CSC STRATEGY LETTER NUMBER 48

Desengaño

Desengaño was noted by one Antonio Garcia Martinez in his most excellent book, *Chaos Monkeys: Obscene Fortune and Random Failure in Silicon Valley*, as a unique style of Spanish genre painting. Literally defined as "the un-tricking," and using his words, it is best translated as the disillusion or the unveiling of a harsh truth. Human deception is revealed, and then an instructive moral lesson in everyday life as the "the tricked one" is shown with an exaggerated expression of betrayal.

That seems to describe the goings on within financial markets globally, as what seemed to be an endless fairy tale world of zero interest rates, nearly free money, and human behavior that defied generations of precedence, history and simple math, has rudely had its financial bandages ripped off to expose painful wounds that seem unlikely to heal quickly. Who can believe it? How could this have happened to us?

Publicly traded asset markets express betrayal quite rapidly in the 21st century, as we can all attest. We won't bore you with ad nauseum details, but for the stock market as a whole—as measured by most indices—it was one of the worst first halves since 1970. This time period, which we will discuss later, is an interesting date to note. And note to self, what's in your private equity fund marks?

Even when you have expected things to become more difficult in life and financial markets, it does not make it any easier to digest when they come home to roost. We didn't own unprofitable crazy schemes stocks, cryptocurrencies, or good growth companies at insane valuations, but nor did we have 50% in energy-related stocks, which was the only real "sector" to show a positive return year to date. So we have done "okay." We held ground through May, but as the sobering non-joke goes, "when you are outperforming in a down market that is about to become really messy, don't worry, they will come for you next."

That particularly applies to two of our largest holdings - Viasat and Compass Minerals, both of which had "what the heck?" declines in the quarter. We will again note that despite post-Covid-related delays, Viasat will launch the first of its next-generation satellite constellation in "September/October." Our research suggests that this long-awaited event will herald a massive turn in profitability as capital spending and pre-launch operating costs begin to be matched with customer revenue. Investors tend to like that. Compass is an uncorrelated weather company that happens to be in the salt production business, specifically road deicing. We have read a lot of finance books and academic papers and we have not yet seen a reference to the correlation between icy weather and the stock market. But, as noted above, we do live in a

world of financial markets that are much more intertwined than in the past via derivatives, index funds and general short-termism. And anything remotely perceived to have a little too much leverage seemingly does emerge as its own Russell equity sector in messy environments. "Sell" tends to be a much more indiscriminate and rapidly moving trend than in the past, thanks to derivatives and indexation.

What good news! Stocks are bizarrely treated as "Giffen goods" as in the higher the price the more they are desired. It has never made any sense to us. We quaintly believe that the opportunity to buy businesses at lower values—rather than higher values—is a good idea. And nothing is more opportune for "new money" than a general stock market mess that produces indiscriminate selling, which often refreshes our opportunity pool going forward. And this one is setting up to be large.

But, it can be argued that it's early. Panic early or double down late is a very effective strategy that is obviously difficult to apply in the financial business. We are generally asked to be mostly fully invested in our neck of the woods. So, we apply some learnings from prior rodeos: admit mistakes, free yourself from thinking you have to ride the same elevator up that you rode down and concentrate more capital on your best ideas. And move carefully, as you will clearly run out of capital in even the best ideas because less steady hands at large have a lot more capital than you possess. We have quoted some version of Kahneman and Tversky multiple times. What happens consistently is that people and organizations rarely see impending change, they are slow to change, they are prone to do nothing and then…full-fledged panic. I don't think we have seen that yet in equity markets. And we recognize that even the smartest money finds it difficult to allocate capital when they should, which is the opposite of how EVERYONE knows capital should be allocated. We can't identify a bottom any better than you can, but the only person who consistently picked tops and bottoms was named Madoff. So, the answer to the timing question is: give us a third of the allocation right now.

We do not think this is March 2020, which was, at the time an understandable panic reaction in asset prices to what was a "great unknown" with an equally rational V-shaped recovery once a consensus developed that we were not living a zombie video game. We are living in a much messier world that is not going to be underpinned by a global policy of near-free money. There are numerous experiments in fiscal and monetary policy that are at giant inflection points with little historical perspective to opine on their likely outcomes. We are still not remotely close in our opinion to the end of one of the great speculative waves in postwar history—or prewar for that matter. There is still a trillion or so dollars between zero and here in Crypto-land to point to one example. Also, Revlon's stock went up 6 fold in a week AFTER filing bankruptcy. Those people need to go back to working service jobs to complete the cycle. We thus postulate that nearly everything that "worked" for years is going to have a problem, due either to zero valuation progress, as any inherent business model goodness takes years to catch up to ridiculous market valuation, or in actual exposure of a false premise, where the tide going out makes one's choice of swim attire become self-evident.

And bringing back that reference to "that 70's environment" that included rising inflation, the demise of a Nifty-Fifty, a war out of nowhere, and terrible policy response to something that had not been seen for a long time. Does any of that sound familiar? While some people point out those toxic circumstances led to a ten-year dead zone for equity investments that didn't end until 1982, there was an outrageous spread in returns during that time between the Nifty-Fifty stocks and the smaller end of the market, which did remarkably well in the "death of equities" time period. Again, this is where Berkshire also made some insanely good investments and really began its juggernaut of performance. But it certainly wasn't easy in the early days.

