CSC STRATEGY LETTER NUMBER 46

To Infinity and Beyond – and the Usual New Year Review Stuff

Every year has plenty of lessons when looking backward in December. Our mindset is that if you are not wiser at the end of the year, then shame on you. At CSC we try to make new and interesting mistakes each year rather than repeat the old ones, a process anyone who is 110% presently invested in a balanced portfolio of cryptocurrency, meme stocks, and NFTs (non-fungible tokens) of vintage Julius Erving pictures might find hard to appreciate.

We are going to divide this Letter into three parts: (1) relevant and repetitive thoughts for 2022; (2) a recap of Cove Street Capital firm thinking and structure; and (3) a bulleted list of 2021 thought to clear out our brain for 2022 fresh thinking. To reiterate, our blog at www.CoveStreetCapital.com/Thoughts has our comments on the world at large. These musings tend to lean more towards bite-sized chunks, as we have heard rumors that TL;DR is a virus more prevalent than COVID variants. (Feel free to Google that—I had to when confronted with feedback on our last Strategy Letter.)

But some things are worth repeating in a valiant attempt to be vindicated within one's lifetime. So here is our 2022 outlook in a nutshell.

PART 1: Relevant and Repetitive Thoughts for 2022

- Near-zero interest rates since 2010 have put most asset classes "off the charts" in terms of any historical sense of valuation regardless of your metric. High current valuation and recent asset appreciation suck blood from future returns, as world productivity and underlying wealth creation en masse are simply not compounding at double-digit rates. They also create volatility as it takes less news to wobble the asset perched on the top of a step ladder. The future and its arrival remain elusive—but there are a lot of truly ridiculous "investment" assets that still need to come down hard to roost properly if survive at all.

- We don't fear rising rates per se, but we fear a complacency in the "expert opinion" running the Federal Reserve. The risk in 2022 is human error in dealing with truly new circumstances with extra zeroes at hand. There is something about the last two years that makes one question the "we are just following the data" pitch from the Federal Reserve. The risk is in how the Fed approaches inflation expectations as much as it is in the actual print of inflation.

- "Be fearful when others are greedy" is really hard to employ with other people's institutional money. Conservatism has not paid off in any fashion for many years. Like "climate," it is easy to confuse your own sense of reason and timing within a sample set that may simply be much longer than that which many of those around you consider. Think Keynes and death. We enter 2022 in good health and remain conservative.

- "Simple, profitable, and bird in the hand" remains an extraordinary relative trade versus a lot of extraordinarily speculative nonsense. The current period is not 2000—it's dumber. But the absolute valuation of small cap today is not as cheap as it was in 2000, a fact that makes it harder to claim that assets like small cap and value can/will outperform the S&P by thousands of basis points because "reasonable" was simply revalued to reasonable and "silly" was marked closer to zero. So we will go with "hundreds of basis points." But directionally we are there. Our misgivings about bigger themes seem to be matched by more than enough reasonable opportunities. For instance, we have barely scratched the surface of a record year of now or soon to be failing IPOs and SPACs—future gifts for public investors after the insider wealth transfer is complete.

- Yes, 2022 will be the year that the deflationary trade will prove transitory—albeit 37 years was a pretty solid trend on which to climb aboard. Taking capital risk—crypto lending, toothless credit lending, leveraging low-rated instruments to achieve a higher desired "fixed" return, etc.—to goose income generation has always ended up as a sad story. This one just seems as interminably long as is the new Matrix movie. And it's not just the level of interest rates on which things change; it's the willingness of credit to be extended. Historically speaking, the two issues are a lot more correlated than many investors think.

- Better businesses with the ability to pass on higher costs in a reasonable period of time are great inflation hedges. And one benefit in owning these is that we don't have to "make a trade" or hope that someone else decides to pile into our theoretically worthless asset (counting on a greater fool generally is not a reliable investment strategy). Stocks remain small pieces of ownership in businesses run by people just like us who are concerned about the same things we are. They are incented to think about ways to prosper in a more inflationary world, and some of them will get it very right or at least not suffer greatly. It is not necessary to pick the right brand of monotheism to achieve some sort of financial serenity.

- With a moment of silence to those who have passed, COVID will—again—definitively prove to be a transitory chapter in our lives. Its effects on human behavior, desires, and economic activity will be measured in the "intermediate-term" at worst, and we have reloaded certain investments accordingly. For those kids who can participate in something resembling school, please encourage STEM. We need more legitimate science and math education than bloggers and influencers and re-Tweeters.

- We completely whiffed on execution in 2021 on what we still consider a self-evident concept: the world is doing an infinitely better job of shutting and shaming down carbon energy supply than conceiving and producing a stable and affordable source of "renewable" energy. We don't see that as changing anytime soon and what is going on in Europe is not just an inflation and geopolitical risk factor, but a source of opportunity to make money in the carbon-based energy sector.

