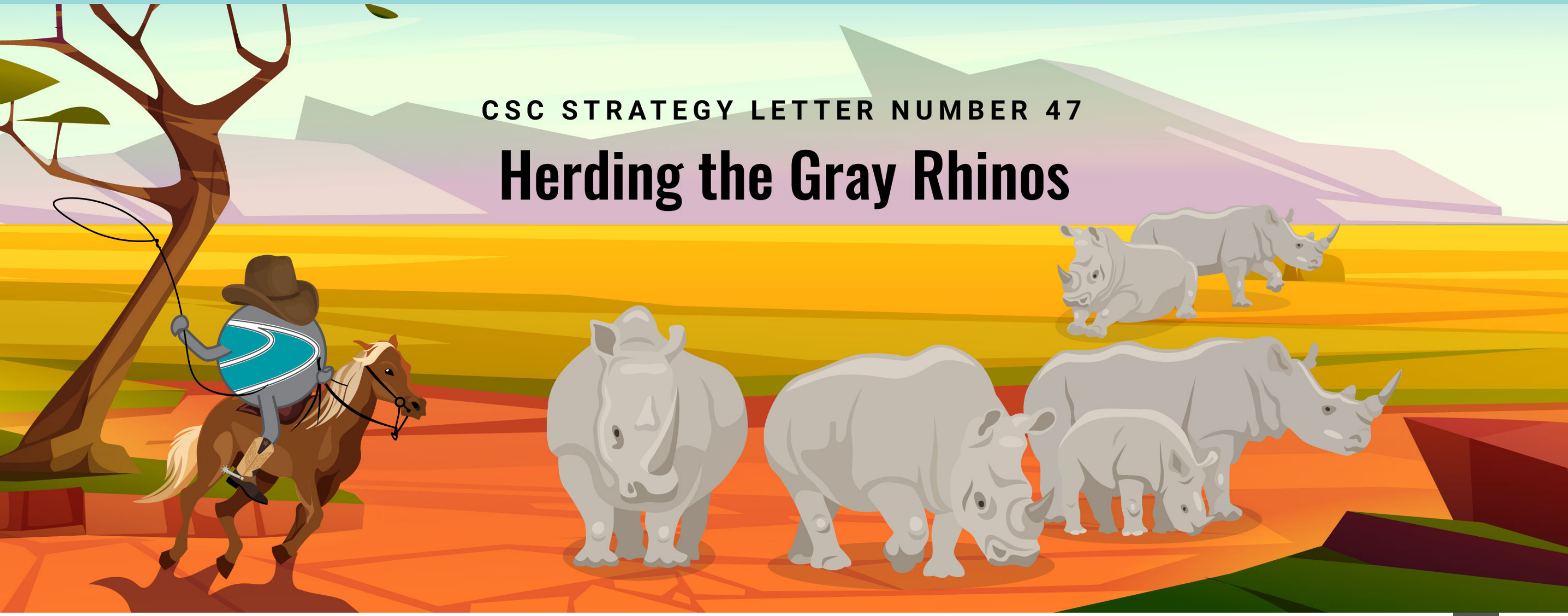

CSC STRATEGY LETTER NUMBER 47

Herding the Gray Rhinos

As we have noted in this space in the past, there is a lot of the world that cannot be captured by the most elegant and detailed of spreadsheets. I am not sure "Vlad, the Fearless Horseman" reads our Strategy Letters, but our guess is that he would now be pretty much in agreement.

Geopolitical issues are somewhat beyond our paygrade. We have opinions (really, really strong ones), but they remain difficult to employ within the world in which we live—mostly U.S. and mostly equity-oriented investing. We obviously pay careful attention to any input that affects long-term profitability and growth, but it is difficult to apply the maxim of "quantify and reassess" to the idea of a reclusive dictator who thinks proudly of a legacy that involves three bloody uncivil wars within the space of 30 years and who believes a closeted and anesthetized population will continue to give blood to support it—for now, at least. And day trading based on "sources close to the negotiations" somehow strikes us as almost as unhelpful as watching an index of daily snowfall across 50 cities as a way to make money in road de-icer Compass Minerals International, Inc. (Ticker: CMP). (Trust us, really unsuccessful.)

Russian Isolation and the "ESG Thing"

What can be seen…and quantified…are obvious issues: the Russian universe is a major energy supplier, a major steel producer, a major breadbasket to the world, and a major supplier of phosphate which feeds much of the rest of the world. And oh, yes, don't forget the nukes and London real estate. Global isolation is going to have many derivatives of problems for the rest of the world, but I would discount the bold pronouncements of "world change" from the chattering classes who generally get nearly everything wrong. The geopolitical balls on the pool table are scattering - political conclusions are early days. This conflict certainly mangles any claims of "temporary inflation," and it mangles discussions of global supply chains, as global businesses have some really interesting, long-term decisions to make other than giving away Russian assets. In the meantime, it's widely and wildly painful for consuming and profit margins—pick your favorite complaint.

