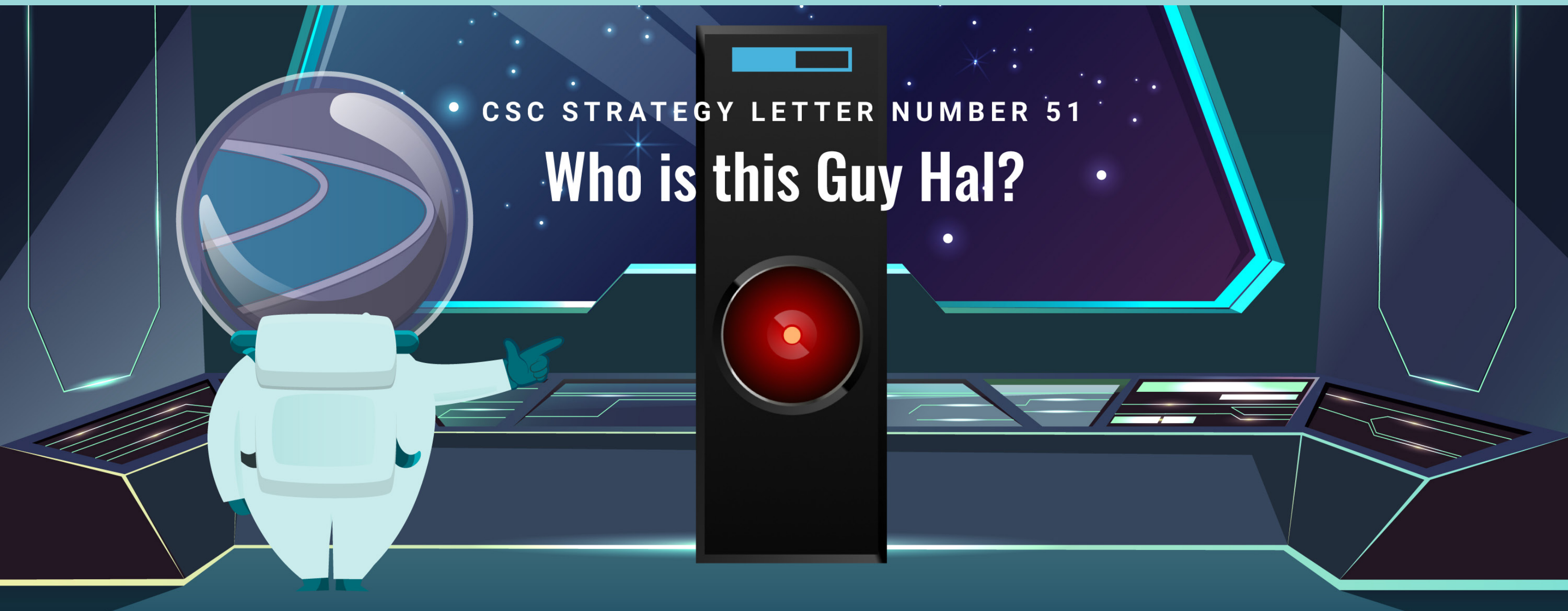

CSC STRATEGY LETTER NUMBER 51

Who is this Guy Hal?

We return after a slightly longer than usual gap between writings as…we were busy. Yes, it is an infinitely better business model and frankly a higher star on the wellness chart to just buy good businesses at reasonable prices run by people who have our best interests in mind than to sweat out more erratic business models and endlessly engage with management and the Board on a myriad of completely self-inflicted issues that were so "off-spreadsheet" that NO AI-based model can machine learn human dysfunction to the degree it actually happens in real life. Nevertheless, stuff sometimes happens and here we are. And being under an NDA takes all the fun out of writing about it, but oh yes, we will have 3,000 words for you on the above topic in likely 90 days. And it looks like a high probability of the proverbial happy ending.