- We believe you should buy as much of the following as you can stand: Viasat Inc. (Ticker: VSAT), Compass Minerals International (Ticker: CMP), Ecoyvst Inc. (Ticker: ECVT), Lumen Technologies (Ticker: LUMN), Liberty Trip Advisor

Holdings Inc (Ticker: LTRPA) and Lions Gate Entertainment Corporation (Ticker: LGF).

No, these views are not original, and it does sap the literary will to write much the same thing in different guises. We have been annoyingly—and in retrospect overly—conservative for the better part of the last few years, and it has been unhelpful to relative performance. But we own real businesses run by real people who are motivated to make the business owners wealthier over time, at least for the most part. If the stock price goes down in a disproportionate way relative to the value of a company that we own, we would like more of your money to invest. And the room goes quiet.

We do not think in any way that consistent learning, thoughtful qualitative and quantitative analysis, being prepared to act in size at "near" inflection points, and thinking longer than the latest Tweet cycle has somehow lost its mojo for the next 800 years as a way to make long-term money. Yes, being early in a great speculative idea, selling it well, and buying a basketball team is a lot cooler than what we do. But we can be quietly effective.

And let us take a moment to frame this form of communication versus others—like our client letters. We go into enormous detail with our individual holdings to our clients… in client letters. And occasionally on our Blog as it highlights something interesting about our thinking and process. So, it is not relevant to suggest that Cove Street at large spends too much time in their Strategy Letters on bigger macro topics. Bottom-up work is almost all we do all day every day, except the four days around each quarter-end when we temporarily put our focus elsewhere. You can also take a listen to Ben Claremon's Compounders: The Anatomy of a Multibagger podcast on our website—there is a LOT of thoughtful analysis there that should be self-evident.

And if you are asking, conducting interviews is another interesting way of doing actual work. Aside from the background work that is actual research, developing thoughtful relationships with C-suite level management is also invaluable. We suggest with no temerity that people, their decisions, and their ability to allocate capital and create or destroy corporate culture matter hugely to an investor. And in answer to other questions, it's more about the above than plugging stocks we own, as Ben's work has moved forward and far beyond our holdings. This activity is additive to our investing efforts… and Ben damn likes it. CSC Newsflash: if people are doing things they like, they tend to do it better. If you are a public company CEO, Ben awaits your call.

PART 2: A Recap of Cove Street Capital Firm Thinking and Structure

This leads to another lesson learned in 2021: young people should join a corporate Board as early as they can in their career. Being able to take money out of your IRA without penalty should not be a requirement to be on a Board. For any investor, it is invaluable to learn and appreciate how corporate sausage is really made and to finely tune your BS detector. Yes, you need fear-inspiring compliance and process—thank you Partner and CCO Merihan Tynan—but I would argue formerly young and current Partner Eugene Robin has done a superb job of putting into action all one learns from reading more than a hundred proxy statements each year. This should be a carefully calibrated exercise for the noted reason, but the output from all that reading and studying is palpably good. Take a look at the compensation program at Research Solutions Inc (Ticker: RSSS), then give us a call. We have a copy ready for your compensation committee. And doesn't "youth" count as a form of diversity?

Before we get to the continuing evolution of Cove Street, let us make a few observations from the world at large for context.

- People hate closet indexing at active management fees.

- Fees, in general, are under pressure.

- People can index assets almost at will (and there are more ETFs and index funds than actual stocks for them to choose from).

- Some people at large seem to think it is a good idea to attempt to quantitatively impose political philosophy onto public and private companies via a buckshot scattering of self-appointed organizations and scoring techniques.

- There appears to be some magic sauce on valuation and goodness when the word "private"' is inserted as a descriptor of a company.

- There was the largest crop of IPOs and SPACs in history in 2021, events that will provide investable ideas from failed or fraudulent aspirations for a decade.

I am sure I missed something, but that seems pretty on track.

Given that backdrop and the changes in our industry, there remains unusually definitive resistance in the organized investment management world towards rethink, evolution, adjacent pivots, and "box leakage" from what might have been in the proverbial pitchbook eleven years ago. These deviations from the "plan" might be self-generated ideas on their own or in response to the points above. But there is also systematic cognitive dissonance—certain asset classes and firms almost by definition have carte blanche for any scheme known to man or woman, while we face the proverbial music on why we don't own 30% of the portfolio in small cap banks as dictated by the index. And there is a GIANT hole of inattention in the world of smaller public companies being driven by the larger size firms not really playing in our space; compliance "code red" lists driven by the brokerage and custodian nannies; and, of course, the "why bother, I own Amazon" trade which has been the gift that keeps giving as of this writing.