It also mangles this "ESG thing" as talk turns from the worship of a girl named Greta and a guy named Fink to some really basic "hierarchy of needs" analysis. You know, those crazy old standbys of food, shelter, security, and energy. One does not have to be Ukrainian or in the non-10% to get really angry here, but we will let that notion linger in the ether. Instead, we will express some simple relief that the building blocks of the last 100 years of human progress are unlikely to be sacrificed at the altar of the New York Times. (Go natural gas!) To paraphrase the writer Matt Taibbi, are we at the end of an era that was almost completely transformed into a Boschian hellscape of penthouse-priced unelected third party entities who see ESG everywhere to degrees so far beyond even the most demented Fox News fantasies that the corpse of Roger Ailes almost sat up? And are we seriously considering trading Putin for Venezuela and a dictator to be named later? And did the SEC's 501-page Pravdian Manifesto on how companies should comply with climate disclosure mark the beginning of the end of inanity?

About those Rhinos

Turning back to our headline, the risks that seem large to us and that few seem to want to be early in addressing surround the price and availability of credit. It is not easy to be in professional money management and be "early" about anything. Whining about a decade's worth of extremely easy central-bank policy, the distortion of pricing in many asset classes, and the mispricing of risk has not been helpful. Trust us. The official internet definition of gray rhino seems to be something along the lines of "a highly probable, high impact yet neglected threat; kin to both the elephant in the room and the improbable and unforeseeable black swan." I've always wanted to use that term, so here it is.

Not to be callous, but while what is happening in Ukraine represents humanitarian awfulness, what we are paid to do is intelligently grow client assets over the long run. And the biggest risk to that remains the end of a 40-year bull market of lower interest rates and a material loss of confidence in those who extend credit and those who buy it. While we can snicker at the phoniness of private equity portfolio marks, "equity" represents the residual value of a business leftover to its owners after liabilities have been paid, and recent history has demonstrated that the perception of that value has had some pretty wild swings in public markets. Our performance has been relatively solid and positive in recent quarters because we have generally stuck to some rational, quaint ideas about profitability and valuation. But, we don't kid ourselves. Conceptions of value can be perceived as disturbingly relative for longer than we would like. It has been a friend for most of a long career. Then there are those other times. The key here is to buy businesses whose main risk is quotational rather than existential and at prices where time is the main risk rather than a permanent loss of capital. Rinse and repeat.

So, we watch carefully the supply chain of leverage. It starts with the private equity sponsors who create the debt pyramids at leverage ratios mostly unacceptable in public markets and with the use of "earnings free adjusted cashflow" and moves to the banks who take the bridge financing on their balance sheets and the fund structures that are expected to take the covenant free paper at the lowest yields and spreads in leveraged finance history in the desperate chase for yield. There remains nothing more cyclical in the history of the human condition than the willingness to extend credit, and we again use the cloud analogy: the change from selling all we have at any price to being able to offload nothing at any price can define ephemeral.

We see signs of unease, such as unsold debt on investment bank balance sheets waiting for a better day. In fact, U.S. lenders are sitting on some $38 billion in committed loan financing deals, with a further $37 billion in pending debt deals remaining on European bank books. Also, don't neglect the dismal performance of leveraged loans this year as the attraction of floating rate structures has and can be offset by credit issues. Take note of the weird differentials between credit ETF pricing and underlying assets as well and headlines like "Worst Day for Junk Bonds in 3 Years." And watch the just-about-inverted yield curve in Treasuries, which technically don't have credit risk, but if the almost perfect record of inverted yield curves equals recession holds, then there is credit involved. The Federal Reserve seems to be determined to raise rates until it has to panic on the first down 5% week. China lockdown? Last week's yen plummet? Rhinos.

Cognitive Dissonance and Herding Rhinos: Portfolio Management

So yes, we advise caution and naturally we are mostly fully invested. And yes, we can take advantage of the TLTROOS (Too Long to Read Our Older Stuff) state of the world and reuse one of our favorite Fitzgerald snippets:

> The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function. One should, for example, be able to see that things are hopeless and yet be determined to make them otherwise. This

> philosophy fitted on to my early adult life, when I saw the improbable, the implausible, often the "impossible," come true.

And there were no spreadsheets then.

