An Exceptionally Wide Range of Outcomes

JUNE 2020 — We are back, to some degree. I am referring more so to communication with the world outside of our client base, as we have been extraordinarily conscious of not being another nowcaster spouting the obvious platitudes about the numerous uncertainties. "Sometimes wrong, never in doubt" is a popular phrase over here.

We communicated hard in March and, yes, it is certainly easier to repeat now what we said then:

1. Markets ceased to function in March across many asset classes.
2. This will be over—timing uncertain.
3. In times like this, you call upon all of the work you have done, the experience you have accumulated, the emotional fortitude (upon which you have fancily pontificated elsewhere in the past), and you lean in to the degree to which you have the mandate—and the cash.
4. We are barbelling: great businesses at great prices with "in the fire" stocks at crazy prices.
5. The world will not look that different when this COVID episode is behind us. Human behavior on display is the result of tens of thousands of years of evolution. Having access to unlimited bandwidth with which to spout platitudes of why this experience must have meaning rarely results in global behavioral change.

So that's what we mostly did, and we have mostly been rewarded on the rebound. We have also leaned the other way recently and sold off some of what we are referring to above. What to do now is a little tougher of a question, one which we will explore below.

Repeating the obvious, one of the hardest things to do in life is to invest capital when most of those around you are fighting to maintain position on a financial or mental ledge. We would like to thank the various clients and their consultants who stepped up near the bottom of the mess in March with fresh cash—as well as the support of all our other partners. We rarely "ask" but this was one of those times.

And once again—trying to "nail the bottom" is a terribly flawed strategy, particularly in small cap investing. We must be buying on the way down, as a 5% position at $30 with a $50 target is a lot better than ticking the bottom at $22 with a 1% position. Liquidity is not an accommodating fact of nature and it rarely exists when one needs it. We expect to be early and you should be giving us money "early." (Just not too early.) In other words, "V-shaped" recoveries happen a lot more frequently than people model—especially in small cap—and they happen much more often in securities markets versus trailing economic statistics.

Although COVID is not "over," we can recognize that this truly has been another historical episode—one that looks different in the light of 24/7 media attention and the continued collective inability of gender-neutral-kind to probability-weight extreme events. Historians will likely write of the process by which a temporary plan to preserve hospital capacity turned into months of near-universal house arrest and chaos: worker furloughs at 256 hospitals, a stoppage of international travel, a 40% job loss among people earning less than $40k per year, devastation of every economic sector, mass confusion and demoralization, a complete ignoring of all fundamental American rights and liberties, and the forced closures of millions of businesses. But that's just us talking.

Yes, this has been a horrendously difficult time for those who have had direct human losses and are living in epicenter areas. But, Wuhan and New York City are not the rest of the world, and let's

just leave it at that—other than to say reason #17 to hire Cove Street Capital: we are not in New York. Specifically, there is no doubt that—on the margin—if you were running money out of the Northeast, you had to be running a lot more scared than managers within our precious and mostly untouched (health wise) state of California. And didn't all the smart money managers leave NY for Florida or Austin? Talking to most New Yorkers over the past month was as deadly as spending your time as an equity manager talking to distressed bond investors all day. It can be hard not to think the world is coming to an end.

So the future remains uncertain despite the desperate and mostly premature attempts to model and then draw insanely incorrect conclusions. Besides an overall humility, can we at least collectively take away from this mess the idea that artificial intelligence, PhDs, and phony precision in conducting public policy (and investing and personal discourse) should be handled with extreme care? Or to paraphrase Dorothy Parker, these are often ideas that should not be taken lightly—they should be thrown away with great force.

It is equal idiocy to dismiss the mathematical probabilities of dangerous outcomes or to exaggerate them. And as we are not going to eradicate viruses from the planet, the least we can do is evolve intelligent strategies to minimize the risk to those who are most at risk. Haven't we spent enough money trying to extend human life not to enact a policy to move the untested elderly into nursing homes?