In the meantime, we are still in the midst of having a pretty good year on an absolute and relative basis because…surprise...being a value-oriented manager does not mean you have to have 35% of your portfolio in energy and/or banks or have owned US Steel every year since 1946. Oh sure, we have natural gas, dredging, local TV broadcasting, and some ICE (that's cool kid talk for internal combustion engine) auto exposure, but we don't wake up every day dreaming of the good old economic days. "Value" should be best judged as "getting more than what you are paying for," not buying the 30 cheapest leveraged cyclicals the day before they don't go bankrupt and hoping for the best.

We also do not play onesie twosie with the indices by which people compare us, which in technical terms means we are playing the alpha game, not a beta factor model by which we line up trailing characteristics in order to hit someone's checklist. Yes, that means we are not for everyone, but I would suggest we a priori offer a prospective client value for their active management dollar. Our operator (Paul Hinkle at Phinkle@Covestreetcapital.com) remains available for your call.

So we are going to find out soon how the investment business really works...again. Over the last 12 years (and another 29 before that of just more of the same) we have had periods of blistering performance and periods of not-so-blistering, particularly the 3.5 years that ended 18 months ago that we refer to as the partially self-inflicted value hell. We have had different numbers of analysts who have differed in background and temperaments. We have gained and lost assets in most cases under the exact opposite scenarios by which we likely all acknowledge we should be acting. We experiment with "process and technology" to help us be more efficient. In the meantime, our investment philosophy remains unchanged: value, long-term, concentrated, thoughtful internally generated research, index-unconstrained. And the portfolio manager is unchanged, in smaller-waisted jeans, and still making combative gestures in the racquet sport of your choice. Yet apparently, we became so much smarter and better looking on April 1st than we were on March 26th for the oldest

reasons in investment management history. And the same wonderful character traits will blossom further at the end of Q2.

None of this should matter to you is our point. We have an institutional caliber firm in all aspects of investment, trading and operations, compliance, and client service. We are "rightsized" to do proper small cap investing - as in, we actually buy small cap stocks. I think people grossly underestimate the number of people who have left our world and the number of people running 160 stock portfolios with a median market cap of $6.5 billion and market it as small cap. Paul is still waiting for your email or call.

On to today's world. What is funny is that I cut and pasted this a few months ago in my "write something" folder when I started this letter. Attribution is lost but:

> *All the trading instincts you have were fostered by easy money and cheap leverage. Growth doesn't always beat value. Momentum can be negative, not just positive. Multiples don't always expand. Risk-taking is now dangerous, not a free lunch. Bad companies will be allowed to fail. Cost of capital is a real thing to consider when making an investment.*

The bin of "makes so much sense but can be terribly wrong in shorter periods of time" shows no signs of emptying in 2023. If there is any naturally based intelligence still operating in the investment business, explain to me the wonderfulness of a world that goes from a massive zero interest rate-led blow-up of literally hundreds of billions of dollars of tech and leverage-led investing, which still hasn't had its reckoning through proper portfolio marks or Chapter 11 resolution and then pivots in 3 months to ANYTHING with AI must have an allocation and will once again change the universe in ways to be determined. Ignoring the private frenzy, and using Jim Grant's eponymous newsletter as a cheap and easy source, as of this writing the S&P 500 Equal Weighted index, which gives equal value to each stock, has fallen 0.35 percent since January. That stands in stark contrast to the 9.5 percent gain for the benchmark S&P 500, where companies with larger market capitalizations account for a larger share of the index.

Rapidly rising demand for the very biggest stocks explains the difference which is riding the AI wave: Nvidia, Microsoft, Alphabet, Apple, Amazon, and Meta have added a total of $3.1tn in market cap terms in 2023. Ignoring their contribution, the S&P 500 has shed $286bn so far this year.