What translates from all of this to us at Cove Street is a renewed focus and more focus. We have narrowed the scope of strategies we offer versus the mix with which we began ten years ago. We have become more willing to own more of what we like. What many professional investors learn over time is that you can lose just as much money in half-knowing 50 investments as you can in knowing 85% in 20. (P.S. It's about understanding the critical variables that can be comfortably counted on one hand, rather than blog to blog recitation of encyclopedic knowledge on industry ephemera.)

And with focus comes the ability to add value more "actively." That is different than being an Activist. We are less interested in publicly embarrassing people than we are in partnering with the right people. When you see us doing the former, it invariably means we have made a "management mistake," but we think the value and the business are materially good enough to make the process worthwhile, albeit this is not our Plan A.

The public often doesn't see our Plan A because it typically consists of private conversations between a small group of people with skin in the game. It's not about chest-beating like a Reddit meme ape. We don't want emotional credit—we want to make money for our clients. Over the years we have put any number of people on Boards without a peep of our involvement. That also goes for the 10-ish companies over the past several years that we have convinced to de-stagger their Board of Directors. In the background, we have signed short-term NDAs with companies to help review their investor relations efforts or kibbutz on corporate finance matters. We simply have decades of experience of watching small companies attempt to grow beyond their current form. And, to steal a certain insurance company tagline, "We know a thing or two because we've seen a thing or two." Applying pattern recognition to our years of professional corporate voyeurism, we have developed contextual "playbooks" for breaking through the barriers that have kept many of these companies in their place. Often these organizations lack the management and Board-level diversity of thought to enable what it takes to go from $200 million in sales to $2 billion. This doesn't mean we at Cove Street want to "run" companies, as that clearly is not in the best interests of either the company's shareholders or our investors. But we do have direct experience in capital allocation, corporate governance, investor relations, and compensation structures, and we have decades of specific experience embedded in a wide network of C-suite level relationships to help.

So we have gotten somewhat concentrated, somewhat more active, and somewhat smarter (in our opinion). Within the context of always getting better, using new tools, and being willing to look at anything that we haven't previously seen: our work is the same, our process is the same, and our people are mostly the same. We are focused on three overlapping flavors: Classic Value | Small Cap, a strategy that is exactly what it sounds like, run by this writer; Classic Value | Small Cap PLUS, a small/mid strategy run by Partner Ben Claremon; and Micro Cap Opportunities, a small/micro strategy run by Partner Eugene Robin, CFA. Paul Hinkle, Chief Client Officer, or as I think of him our Director of New Money, stands by awaiting your call.

PART 3: Lessons and Clean-Up from 2021 in a Choppier Bullet Point Format

- **The Damn Banks.** The Russell 2000® Value, the index to which we are commonly compared, is nearly 26% financials, most of which are banks. When that big dog moves, you feel like a mere tail. We have owned banks and will own banks again. We haven't for a while and it hasn't helped relative performance. Ignoring the cognitive dissonance embedded in the strong… and transitory… performance of small cap banks in the early days of both the Trump and Biden administrations, we remain wary of credit in general, and in commercial real estate specifically, as small cap banks are simply leveraged versions of such. All else being equal, higher rates can help a financial institution, which has been a big part of the "trade." But we think that the positive effect on earnings is outweighed by the inclusion of a "normalized" credit loss number. Rising rates and yield curve change are not a monolithic positive for smaller banks. A high single-digit ROE is not a magic kingdom-type of return unless you are buying under book value. (We could have, but sadly didn't.) We like what we own better for any sense of a longer run.

- **Energy.** In early 2021 we nailed the proper narrative in Energy but didn't execute properly in size. In baseball parlance, we saw pitches we liked, we didn't swing enough, and we fouled off with the swings we took. To wit: global carbon reduction programs are reducing supply much faster than demand, and investor sentiment toward investing in carbon-based companies is still lousy. Translation: A lot of money was made in Energy. How did we miss with the swings we did take? One of our holdings was merged into a larger company, taking the company out of small cap and removing the position from our portfolio before the big move. The other—CNX Resources Corp (Ticker: CNX)—was a natural gas company that touted financial discipline and shareholder value. Translation: They were hedged to the gills and had low beta to the massive uplift in energy prices. The "obvious" play in small cap energy was to buy a basket of companies recently freed from bankruptcy or companies that would have been in bankruptcy absent the massive price uplift. This was a miss for us, but the oddity of life is that $80 oil and $5 natural gas makes a lot more of the industry viable. We think the narrative remains on track and we are doing work in the space.

- **Fees.** We have explored numerous avenues to engage potential clients with incentive fee structures. There is "convention"—management fee, incentive fee, and annual measurement—which can be correctly understood as more in the manager's favor than the client's, but there is a simplicity to it that has some definitive appeal. What we ran into in 2021's iteration is some math issues: we are offering an adjacent strategy/structure that has a zero percent management fee with a 30% performance fee over a 5% return hurdle. Like many things here at Cove Street, we took inspiration from Buffett's original partnership papers. We have been told more than a handful of times that is "too much" by folks who seem to be happy paying "2 and 20." We find that a little odd given the indifference point between our suggestion and a "2 and 20" structure is north of a 30% return. Moving forward.