Moving off the humanity soapbox, we learned a long time ago (and are reminded regularly) that the entirety of life is not contained on a spreadsheet or within a petri dish. We invoke the Colin Powell rule for living and investing: you must do the work to acquire 40% of the information available but ease off at 70%, as the curve begins to bend hard and you are either duplicating what you likely already know or falsely convincing yourself of precision that simply isn't there—or both. The fact that in this day and age where more people in the history of the world have more access to more information and yet can't be bothered to spend the time to get to the 40% level, is support for our point on the lack of a noticeable second derivative on "human change."

But, moving forward to arguably the worst question one can ask in regard to investing—and yet we hear it all the time—why is the stock market moving up when all the news is so bad? The answer is almost always the same: markets as a whole are discounting mechanisms for the future—albeit not always correct ones—but always moving toward what is next rather than what tweet was received yesterday. Is the valuation suggested by current prices overly discounting the bad news? Is the "next" piece of news better or worse than what preceded it? And if the end of the world is here, are you sure you can collect on the bet? That simply has been the story since the week of March 16th lows.

Most of the world has mostly gotten more knowledgeable about the width and depth of the COVID virus pandemic. It is now a known unknown rather than a complete unknown unknown per the Rumsfeld theory, since we apparently are going to be quoting the first Bush administration through this letter. And thus slightly more rational participants in search of opportunity carefully develop the fortitude to make decisions, and "pricing" in most areas gets slightly more rational. And guess what? The biggest updrafts often come right after the biggest downdrafts. So again, turn off the TV and stop staring at flickering prices in wonder. It's irrelevant and unhelpful.

What remains truly uncertain is the duration of the full or partial economic halt, and just how awful human response will be toward it. Our guess is that now the hard and plodding work on the former starts and on the latter, not so good. Even not so old people can take a moment and pause at the awe inspiring spending at both the fiscal and monetary levels—which truly is uncharted territory (1st mention). Pause again.

Starting with the Federal Reserve: trillions committed toward new asset classes of direct lending, the purchase of corporate bonds and Exchange Traded Funds that contain illiquid bonds, municipal bonds, counterparty guarantees, and essentially the practical adoption of the "Whatever It Takes" Policy. Isn't there something really different about emergency lending around collateral versus out-and-out buying, much less pure direct lending? Just as "established" companies who have been whining for years about having to compete against players with vastly different rules about profit goals and

balance sheets, are we now in a future where the people with the printing press are competing against us for investments? I guess the good news is that, as noted in the Financial Times by one Roberto Perli, a former Fed economist and the Head of Global Policy Research at Cornerstone Macro, "It's tough for the Fed to basically buy the whole financial system...they have to prioritize and say, 'Hey, what is the most urgent need?'" Given the likelihood of mask wearing, it was tough to say if his tongue was in cheek. And this in a world that essentially rejected Elizabeth Warren and Modern Monetary Policy 4 months ago?

I know this is all good clean fun in a scary amount of other sovereign nations, but this is really a Rubicon for U.S. fiscal and monetary policy, and it requires thought and re-think. Does this break the Van Hoisington debt death spiral and portend the deafeningly loud dog whistle of a 38-year inflation inflection point or is it just more of the soul and interest rate crushing same? Does it really help the economy to support other people's past mistakes and juice the returns of those who made the mistake—such as over-levered private equity firms and the pensions who desperately hoped for a lifeline? Are there any signs of legitimate fiscal "stimulus" or are we essentially burning money with likely nothing to show for it at year end? Not even one shiny, nice bridge? Is it possible that this "stimulus" is a bigger waste of money than even the 2009 show?

We will interject here and note again, that we are equity-oriented investors and whatever your future misgivings, what cannot be denied is that low and lowering rates in at least an "acceptable" economic environment has been a solid backdrop for equity prices for a long time. It is just hard to say that is a sustainably ideal state of affairs for the world at large. But we have that tenuously going for us.

