CSC STRATEGY LETTER NUMBER 50

Isn't It Always the End of the World as We Know It?

This is always the worst time of year to write about "Strategy" because of the cacophony of concurrent noise, lists, and predictions and the silliness of conforming the continuous process of investing to yet another lap of our blue-ish rock around the sun. Even being right on the "what is going to happen" often runs hard into the mysteries of why things happen when they do. We have learned a lot in the past year, as we hope to do every year, but have made zero progress on fixing that timing issue.

Today's world is particularly annoying as we collectively suffer from PEAK WORDS. How many damn podcasts, blogs, substacks, and interviews can there possibly be, much less be absorbed? (We assume you have finished Ben's podcast series at CoveStreetCapital.com) Do we really need that many interesting and erudite people talking about…really interesting things in interesting ways? A surefire way to lose money is to buy into the viewpoint of a "well-regarded" opinion persona without having done the work yourself. If you know nothing else, what do you do when things go off track? Mini-setback? Timing off? Or just horribly wrong? Wow, he owns 9% of the company and can articulate why the stock is cheap. (Uhh… that is .4% of his net worth or fund.) Yes, studying the success and failure of others is not unimportant on the path to your own long-term success and wealth creation or anything at large, but in the alleged words of St. Francis of Assisi who told his followers, "Go into the world to preach the gospel…and if necessary… use words."

And, with the explosion of AI agents and ChatGPT, who are you really reading? (I have put our Strategy Letter into the machina and it's scary good.) I don't think reading 10-Ks under candlelight in Ted Kaczynski's cabin 320 days a year is a path to investment success, but I think striving for less noise, including others' opinions, and more internal work and thinking is a solid 2023 resolution.

Which leads to a relevant comment for 2023. We put together a Scale of Justice-looking thing for our client presentations this time every year, weighing lists of positives and negatives that seem relevant. Ignoring the obviously HIGH probability of off-spreadsheet events and the previously noted issue of timing, it is almost always easier to pick negatives than positives. The negatives usually have a lot of backward-looking data to support predictions of doom, and the people attached to them seem educated, experienced, and successful. As any student of behavioral finance knows, we have simply never really evolved from the cave and saber-tooth tiger mentality and continue to prioritize, over-focus on, and over-estimate the probability of extreme events, particularly those that vector toward end of world as we know it. "Organisms that treat threats as more urgent than opportunities," wrote Nobel Prize-winning behavioral psychologist Daniel Kahneman,

"have a better chance to survive and reproduce." And…doom porn sells, ask people on Twitter. Or Paul Erlich (author of the 1970's unprophetic book *Population Bomb*).

We do extensive work on both sides of the equation and try to develop scenarios that help us assess the probability and materiality of both good and bad future outcomes, and we freely admit to being cheerfully bearish a fair amount of the time. But even we acknowledge the positives sometimes seem…pollyannish. I have used this before, but I still love this exchange in the film, "Shakespeare in Love". Note the paraphrasing.

Philip Henslowe:

> Mr. Fennyman, allow me to explain the investment world. The natural condition is one of insurmountable obstacles on the road to imminent disaster.

Hugh Fennyman:

> So what do we do?

Philip Henslowe:

> Usually little. Strangely enough, it usually all turns out well.

Hugh Fennyman:

> How?

Philip Henslowe:

> I don't know. It's a mystery.

Isn't it that fiendishly simple? Avoid doing really stupid things, be generally invested in generally reasonable things with some sort of historical baseline of reasonable past success, and have a long-term view that properly matches long-term priorities. And, what IF something good happens?

And obviously, 2022 was all about stupid things coming home to roost. We lost money, but less than many, and less than the indices. We make our own share of mistakes by omission and commission, but there were some seriously ridiculous things happening over the past few years that flew in the face of all present and accumulated common sense and that attracted, and then blew up, tens of billions of dollars of other people's money. But the Charles Prince theory of behavior will always exist: "As long as the music is playing, you've got to get up and dance…and we're still dancing." As noted in this space dozens of times, low-to-zero interest rates for years eventually got nearly every asset class and even the most dorky investment manager onto the dance floor in some form, and when the band stops, many were busting moves that look a lot like Elaine Benes.