We remain concentrated in better businesses that our research suggests are "merely" at risk of quotational depreciation rather than "what the hell could you possibly have been thinking" risks. We continue to see a lot more pain to come in the land of "silly" valuations, as a 70% decline in speculative and/or grossly overvalued pieces of nonsense do not in any way remotely translate to value. It's just one number moving to a lower number and profitability is still not projected until 2026. The case for the relative trade of Rational versus Silly (the technical phrase is Value versus Growth) to display centipedal legs of duration remains strong. A curated portfolio of reasonably priced equities—and we mean reasonably priced—may be the tallest investable asset class in the room.

We think people really underestimate the lack of attention still being paid to the small cap universe. One example is small cap investor conferences, which are great for youthful data absorption, but which are in some ways a solid indicator of a failed business enterprise when you start seeing some of the same names ten years later. Our point here is that we used to have to fight to get one-on-one meetings with a management team, battling with hedge funds who had nothing better to do than turn over their portfolio twice a month and thus garner love, attention, and meetings with whomever they chose due to their prodigious commission flow. The worm has turned as we now get calls from the conference sponsors (with whom we do no business, mind you) begging us to fill a 30-minute spot.

Why So Private?

Other things we think people miss is the arbitrage between public and private markets. I don't think we can exaggerate the amount of private capital that is running around chasing private companies. Buying a good small public company is considered "dumb money" because in theory anyone can do it—the market is open every day. But in actuality, our "deal flow" is in our face every day; a lot of our due diligence can be accessed via a long history of public documents and management pronouncements, and we have no "bids due by this date." We can read and talk and learn and develop relationships for years that prepare us for actionable inflection points or the ability to take on people's need for liquidity. There are plenty of opportunities in this world for us if one has a reasonably manageable amount of patience and thoughtful capital backing you. We have been/are involved in an interesting "Project ES" involving some of these concepts and it's bewildering to us. If you are interested in an opportunity to employ a "Private Equity in Public Markets" approach—and we know you are out there—our number is at the bottom of this letter.

And we remember back around 2017 when a prominent allocator dismissed our professional lives as "doomed" because private capital was taking everything private, ergo our target world was full of dysfunctional secular value traps. So, why bother? Umm…well that has changed! We have years ahead of fresh research into decent businesses that simply went public at stupid valuations and are in the midst of disappointing everyone they know. We welcome you to our process!

On a side note, we have maintained our aversion to small cap bank stocks for those scribes who watch the coming and goings of performance vs the Russell 2000® Value. Plucked from a recent Grants Interest Rate Observer:

> Ben Mackovak, co-founder and managing member of Strategic Value Bank Partners, investors in community banks nationwide, tells Grant's that "real estate projects that penciled out at 3.5% or 4% interest rates don't work at 4.5% or 5% interest rates. So we're actually, in some of our portfolio banks, seeing some decline in that demand because some of the projects people thought they were going to do won't work at these higher rates—which is kind of scary, because the rates are still pretty low.

Small cap banks are generally geographically undiversified real estate funds with single-digit ROEs but are selling at premiums to book. We just don't think that is a place to be.

Catalysts Found Us

This brings up another something to re-note. We have always recognized that we are trying to invest like "business people" in an absolute return way, while the world in which we live tends to be inclined to judge us on a relative basis. This can exacerbate our tendency to be "competitive" in up markets and outperform in most down markets. While we said the same thing when we looked somewhat less than smart in 2017 through mid-2020, we will repeat it as we continue to pick up relative performance:

- We don't change as much as does the tweeting world around us.
- Good team? Check.
- Consistent philosophy and process without being overly dogmatic? Check.
- Willingness to think differently and longer-term? Check.

From our research and experience, we estimate our three-year numbers are likely going to turn really good soon. We aren't any smarter, we were just never that dumb.

An interesting thing about our 2022 portfolio is an unusual number of catalysts expected to materialize this year. It is popular sport to be asked, "what is the catalyst?" or "if there is no catalyst, why am I investing?" This focus on accelerated outcomes is not completely stupid thanks to the concept of opportunity cost. And being 7 years early in a relative performance sporting event is NOT going to win you a lot of friends and Met Gala invitations. Most of the time our answer is if you have compounding businesses with a strong management team and solid values, time will resolve it. Unusually, this year has some "no, this year" elements to it that we think augur well for "value maturation." Some examples:

- Alleghany—Done. Thank you, Uncle Warren.
- Tegna—Done.
- Colfax—Spin next week.
- Viasat-3—Launches to begin in "late summer."
- LionsGate—Seeking "strategic alternatives."
- Landec—Goodbye, avocados!
- Millicom—Financing overhang is almost over.
- Lumen's—Two large divestitures are closing soon. Perhaps more to come?
- Ecovyst—Interesting "news" floating about.

While we are happy to be patient and invest with the intention of being so, it's always nice to be validated sooner rather than later.

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.