One thing that HAS changed over the last 30-odd years of investing is the "de-value" of securities pricing and market moves and what they suggest for the future, thanks to the legions of federal dollars under a myriad of asset classes and the massive amount of indexed assets. Did the panic of March really "mean" a long and painful recession or was it more of a massive short-term illiquidity event? Is the subsequent rally suggestive that all is well if it is the Fed that is doing the buying—or standing right underneath me saying buy or I will? What do zero interest rates mean? What do credit spreads mean if loan covenants are so weak that highly leveraged firms can zombie on indefinitely and there is a grim realization of why bother putting something into bankruptcy if I am going to be pillaged by my lack of curiosity about the loan covenants that have stripped the assets out of my recovery? Do the prices of stocks, bonds, loans and real estate have less to do with the conceptual earning power of their respective assets than with federally funded liquidity? WWBRD? BlackRock's global chief investment officer of fixed income Rick Rieder awesomely announced: "We will follow the Fed and other developed market central banks by purchasing what they're purchasing, and assets that rhyme with those."

And another thing we think is changing hard is the replacement of equity for debt. It is happening, whether you are looking at an IPO rush, the cessation of share repurchase for good and bad reasons, and the current state of "closed" affairs in leverage markets, the Fed argument aside. This is a longer term headwind for equity participants, but it might erase the idea that public equities are going away. As a for example, the dilution delivered to public equity holders averages between 2 and 7 percent per annum before "phony" share repurchase. That is the vig between corporate enterprise growth and per share value creation. That is a big number in a lower growth, zero interest rate, "sustainable" world, but I don't see that a lot of evidence of that is being reflected in strategist models or pension plan actuarial assumptions.

Overall, like a number of things we touch upon in this letter, a key issue in life is timing. Value takes time outs but the timing and correlation with other variables seem off versus history, as does the increased likelihood for vicious head fakes, extreme movement from "the norm," and sometimes just bizarreness on a week-to-week basis. But we should not complain between feedings on the carcass of ridiculous short-term movement. And we have plenty, with people trading the stocks of declared bankrupt companies with 99.9% likely zero recovery value with stimulus money or just out of plain boredom. Is that an undiagnosed COVID malady or just really stupid? And, doesn't the last 90 days bury any doubt about the efficient market hypothesis? (The tongue is in cheek if you can see past our mask.)

All of this is generally good news for us, although we can hear the voice of Keynes in our ear reminding us about the "long run." There are many more managers with many more dollars and many more statisticians buried in a back room producing epic tomes on "value investing." Enough already. People get it, but on the margin they just won't do it until we produce 3 years of great relative numbers versus growth. However, it is hard for us to stare at the words and find it still doesn't make sense that there are asset classes for which the following process is not still applicable: thoroughly study a business model to look for good ones; "surround" a valuation with different methods and scenarios; understand and study the incentives of the players; think longer-term than the surrounding noises; step up and buy/sell when the 3 buckets are generally in alignment. It works to compound wealth. It can work less well in tracking market indices where a very small number of tails can and do throw the dog back and forth across the room.

The world still wakes up every day and ends up doing what it should have done three years ago and there is not much to say otherwise that hasn't been said about the 19 reasons why value-oriented investing is not "dead" and how rare it is that today's "leadership" remains the gift that keeps giving for years to come. Under the "now what" category, our work suggests there is still a lot of value at lower market capitalizations if you are curating versus firing birdshot, but obviously there will be less instant gratification than during the last 3 months. But who is thinking 3 months ahead? (Another mask joke.)

