instincts of not only the American public but also the worldwide public, it's not the most admirable [thing]." The retort from Robinhood, the arms dealer in stupid, followed as such:

"There is an old guard that doesn't want average Americans to have a seat at the Wall Street table, so they will resort to insults. The future is diverse, more educated, and propelled by engaging technologies that have the power to equalize. . . The new generation of investors aren't a 'casino group.' They are tearing down old barriers to investing and taking control of their financial futures. Robinhood is on the right side of history."

There will be a Robin Hood IPO this year. Best of luck.

Cryptonite

Stealing a line from George Soros that now floats around our website: the process of good investing is rarely fun. Celebrating success is a LOT of fun. But as one becomes better acquainted with positive "feelings" and successful investing, it becomes clear that they are inversely correlated, if anything. Success leads to overconfidence and a diminishing ability to second guess and question increasingly "concrete" beliefs. The best investments often begin as painful exercises in self-doubt as you ask yourself, "Why am I doing this when others are seemingly passing it up?" While we too have occasional moments of sheer brilliance in retrospect, a lot of proper investment work is a steady process of trying to eliminate the high possibility of doing something truly stupid. That is a baseline that seems to have no relevance in much of today's world. As Sam Zell puts it: "All of my investments are oriented toward barriers to entry—how do I protect myself from the insanity of others?" And seriously, please do a Google search for conversations about Meme stocks. Truth stubbornly remains stranger than fiction.

But, as Sam Bankman-Fried, the Hong Kong-based chief executive officer of the FTX crypto exchange notes:

"At some point, something is just real. If Dogecoin is stupid and valueless, it shouldn't be worth $90 billion. How about gold or Bitcoin or euros? Our collective imagination has given them value, and now we just think about them having value."

So, how should we think about the appearance of an asset with no inherent fundamental value that has managed to appreciate by, let's say, 15,000% in five months? Going back to a previous statement, think of how you were called a moron 14,998% ago when you told your friends you were buying a crypto currency backed by some dude's dog. What about now? The now when your fundamental value is the latest Tweet from a multi-billionaire who appears to have a solid affinity for a good laugh at your expense? We love this from the ever present Mark Cuban, "The thing about [decentralized finance] plays like this is that it's all about math, and I was too lazy to do the math to determine what the key metrics are." And this came after his crowing about skimming an IRR north of 200% every 24 hours by crypto currency yield farming (yes, you can spend a lot of time online learning about a truly new world), only for it to go zero nearly overnight. Okay, that is the second way very smart people can lose money—simply not caring enough to do the work. So when you shake some loose change from your old fruit jar which held a dime for every time you lost money investing "with" a billionaire, consider the possibility again that they are simply enjoying the spotlight with an inconsequential amount of their capital at stake. Only then should you think about what the heck you are doing with your own money.

This will end badly. Lots of "found" money will be lost. There will be lots of frauds revealed. There will be lawyers and perp walks. The relevant question for us is, will this look like 1999-2002, when much of the publicly traded world got clobbered while we sailed through with a portfolio of reasonable businesses trading at reasonable prices? Or, will it precipitate a depressive cycle that leads to a correction in the perception of wealth that will

ripple through spending, risk appetite, and the appetite for large investors to commit to rational activity after revealing prior, and now obvious, silliness? It's a good question.

The Value World

This leads us back to Cove Street Capital and value-oriented investing. Yup, it's been a much more hospitable environment for us over the last six months since the dog whistle blew, signaling the end of an extraordinarily painful drought. We would again suggest that it is hard to argue that nearly anything "en masse" is cheap in a world of asset party balloons levitated by what seems like an era of flat-lined low rates and limitless credit extension. But let us say it again, the value versus "whatever the heck else is going on" relative trade is just beginning and will have legs. We may barely make par the next three years, but a lot of the rest of the world smells like 8s and 9s. (Summer golf reference)

A lot of people put out a lot of research on the history of factor tilts, such as headlines of value versus growth, and we read nearly everything on nearly anything in the allotted time we have in a day. And again, a tailwind is always better than a headwind, but I am not sure how much this fits what we do. As firm Sanford Bernstein said in a recent note, "Value performs best in the early phase of a Fed tightening cycle, but then less well in later phases, therefore if the Fed is holding off a tightening phase, then value has a lot more room to go . . . Inflation has a long-run in line with value performance."