We think that shorting or simply avoiding silly and looking for things long in commonsense/ value is a theme that has legs. While you can go deep with Cliff Asness and his gang of quants and researchers for self-serving deep data, a sense of history, 38 years of learning and experience, and a still very modest flow of funds from A to B suggests that the collective institutional brain is still grappling with, admitting to, and pivoting from mistakes of the past. And with interest rates moving irregularly higher(CSC multi-year prediction, see above) to reflect a historical +200bps over your favorite inflation indicator (hard to see a 10-Year Treasury at 3.62% as of this writing having read the beginning of this sentence), we think the pressure to admit defeat and change position is just starting.

We postulate that two big things ran into a wall in 2022: Peak Private Assets and Peak ESG. Spoiler alert: "our" world has been under pressure because paying insanely higher fees for illiquidity with leverage and based on an utterly phony premise that just because assets are marked quarterly versus daily means they are really less volatile is a concept that has been marketed brilliantly by the world's smartest men. Also, it fits perfectly into a system that needs the "right" number to fit into an accounting scheme. I am in no way arguing that running a public company for quarterly numbers, listening to an increasingly inane and irrelevant sell-side, and being guided by a checklist Board of Directors with zero skin in our game is a perfect manner in which to run a company for long-term wealth creation. But, the idea that select groups of companies can be taken private with highly incented management teams guided by capital allocation geniuses and get superior outcomes has been buried by hundreds of billions of new dollars, ruining the returns of what was a good idea served in smaller portions. Conversely, opportunities are staring you in the face and trading every day for purchase or sale

in public markets. And I will say this again, owning 25% of a small-ish public company with commensurate board representation is EVERYTHING that you are being pitched in Private Equity, but with more liquidity and optionality and less reliance on leverage.

If anyone is seriously paying attention to the "ESG Industry," we would suggest most in it have moved way beyond rational cause/effect thinking and are almost on auto-pilot. The "Peak ESG" notation here is not a political comment, and yes we are probably early, but comes from hundreds of hours of reading, meetings, participation in sub-committees, and answering 40-page questionnaires. No, we shouldn't go back to our Snidely Whiplash base case of the pillaging and murdering ways in which capitalist society has managed to produce massive improvements in global wealth and well-being over the last few hundred years. We are 100% behind more intelligent diversity in this industry, as anyone who has sat at an idea dinner with 10 Patagonia-vested hedge fund bros can attest. But this statement by Vanguard in 2022 speaks volumes to the wall in which institutionally good intentions have crashed: "We have decided to withdraw from NZAM (Net Zero Asset Management Initiative) so that we can provide the clarity our investors desire about the role of index funds and about how we think about material risks, including climate-related risks—and to make clear that Vanguard speaks independently on matters of importance to our investors."

The four relevant issues here are mission creep, fiduciary responsibility, time horizon, and math. If you hire me to run an X sensitive portfolio, we both should know and expect what we are getting, part of which is accepting the risk that we will be sacrificing/enhancing returns for a philosophical decision being expressed via the choice to avoid an economic sector/s. Your decision. But it is grossly unfair and arguably a violation of fiduciary responsibility for our firm to make philosophical and political decisions on your behalf. We can argue all we want about the cost/benefits of achieving specific political ends in a democracy over wine at dinner, but our contracts and understanding with investors is generally focused on generating attractive risk-adjusted returns while pursuing the strategy as stated in our presentation and website.