The poster child is obviously NVIDIA, which using 2024 data, sells at 20x $50 billion in revenues, 50x insanely-adjusted EBITDA, 40x equally insanely-adjusted earnings, and trades with a $1 trillion market cap. Whatever one might make of "AI" - starting with a $1 trillion market cap and going from there is….a very large hurdle to future success for shareholders. And yes, like watching the birth of a child, or the northern lights, or no traffic on the 405 on a Friday afternoon, we remain in awe of a wonderfully successful speculation based upon being early in the hype curve that spins incredibly upward and out of control (requires both buying and selling FYI).

As a compare and contrast, on August 19, 2004, Google went public in a highly anticipated initial public offering that valued the six-year-old company at what seemed to be an astronomical $23 billion, with a price-earnings ratio of 80, a mere six years after its founding. The company was already generating annualized revenue of $2.7 billion and profits of $286 million. There is simply a lot of room left for shareholder upside with those tiny numbers. The US GDP in 2022 was $25 trillion. That means there is only a 25-bagger left for NVIDIA because it seems hard to imagine an investment room with any air left once AI is mentioned.

We will say this about all that. There is nothing remotely clear or obvious about making money in AI. This is a marketing term that is in many ways simple table stakes for any company or process that falls under the heading of "continuous improvement." ChatGPT knows zero about the future much less anything after 2021. Hiring consultants and "training" an AI language on your own particular dataset can enhance efficiency...but so economically what? That savings likely goes to the consultant and the customer if everyone is doing it. Stockpicking? Sure it provides a neater answer to the question, "What is the boiling range from which Naptha is extracted from light petroleum distillate," but it says little about future oil prices, politically driven midstream infrastructure regulation, the capital allocation

tendencies of one CEO vs another, much less the likelihood of Covid, Canadian wildfires, or Aaron Judge being on the injured reserve for spraining his big toe while breaking the right field fence at Dodger Stadium. There is no end-of-civilization threat or wholesale dystopia where Hollywood screenwriters stalk your neighborhood for food. It will get better slowly, it will become more useful and life will go on. (Though I might bring a personally sized hatchet to my next group investment meeting to end the agony of listening to some numbnut ask an acceptably clueless management team about their AI plans and how they are being somehow disintermediated). And, as we see already in the financial world, AI is being used by companies to game AI trying to parse financial statements and press releases.

Those are games that are regularly played to which we decline the daily invitation. In the words of Carl Icahn, "Some people get rich studying artificial intelligence. Me, I make my money studying natural stupidity." (And yes, recent analysis of his holding company suggests he is playing this game to win: https://hindenburgresearch.com/icahn/). Our smiley performance this year is simply the result of "alpha-esque" work that is belatedly seeing the light of day or the darkness of space depending upon your angle. We naturally refer to Viasat, our largest position, which also became our largest long Covid exposure stock, which we did not realize at the time. Amid the tens of billions that have been burnt in space investing in the last 3 years and the mystery of Starlink math and Amazon's Kuiper existence, Viasat in our opinion is arguably one of less than a handful of investable assets in the sector and is at a monster cash flow inflection point. Being roughly 50% this year is barely getting started if one does some conservative math. And we are actively attempting not to succumb to the "been down so long it looks like up to me" refrain which is irrelevant to the actual value at hand. And it's a good example of "sell or not discipline" which people ask us about when things are not going well. The bearish premise on Viasat is largely that they are throwing up billions of dollars in the wrong geosynchronous orbit and the returns will be eaten by Starlink. Hard to disprove when the damn satellite had been in a warehouse literally two miles from your office being held hostage by the Post Office efficiency of a post-Covid Boeing organization. Thankfully, it's up in the air now and its siblings are getting teed up.

But we have had a few others up our sleeve- Lifecore, Viemed, Millicom - that just happened to be happening in bulk this year versus spread out over time to produce the 1.5 percent a month gain that we all desire in our hearts but ultimately and grudgingly must accept the unrequited volatile love that financial markets offer. And if you are asking, Ecovyst is our Pick to Click and our second largest position, and about to escape a year of punishing secondaries by PE after CSC proved unable to buy 25% of the stock and take the two Board seats. (Paul can also talk about new versions of this we are seeing as well.)