- **ESG.** Paraphrasing a George Will column on ESG issues:

  One reason for optimism is that the prescription—treating companies and people as members of groups rather than as individuals—runs counter to the American tradition of upholding "a zone of personal sovereignty independent of communal arrangements." This tradition, as articulated by Michael Oakeshott whom Will quotes, holds that government must be powerful enough to protect the order, without which the aspirations of individuality could not be realized—security of person and property—but not powerful enough to threaten individuality.

- **Inflation.** We are way past the transitory concept because there is more going on in the world than supply chain issues. The best gauge we have seen are recent deals between unions and the companies Kellogg and Deere, where the unions passed on current wage increases in favor of a cost of living adjustment (COLA), a mechanism that adjusts wages annually for inflation. Under the heading of really bad things, COLA was a huge piece of tinder amid the 1970s inflation fear bonfire as it enabled an explosive cycle of expectations: I fear inflation, I demand protection, I contractually pay it out to employees, and I raise prices to compensate, all of which further fuels inflation expectations, which runs the cycle hotter and hotter. Nobel Prizes to the Union representatives if they got this right.

- **More on inflation.** As stated by Milton Friedman, "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." Okay, we have that going for us. Inflation also has its roots in labor costs and labor costs RARELY go down. Also, new, ESG policies are definitively inflationary.

- **Last one on inflation.** A quote from Caitlin McFall writing for FOX Business:

  "Now, another leading Dem economist has weighed in. Biden's line is that the pandemic caused inflation. But former Obama administration economic adviser Jason Furman tells AP that policymakers poured kerosene on the fire with federal spending. They were so intent on staving off an economic collapse that they 'systematically underestimated inflation,' Furman says. Furman cites as an example Joe Biden's $1.9 trillion coronavirus relief package, with its $1,400 checks to most households in March. This money overstimulated the economy, he states. Furman adds: 'Inflation is a lot higher in the United States than it is in Europe. Europe is going through the same supply shocks as the United States is, the same supply chain issues. But they didn't do nearly as much stimulus.'"

- ***The Caesars Palace Coup*** by Max Frumes and Sujeet Indap was a great book of 2021. Apollo Global Management Inc. Co-President Scott Kleinman, a person who would know, said record-low interest rates are causing a "collective delusion" on deal valuations. "We will look back in 20 years from now and say, 'What were we all thinking? How is this really feasible that a buyout can happen at 25 times EBITDA?'"

- **Charlie Munger** in a conversation with one Mark Nelson of Aussie hedge fund Caledonia: "I think the dot com boom was crazier in terms of valuations than even what we have now. But overall, I consider this era even crazier than the dot-com era." He also noted that he would not participate in an "insane" cryptocurrency boom, and was scathing of promoters of crypto assets. "I'm never going to buy a cryptocurrency. I wish they'd never been invented," he said. "I think the Chinese made the correct decision, which is to simply ban them. My country—an English-speaking civilization—has made the wrong decision." Cue Gary Gensler, the new SEC Chair. "I just can't stand participating in these insane booms, one way or the other. It seems to be working; everybody wants to pile in, and I have a different attitude. I want to make my money by selling people things that are good for them, not things that are bad for them," he said. "Believe me, the people who are creating cryptocurrencies are not thinking about the customer, they are thinking about themselves."

- **Avis Budget Group, Inc.** (Ticker: CAR) closed 108.3% higher on November 2 after rallying by as much as 217.9% intraday. The car rental company announced that it would follow peer Hertz Global Holdings, Inc. (Ticker: HTZ) in adding electric vehicles to its fleet. Avis is the No. 2 holding of the iShares Russell 2000® Value ETF. The top holding, AMC Entertainment Holdings, Inc. (Ticker: AMC), the meme stock and (unprofitable) movie theater chain, has rallied by 1,886.6% so far in 2021, a lament for those benchmarked against the Russell 2000® Value and that have even an ounce of common sense in their being.

- **"You mean that wasn't in the spreadsheet?"** The pivot of Zillow Group Inc (Ticker: ZG) to stop buying houses into inventory via artificial intelligence and model algorithms is a solid example that real stuff happens outside of a screen and not every business decision or process can simply be digitized and run through an app on your phone. It only cost shareholders $422 million pretax.

Jeffrey Bronchick, CFA

Principal, Portfolio Manager
Cove Street Capital, LLC

Visit our weblog at CoveStreetCapital.com/thoughts and sign up to receive commentary from the CSC research team.