So, we are leaning in where our research suggests this is a real business, at a very reasonable valuation, run by people who seem highly competent and are incented to work on our behalf. And yes, as noted above, the downside in x investment usually seems to be "20% below our worst case scenario" in tough times. But we can look at history and other cycles, look at cash in hand and cash still to be generated and establish reasonable comfort levels for a range of values at which a stock should trade. There are still a lot of ridiculous public companies that have market caps in the tens of billions of dollars but for which

there is no history from which to develop a baseline that allows investors to sleep well at night. That is not our world. And if you need to go back to the basics, review your Berkshire Hathaway readings. That is usually how the world works.

While it might not be terribly productive as far as being right about the future, a fun exercise today consists of making a list of "pros and cons" for equity markets at large. We can help! There are a lot more cons than there are pros (there always are) and the gaping hole on the left side of the paper in front of me is arguably one of the most positive things we can say. "Sentiment" is miserable, and when combined with "cheap stocks," that is usually a pretty neighborhood for a bottom. We just see it more from a "one at a time" basis rather than a grand statement about equity valuations at large, absolute or relative to a pretty long baseline. Also on the positive front we would also throw in the likelihood of complete deadlock in Washington come November, an outcome which we always argue is a good thing regardless of which side of the aisle from which you are tweeting. One can argue that "this" inflation is not remotely transitory, but it arguably could be a 5% five-year number and not the pace of the recent 9% prints. So "less than expected" is in theory less than awful news. Just a standard crappy recession (which is almost always the case) versus the impending doom of the Western world, which is how people like to write and read it. All of which would suggest a less aggressive Fed than feared? And for "us," the continuing march of the relative performance of "rational vs silly."

The big picture stuff is fun to talk about from time to time, but not how we spend much of our time and we are not sure we can really "add" something to the cacophony to which you are also subjected. Said yet one more time, if we mostly own solid businesses with reasonable balance sheets run by qualified people, we will be mostly okay. Asset classes are not monoliths colliding with overwhelming waves of macroeconomic inevitabilities. Things change and the people who are running our companies are doing the obvious hard work to adapt and pivot where necessary in order to further…or preserve…growth, margins and returns. It's fiendishly simple: be mostly right on our choices. We have a deep pool of analytical history, wide C-level industry contacts and strongly believe in curation. It's much harder to make these judgments over a 150-stock portfolio and discern differences between winners or losers. And, as of this writing, almost two-thirds of the Russell 2000 constituents are either unprofitable or trade north of 20x their earnings before interest and taxes. As such, we are quite happy not to have to own the entire bucket.

The obvious area of interest for us is in what we call "growth cyclicals," superb niche businesses with stupidly good return and growth characteristics but that certainly will take an inevitable beating in a difficult economy. Recessions happen—it's not the end of the world or anyone's first rodeo. And if something is properly defined as a "cyclical problem," then almost by definition it is a buyable problem. We own some and have been adding, and we have a checklist of prospects.

Before we close, we want to highlight a few economic tidbits: roughly 15% of the US economy is in some way tied to residential housing. Interest rates are up and housing affordability has taken another whack. That just won't be good for GDP. The top 25 banks have roughly a 70% of shareholder's equity exposure to commercial real estate. They have diversified business models, fee income and on net benefit from reasonable interest rate increases. The next 500 banks by size have roughly 245% of their shareholder's equity in commercial real estate. Walk into an office building near you and tell me what you see. Now tell me what a commercial real estate loan up 300 bps looks like on that math on a refinancing? That is the answer to why we don't think smaller banks are buyable here en-masse at 1.5x book value.

And yes, Dear Brutus, mass adherence to ESG has been a very expensive and inflationary factor in the world, a concept doused with kerosene by Putin and Russia. As of this reading, it remains impossible to reconcile the desire for "Green Now" with the ability to create supply for any number of raw materials in order to at least maintain the world's living conditions. Europe has declared nuclear and natural gas to be acceptable, and a few more election cycles in the EU may succeed in pushing out grossly over-ambitious goals by a few decades—where they should be. It is conceivable that it will be the same in the U.S. Net, net US domestic energy has an unusually

strong claim to be stronger for longer. We own some and are looking at some more. It just remains easier to buy Occidental Petroleum all day long than much more narrow slices of smaller companies.

This is simply a great time to begin or continue conversations about allocating capital to our world. Thieved from a recent Grants Interest Rate Observer: "Right now," David S. H. Rosenthal, renowned computer scientist (he was employee No. 4 and chief scientist at Nvidia Corp.), told a Stanford University audience in February, "there is way too much money"—that is, money in venture capital. "I'm a big believer," Rosenthal went on, "in Bill Joy's Law of Startups: 'Success is inversely proportional to the amount of money you have.'"

Not our problem..and another argument for our 1/3 allocation today.

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