To further our point, ex-Bernstein guy and investment manager Rich Pzena recently noted:

"Over the past 50 years, pro value periods in the market have lasted, on average, 62 months and generated 138 percentage points of excess returns. This compares with 6 months and approximately 39 percentage points so far in this cycle. Further, the depth of prior anti-value cycles appears to be correlated to the length of the pro value cycle. Needless to say, following the deepest and longest anti-value cycle on record, we're optimistic about the opportunity for a long pro value cycle ahead."

We'll take it! But we merely fish in a value-oriented pool, we don't own or have to own the entire body of water. What is arguably more relevant is this from the Bernstein quant team:

"Despite the rally, we do not see evidence of a major shift in allocations into Value. While there has been accelerating inflows into Value ETFs, when we look at the largest over-weights of single stocks by active managers, we do not see overall any increase in the ownership metrics for Value stocks. While there has been some increase in ownership of Materials, Energy and Financials have not had any increase. Overall, Value stocks remain the most uncrowded part of the market."

This follows very much our personal sense of investment management industry history: in Phase I, very few want to be first and suffer career risk for being painfully early; in Phase II, after having missed the bottom, the thinking becomes "I will wait for the pullback;" then in Phase III, the pullback never came, our performance numbers suggest complete genius, and we rake in new money. There is a whiff of a pullback here late in Q2. Help us not miss it.

We Will Not Stop Talking about This for a Long Time

On the subject of interest rates and Federal Reserve policy, the current world has developed into an amazing obsession for someone who spends most of his time stating a general indifference to its relevance as an investment tenet. But its posture is so extreme (for so long) and the cognitive dissonance between what is "said" versus what is happening is so wide, and thus the consequences of a change are so large, that we have to slow down on the investment highway and rubberneck. As any real suggestion that rates are going to rise to levels visible without the help of reading

glasses has been treated as well as walking into a Whole Foods without a mask before June 15th in California, it bears much noting. To wit:

- "The best analysis we currently have is that the rise in inflation to well above our target will be temporary. But those of us on the FOMC are economists and lawyers, not prophets, seers, and revelators. We could be wrong, and what happens then?" — Randal Quarles, Federal Reserve Board member

- The velocity of money is the monetary variable whose relationship has broken down between money supply growth and inflation. Fiscal policy has now enormously changed by putting money into the hands of people who have higher propensity to spend. Is inflation in real things in addition to inflation in financial assets coming?

- We don't have a shortage of workers. We have a shortage of people willing to work for wages versus couch sitting, meme trading, and dope smoking. How can we have the highest number of job openings in decades and yet Washington wants to spend WWII-era money to support elevated "unemployment?"

- Isn't a giant Green tax—either actual or regulatory—highly inflationary?

- Doesn't current Fed Policy seem like, "we will address inflation when we actually see it" versus the entire history of "Punch Bowl Removal Theory?"

- The following is an excerpt from our Q1 Earnings call with Six Flags Entertainment Corp: "We have encountered difficulty fully staffing our parks upon reopening with a shortage of labor availability due to many factors, including COVID schedules; immigration restrictions, limiting the number of international temporary worker visas; and extended unemployment benefits, keeping people at home."

- Riddle me this from a recent Fed meeting: "You can think of this meeting as the talking about talking about meeting if you like... the economy has clearly made progress, although we are still a way from our goal of substantial further progress . . . assuming that is the case, it will be appropriate to consider announcing a plan for reducing our asset purchases at a future meeting." Yet as we speak, the Fed buys $80 billion of Treasuries and $40 billion of mortgages a month. UNCH.

- Here's a nice explanation for how government spending works by Brian McKeon, former Deputy Under-Secretary of Defense for Policy, "We're looking at that big bow wave and wondering how the heck we're going to pay for it, and probably thanking our stars we won't be here to have to answer the question."

- From insanely wealthy pundit Stan Druckenmiller, "The Fed is constantly reminding us that monetary policy acts with long and variable lags. Why then is the Fed still providing emergency financial conditions, when the recovery—as I've shown—is in full acceleration? Why are we buying $40 billion of mortgages a month, when we are clearly running out of housing supply? Not only is the Fed still providing large amounts of the foundation, it is promising not to raise rates until after 2023, even when the recession is already over. If the Fed raises rates in the first quarter of 2024, as indicated, it will be forty-one months after recovering 70% of the drawdown in unemployment. What do you think the average number of months before the Fed's first hike after a 70% employment recovery is? Four months. Simply put—the fastest and strongest recovery of any post-war recession is being met with the Fed's easiest response on record, by a mile."

