CSC STRATEGY LETTER NUMBER 49

The Future

Yes, it would be hard to use a Yogi Berra quote while wearing a Dodger uniform, so we will fall onto the Fitzgerald sword that the ability to hold two opposing teams in mind at the same time and still retain the ability to intellectually function is a sign of a first-rate intelligence. Please read through the letter to render your own opinion.(Postscript - Ok, Anyone but the Phillies)

Let's start with repetition. We are living in a much messier world today that is not going to be underpinned by a global policy of nearly free money. We thus postulate that nearly everything that "worked" for years is going to have a problem. That will mean either zero or negative 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—the tide is going out and one's choice of swim attire will be self-evident. So we do "micro," try to worry less about the world and focus on a narrow group of opportunities where we can self-help our way to solid returns.

And the opportunities are there and getting more plentiful. Lower prices for good assets are good things for investors with fresh capital. As Jim Grant has noted in the past, "value restoration projects" are what astute investors dream of; you just have to have the cash and disciplined stomach to take advantage. "We don't know" is a much maligned response to the question about what lies ahead, but anyone who has toiled in our world for any amount of time understands how underpriced "off-spreadsheet" events are and why margin of safety is not just a slogan on an old sweatshirt buried in the closet. In fact, it should always be a large animal in the room. We don't know the bottom, but it can be argued that the period for "panicking early" is behind us, leaving the next logical action: looking to double down late.

So, along with everyone else, we are now in the midst of watching another horribly painful movie featuring the same "experts'' that got us into our current mess. In this installment, this motley crew continues to blunder into a variety of "cures" that simply compound matters or create new seams of idiocy on a global landscape. And like baseball managers, they seem to just shuffle into a similar post somewhere else versus having the decency of elephants to find their graveyard and quietly go away from the rest of us. Or, in some cases, they get Nobel prizes. The obvious point of reference here is Federal Reserve policy, which for ten-plus years dumped money into the system to lower interest rates, enable limitless liquidity, create the illusion of low volatility and generally employ a mandate of saving people from themselves—and the entire private equity and leveraged finance world thanks them for it. Now we have the inevitable

over-reaction: draining funds and raising interest rates in an ad-hoc fashion to fix the problem that was self-created via other ad-hoc reactions. Like the ringing of a dinner bell, we have the UN, Congresspeople and, I am sure, religious leaders to follow bemoaning decisions to belatedly put a stop to this "adulting." As I tire, as do you, the reader, of yet another opinion on this topic, we will simply note two things. First, Federal Reserve policy works with an indeterminate lag, a concept that does not fit neatly into the daily political or news cycle. How frustrating for the policy maker who so desperately wants immediate gratification and so desperately does not want to overdo it, like he did last time. Secondly, what we ALL want is for security prices and interest rates to mean something more than just a manipulated set of numbers, as well as an environment which allows—eventually—for functioning markets. It is certainly clear that we are not remotely there yet and remain in danger of unnecessary global problems.

Let's get most of the bad news out of the way first, which might take 17 pages. We most certainly are in a recessionary wave due to three simple factors. Number One, rising rates are crushing real estate values and anything remotely related to "housing", which by any number of estimates is something on the order of 25%-ish of economic activity in the United States. We are also on the verge of a massive inventory purge recession. The corporate world has built itself mountains of "oh my god we have a supply chain issue" inventory and we are now hitting that wall. The next several quarters will see lower production and inventories worked off and that can really eat into GDP. And lastly, we have wealth effect issues as literally hundreds of billions of dollars of truly phony, fraudulent or just out and out dumb valuations that showed up in investor monthly statements are/have been torched towards normalcy. It's the talk of the town. And yes Ms., "oh not me, I am in private equity versus the filthy squalor of public markets," you are next. (You can throw in your own global mess issues here.)

Our initial response to the above is: mostly so what? There is nothing new about inventory cycles, which define cyclicality. There is also nothing new about rising rate environments or about a screwy world that doesn't work as it should. There is nothing new about upcoming credit and liquidity issues for those who are hopelessly leveraged and dependent upon friends who will not come when needed. And there is nothing new about a commercial real estate mess which is impossibly challenged by the simple math of interest rates.

Okay, there are a few new "zero history to rely on" issues involving a LOT of zeros globally. Dare we say it: de-quantitative easing? There is nothing actually fun about getting back to what the world usually looks like: messy, unpredictable, and volatile with punishable risk. That is what makes good investing wonderfully opportunistic. You, kind reader, with cash in hand, can act when you know you should, and buy decent businesses or assets with margins of safety of valuation from price insensitive sellers who "feel" that they must sell. This is the cycle in which we are find ourselves.