Among notable new and interesting things, we are blowing our 5-Globe Morningstar ESG rating with a foray back into energy. We have little to add to "tell me what the price of the commodity is and I will tell you we will make money" other than our sense that the price of the commodity will be going up. (Sharp eyes would note that "from negative numbers" is a somewhat lopsided bet.) Our thinking is simple: demand will not be lower than the March lows; U.S. supply growth looks dead in the tracks, and there truly is no long-term reason why the Russians and Saudis think lower rather than higher is a good idea for their own national interests. What is noteworthy is how difficult it can be to invest in small cap energy, as management is prone to enjoy spending others' money recklessly, balance sheets tend to be weak, and the entities are simply not too big to fail in the eyes of the banks. WPX Energy (Ticker: WPX) was a large cap, it became a small cap, and we are hoping for mean reversion. WPX has excellent assets (mostly well-purchased) and a management team that at least pays verbosity to the idea of capital allocation. Many in the space can't spell it. We are looking for more.

Net-net we bought well in March, we cleansed some of our mistakes in the subsequent rally, and we are somewhat back to the normal business of investing: a quiet-time, lots to read, much to think carefully about. After all, if machines are learning, why can't humans? The perceived "need" to follow this quarter's earnings have been choked into submission—an outcome that helps—and we are trying to re-drum that statement into process. We sure as heck don't care what happened in Q1 and management doesn't really have to remind us that they have no idea what is about to happen in Q2, other than it's bad. But yes, Mr. or Mrs. CEO, we are glad you care about your employees, the world at large, and that you hire consultants to tell us you do.

We are hopeful for a nice dull summer that will undoubtedly disappear into the election cycle, and a new round of idiocy around the COVID virus as we approach winter. I am confident time will present an opportunity similar to one of going to Disneyland on the first day it re-opened after September 11th. (An awesome and fun experience.) But there is a lot more weirdness to unfold over the next 6 months as debt and "who owes who" in many forms and asset classes begins to settle in and out.

On that note, I have wanted to use this quote for some time from a gentleman named Jawad Mian who writes and invests from Dubai at his website Stray-reflections.com. Not all of it is for us, but he has an agile mind and pen. To wit: *"The great tragedy of speed as an answer to the complexities and responsibilities of existence is that very soon, we cannot recognize anything or anyone who is not traveling at the same velocity as we are. We see only those moving in the same whirling orbit and only those moving with the same urgency. Soon we begin to suffer a form of amnesia, caused by the blurred vision of velocity itself, where those germane to our humanity are dropped from our minds one by one.*

We start to lose sight of any colleagues who are moving at a slower pace, and we start to lose sight of the bigger, slower cycles that underlie our work. We especially lose sight of the big, unfolding wave form passing through our lives that is indicative of our central character."

In closing, as a firm, Cove Street Capital remains in good shape, but yes, we could use a few new clients. The current work environment is not ideal and anyone who suggests otherwise, particularly those with children at home, is simply an out-and-out liar. It has nicely changed some workflow as we encourage people to take the time to think, read more deeply, and not feel like they have to talk or virtue signal their involvement. There are a lot of unusual things going on in the world and it's okay to deeply think about them over time without the need to clog inboxes and Twitter with today's version. We will be together as a team and a self-created cultural entity as soon as legally possible.

Sending our best—and please feel free to call and discuss.

Jeffrey Bronchick, CFA

Principal, Portfolio Manager
Cove Street Capital, LLC

SIGN UP to receive commentary from the CSC research team: **CoveStreetCapital.com/Thoughts**

The opinions expressed herein are those of Cove Street Capital, LLC (CSC) and are subject to change without notice. Past performance is not a guarantee or indicator of future results. Consider the investment objectives, risks and expenses before investing.

You should not consider the information in this letter as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that any of the securities discussed in this report are or will be profitable, or that recommendations we make in the future will be profitable or equal the performance of the securities listed in this newsletter. Recommendations made for the past year are available upon request. These securities may not be in an account's portfolio by the time this report is received, or may have been repurchased for an account's portfolio. These securities do not represent an entire account's portfolio and may represent only a small percentage of the account's portfolio. Partners, employees or their family members may have a position in securities mentioned herein.

CSC was established in 2011 and is registered under the Investment Advisers Act of 1940. Additional information about CSC can be found in our Form ADV Part 2a, www.CoveStreetCapital.com/FAQ.