We will take a moment to digress on "banks" again, which 90 days ago was the topic d'jure among the investment community. We would generally sum up the topic under the Elon Musk paraphrase entitled "Rapid Unscheduled Disassembly." We say brief because there are plenty of chapters to be written as part of the Greatest Credit Cycle ever winds down into its relevant pockets of mess and the Feds concoct different politically acceptable ways of addressing the problems presently in the rearview mirror. Oh, sure we are going to be talking about actual loan-level delinquencies and credit losses as the year goes on, which frankly has been our hurdle in owning banks. But the key issue to understand is that the 2009 crisis created a regulatory concoction where a handful of TBTF (a blast from the past acronym) institutions whose deposits are 100% guaranteed would OBVIOUSLY drain the system of fleeing deposits in some future debacle, which we now see is the old school lend long, borrow short issue. Oh, and risks were deemed as "lending" and thus the percentage of bank assets stashed in securities yawned inexorably higher since 2009. And why not buy the crap out of AAA-rated securities which were awarded capital priority by regulators?

We have no special perch by which we can see how this world will evolve, but it will clearly involve massive socialization of risk previously incurred, and a variety of nicks and gashes against the innate profitability and returns of the banking industry. Oh, and this will be led by teams of regulators at the Federal Reserve, who at the end of 2022, showed an unrealized loss on its securities portfolio of more than $1.1 trillion on capital just of $42.2 billion. It is nice to write the rules by which only you can live.

So we haven't owned banks in small cap in a very long time and while we admit to digging out the old 2009 list, we haven't budged yet. Cheap? Not really and not yet? The median Price/Book for banks in the Russell 2000 is still well north of 1, and that is an "unmarked" book. It probably goes up another half a turn if you count unrealized, but we frankly think that is a dumb idea that is being delightfully drilled by short-sellers and those who know little about financial services, or one and the same. The bigger issue in our mind is that highly geographically concentrated, commercial real estate, including multifamily and construction loans, are on average 5 times the average equity of the small cap bank. Delinquencies on commercial property loans, as reported by the Fed, were still at record lows at the end of the year, but the dangling sound of keys to underwater properties is starting to jingle in the mail.

Said again, regulated financial services is "different" than your "C" corp. And besides regulation – which is noted as awful – you cannot really "channel check" a balance sheet of a bank. And contrary to a "normal" company – you are subject to "viral runs" which in today's world of social media, is an interesting twist with a higher probability of higher incidence going forward vs history. And as we have noted in the past, smaller banks are inherently low ROE businesses and they are likely to have poor risk management skills on say, asset/liability mix and interest rate sensitivity. And any and all compliance and regulatory costs are inherently more difficult to shoulder on a smaller base. To wit, the return on the KRE Regional Bank ETF has been annualizing below 3% since its inception in 2006. We think we can do better, and we think someone running a portfolio of 40 clobbered banks or an ETF might be a better play to capture "the trade" than us buying 3.

Markets are more like biological systems - messy, complex, and confounding - rather than modelable point outcomes with easily available inputs of quality factors. A good investment process hopes to reduce uncertainty, but can certainly not eliminate risk, nor eliminate reasonably assessed risk-taking. And it's not just about getting the probability of X event right. It is understanding how a company's securities are priced relative to that potential outcome. Recession in 2024? A pretty good bet. Is an economically sensitive stock pricing in that probability? Not en masse, if you are asking, which is why we don't buy stocks en masse.

To conclude, there continues to be an enormous opportunity in our small cap space. Financial scares, recessions, and nasty headlines create future returns. We have the experience and depth at Cove Street Capital to take advantage of these emerging fundamentals to buy better businesses at cheap prices. There is a whole world going on beyond the 8 largest stocks, which some people can't see without a microscope or frankly have no inclination to bother stepping into the lab.

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