The relevance, of course, is that when Treasury Secretary Janet Yellen tosses in a throwaway comment like, "It may be that interest rates will have to rise somewhat to make sure our economy doesn't over-heat" and the Nasdaq 100 tumbles in minutes, we are reminded that we have a highly leveraged economy and a heavily margined stock market. What we own should outperform in a "taper tantrum" when the consensus is paying 20 times revenue for

currently unprofitable business models. Again, there's that value versus growth thing.

As well noted by surfer and CEO of investment consultants Alan Biller & Associates John Skjervem in a recent Wall Street Journal article by Jason Zweig: "In the face of prolonged low interest rates, all investors face three basic choices: you can raise your existing holdings of traditional risky assets like stocks, even though no one thinks they're cheap; you can add a bunch of new and exotic bets and hope they don't blow up on you; or you can grit your teeth and stay the course, through a period of what may be lackluster returns, until interest rates finally normalize." He continued, "People are looking for the silver bullet, the magic wand, the get-out-of-jail-free card. There isn't one."

So, we stick to the game plan. We analyze business models. We talk to industry people to understand what is going on around us. We find combinations of reasonable businesses, reasonable values, and like-minded people. We buy their publicly traded securities when they seem to be out of favor. We try to understand cyclical versus secular issues. We don't have a crystal ball. (We do have a fancy set of Tarot cards to be fair.)

While we are not a special purpose vehicle with one stock, we do run fairly concentrated portfolios by conventional standards, so we don't need the whole world to line up right behind everything—just the handful that we own. And oddly enough, despite the habitual whining partially espoused above, there remains a fair number of interesting opportunities in front of us, without having the sinking feeling that we are dumpster diving behind a strip mall restaurant on a hot summer day. There are some things that we want to go down a bit more so we can buy more. (To a point!) And with "hundreds" of stories being floated around about new public companies in the last 2 years, we think we have a rich pipeline of replenishment ahead of us to keep busy and enable performance.

The Refrain From El Segundo

A final tidbit from Ben Graham that we again pull from the deceased file:

"The investor who buys securities only when the market price looks cheap on the basis of the company's statements and sells them when they look high on the same bias, probably will not make spectacular profits. But on the other hand, he will probably avoid equally spectacular and more frequent losses. He should have a better-than-average chance of obtaining satisfactory results. And this is the chief objective of intelligent investing. The risk of paying too high a price for good quality stocks—while a real one—is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low quality securities at times of favorable business conditions." (View related chart.)

Yes, the internal line on our letter this quarter was too much of "them" and not enough of us. The counter is that next month you will see our ten year anniversary musings, which I promise will be more than enough of us! In some ways, this also reflects a fear of monotony: we have essentially been saying—for a long time—that we are wary of a world that seems grossly dependent on the "sustainability" of a manipulated discount; there are too many anecdotal notes of absurd enthusiasm that suggest a near wholesale abandonment of fear for greed, and much of what we talk about outside of pure security selection are unusually novel ideas that rhyme poorly with historical study. These are statements that have been tightly following Newton's first law of motion—in many ways little has changed since the rebound from the 2009 Financial Crisis: rates stay low, risk appetite grows, US stocks go up. Yes, I am calling "COVID" a man-made blip as far as investing is concerned with all proper respect to those who are not with us.

What we do is also unchanged as far as philosophy and method, but we do adapt. The latest example is our soon-to-be-announced Cove Street Partners Fund. This is an "aligned" GP/LP structure that is pursuing a Private Equity in Small/Micro Public Equities approach. This encapsulates a number of "learnings" over the past decade, a giant one of which is that we run into a number of smaller companies that trade for far less than their private counterparts—no surprise given the insane amount of money that is chasing private deals. But smaller company X might be good at widgets, but lacks experience and breadth in corporate governance, proper Board representation, incentive structures, a proper understanding of M&A evaluation, and investor relations. We have developed a wide network of finance and operational people that seem to have too much time on their hands and like business challenges and making money with like-minded people. The crystallization of this strategy was a recent opportunity to buy a material stake in a small software/services company from a "tired" seller; we put strategic partner X on the Board, supported a management change, and have helped moved the company from a straight line of near oblivion to a public company that has a defined growth strategy, now properly understands capital allocation, and wants to tie this to a stock that can go up over the long run.

None of this is new to us, and we can bring the skills at which we think we have competence, add the people which bring the skills at which we are not expert, and create our own catalyst, which is often needed in our sometimes forgotten world of small and micro cap. This innately fits with what we do from day–to-day, and is formatted for the task at hand, complete with lock-ups, low management fees, and incentives that pay commensurate with success. Voila.

If any of these musings make sense to you, call us. Our whining about the world at large aside, we can put money to work.

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