No one is going to ring the bell for you as to when to act. Yes, we are postulating that you will have time to maneuver carefully and lean appropriately, as there are any number of things that simply aren't transitory. While we can argue that we have no legitimately additive ideas on the subject, we understand history and baselines that we would suggest rhyme with the future. Inflation issues and interest rates movements tend to be very long trend items. Specifically, a quick look at Big Rate History shows yields generally declined from the close of the Civil War to 1900, rose until 1920, fell to 1946, rose till 1981 and fell unitl 2020 or 2021. Counter-trend rallies or selloffs kept speculators on their toes in each phase, but the underlying trends persisted for as few as 20 years or, in the case of the presumptively concluded bull market of 1981–2021, for as many as 40.(Thanks Grant's.) So, to keep it simple, "Don't Fight the Fed" is as simple as "You should have bought Amazon and Apple in the single digits."

With all of that in mind, there is a general playbook: use a mess to eliminate mistakes and you know what yours are. For us, it is the 3rd column on our Decision Process Spreadsheet where an esteemed colleague is making a new and different, impassioned and erudite case for why he is not wrong but merely very, very early. "You don't have to ride the same elevator up that you rode down." Use proceeds

to continue to leg into your best ideas as they gravitate downward to "20% below your best estimate of downside risk."

We see several avenues for your interest. The first is "standard stuff": we run separately managed institutional accounts and a small mutual fund where we buy a portfolio of a fairly concentrated, 30-ish company portfolio made of up what we define as "Buffetts or Grahams." (www.Covestreetcapital.com will give you all you need short of lunch with us.) This SHOULD be an excellent area for movement of funds to people like us, both on an investment opportunity basis as well as the persistent theme we hear that "many" are beginning to relook at investment guidelines that suggest there are other asset classes other than large cap growth, PE/VC and multi-family real estate. And we will note again, you HAVE to be early in small cap because that is when the liquidity materializes. What we want is a full position at $13 per share in a stock we think will be $25 in 3 years, rather than the emotional smugness that comes with picking off the 1,200 shares that traded at $10 but failing to get the full position.

An extension of this approach is what we would argue is our "best idea," which often translates into "no one but us thinking so" at the time. (Think Viasat). There are large stakes in smaller public companies "stranded" from the private equity world, often with "end of fund, now what?" issues. PE is now raising secondary funds from private sources to invest in "hung" private companies that are at fund life end. What very few people are doing of any stripe is raising money to take out PE owners that are "hung" in public companies. The current issue is that the exit strategy is now stymied due to far more difficult capital markets, and seemingly an innate inability to understand how public markets work—and how a stock can be offloaded without crushing prices. It is both mind boggling and a great opportunity. As a result of persistent, multi-year research, long standing C-level relationships, and general behavior that suggests we might be good investment partners versus Patagonia-vested, hedge fund stock jockeys, we have been offered "nearly" control blocks of stock with material board representation. In the end, the businesses needs to be good, the balance sheet reasonable and good management in place. We have/are seeing these opportunities, ranging from $24mm to $300mm in investment size. This is an absurdly interesting development in which we are superbly positioned and yet…nothing has happened. The world's smartest minds in the PE, family office and endowment world (insert frustration emoji here) appear to have yet to recognize that owning 25% of a publicly traded small cap company with two board seats represents effective control (unless you morph into Vladimir Putin or Jeffrey Epstein) or that there is ALWAYS more liquidity in a public name versus a ten-year, locked up fund. Such investments can be actualized via a Special Purpose Vehicle with investors' involvement being either passive or active as far as Board participation. And for taxable investors, compounding tax-free with discretion as to when and how to exit, if at all, is interesting.

So there we have it. Bad news is always devastatingly obvious and presented well when staring us in the face. So some part of it is reflected in current prices. There is no reason to suggest that now is the world's best opportunity to allocate capital to small public equities, but we are on a path to making that statement accurate in the near future. Of the two immutable rules of investing—that size will kill you and that higher flows of money into an asset/industry will ruin future returns and vice versa—we suffer from neither as a firm or asset class. In a recent interview, fellow sufferer David Einhorn noted that "... it isn't as if investors are now embracing value investing and pouring into value stocks. The community of disciplined value investors has shrunk considerably… The market is still dominated by the types of investors who we described in our year-end 2020 letter: those that either will not (index funds), cannot (untrained novice investors) or choose to not (valuation indifferent professional investors) have valuation as a cornerstone of their investment processes. A lot of these investors have had a tough go of it during the current bear market."

Uhh, huhh. Cove Street Capital gets questions, and what can I say? Our assets are down from peak levels, our recent performance has been "eh", and, obviously, we are making less money than we were. None of this is any fun. We have managed staff down to match and have increased spend on technology to run the business, without sacrificing our investment team. We have the huge benefit of answering

to no one but ourselves and our clients, and we have a founder and lead principal who is a stubborn SOB who brings endless enthusiasm to the task at hand, supported by a "privileged" career.

So we love what's going on. There is a stupendous opportunity brewing to put capital to work and are open to your suggestion as to how to work together.

Jeffrey Bronchick, CFA
Principal, Portfolio Manager
Cove Street Capital, LLC

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