The time horizon and math fallacies are related and self-evident, as hinted to above. We simply aren't in imminent danger of dying out, we have globally limited resources and it simply takes a very long time to enact policy and spending to change the last hundred years of history and its trillions of dollars of fixed cost. Our industry seems to have tied itself to slogans around desired time horizons without any real analysis of whether the 2030 or 2050 math actually makes sense. The last time I checked, the point of the CFA society was actually to professionalize our industry around supportable standards and processes. Say this with authority – we aren't remotely "there" yet.

I don't think we are going way out on a limb to suggest that the investment industry was/is pressured to get with the game, and for those who have even tried, "we" have badly attempted to quantify and governmentalize processes to achieve certain goals. "Rating" firms becoming unelected officials making ridiculous quantitative comparisons that twist logic beyond comprehension? Government spending in the trillions of dollars to convince the largest corporations in the world to do what they would have surely been doing already, led by an administration headed by a guy with simply a badass '67 Corvette? (Screw the papers, save the car!) Should we just crowd into the "good" companies? Or spend more money to help the bad ones? Should the role of the SEC be the tip of the spear for climate regulation? Or should they be, oh I don't know, paying attention to the emergence of an unregulated new currency and the immersion of retail participation in it? Even the New York Times is sneaking in some questions recently in its Op-Ed pages about whether "we" are going about this the right way.

To be clear, the investment management industry is NOT who you want to be changing the world. It simply markets product to the trend d'jure and is generally ineffective at anything but profiting from the trend. We have run money for decades with client restrictions that reflect the wishes of clients. And over the long run, in our experience, it is not entirely 100% clear that avoiding a specific industry or sector hurts or helps performance. And it is certainly far from clear that there is any math today that actually defines ESG criteria in a rational way, has access to data that makes it rational, and then has any legitimate backtesting that supports it as a standalone or

complementary investment strategy. I owned Tech and not Energy, and now I own Energy, not Tech, is not a robust backtest of how your personal formulation of ESG does or doesn't add value to investing outcomes.

What makes this relevant to us and it should be to you, is our contention that these are more examples, and there are plenty more where they came from, of more and more attention paid to non-economic issues and general daily chatter. Less and less attention is paid to actual securities analysis in public markets. That suggests a higher likelihood of mispricing in public securities with fewer attentive eyeballs with which to take advantage. Indexing has definitive places for large sums of money, but with 40-ish% of the Russell 2000® index printing a definition of unprofitability, is that really the best implementation strategy in a world increasingly cruel to the credit-hungry? There are hundreds of new, mostly but not totally failed businesses, that have been abandoned by their SPAC and IPO promoters and burned investors. This fact should also increase the payoff for those who focus and pay attention. Fiendishly simple. Operators are standing by to take your call.

So, we are looking to make money in 2023, employing most of the processes and thinking that we have pursued since we began. You don't have to feel optimistic or pessimistic, you just have to be as rational as you can. US equities have almost 100 years of a high-single-digit average annualized return. It's just never 9.1% every year. Our valuation-driven guess is we are still in the part of the cycle that argues for "lower than that." And again, if you are asking, bonds are not going to be as awful as a ballast to equity volatility as they were in 2022 (see the chapter about coupon reinvestment and total return), but it seems hard to argue for great news given what we think is a secular inflationary trend with potentially generational stubbornness. Our advice is not to throw away the entire 60/40 bucket for high fee alternatives strategies.

We would also argue there is something large and fishy going on in terms of Domestic vs Global. Despite what seems to be a very high correlation for hundreds of years between comparative advantage and globalism, the world at large seems intent on retreating within borders. We think that bodes very well for US small cap investing, as all of a sudden lack of scale and infrastructure to go global where the growth was considered to be in the bag is… right in our backyard?

We continually improve a rational process that seeks to identify, study and, eventually, purchase securities whose valuation does not reflect a proper analysis of the underlying business, the history and commitment of management toward making money for shareholders, and/or the duration required for good things to happen and be reflected in a stock price. From time to time, we seek to employ our experience and pattern recognition to help the process along, by either directly providing assistance to companies, or helping them see the shareholder light.

And what if something good happens?

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