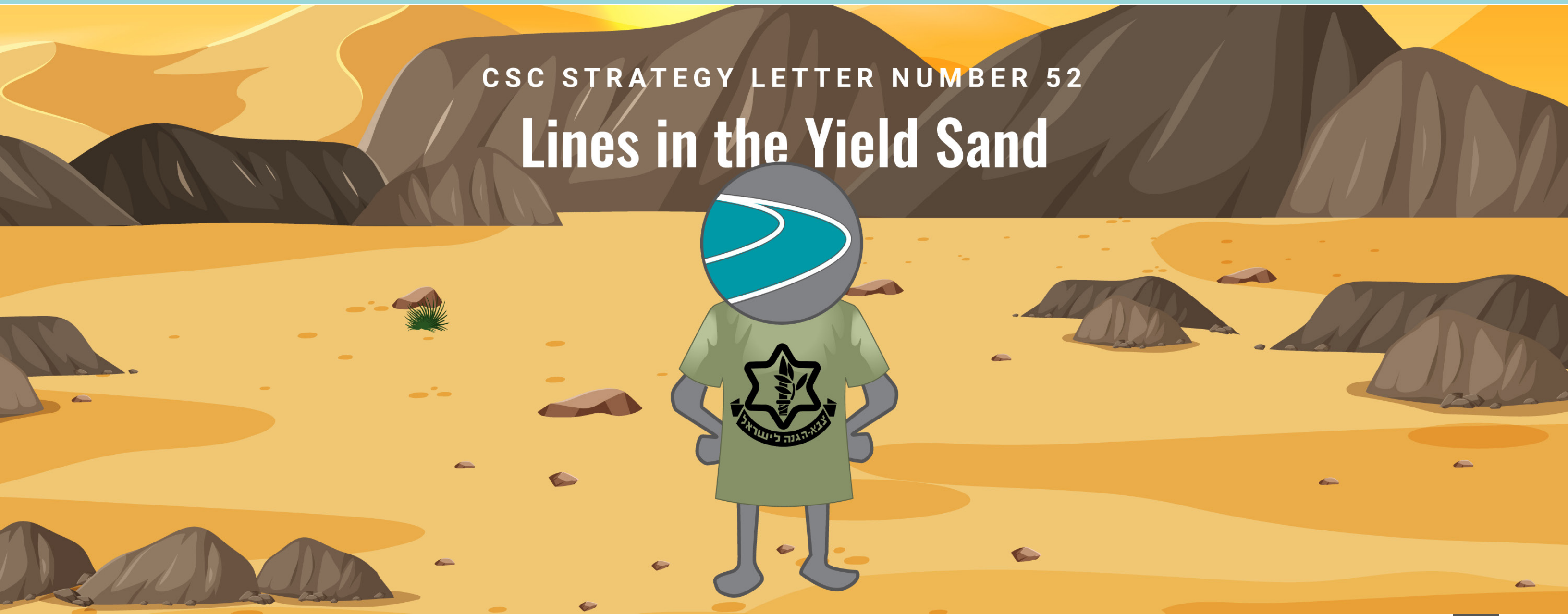
CSC STRATEGY LETTER NUMBER 52

Lines in the Yield Sand



The calendar third quarter of 2023 was a messy one for financial markets at large, and we were not immune to its lack of charms. Nonetheless, it's been a pretty good year for our smallcap strategy.

Oddly, the re-emergence of Middle East depravity has a weird connection to risk and investing: it is never "not there." There are simply sudden changes in participant willingness to see it…and then risk appetite adjusts accordingly. And quickly. And sadly and painfully.

In our core institutional strategy, our top ten positions, which as always represent 40 to 50% of our portfolio, mostly held their own. We had two takeovers of longer-term holdings at "reasonable" prices and another in the making, which has created cash for reinvestment in what looks like an "interesting" close to the year. To paraphrase words written long before us, new money wants volatility and uncertainty, for that is where opportunities are created. Good news and cheap stocks rarely co-exist.

And to get the big satellite out of the room, yes we own a stock - our largest position at the time - that managed to successfully launch two of the world's most advanced satellites...only to have them fail 22,000 miles away from earth. One was the first failure in 13 installations of a Northrup Grumman antenna, and the other the first complete failure in a 40-year history. Let's just say we once again appreciate the concept of "off-spreadsheet" risk. Dealing with a "mess" is a learned experience in life and managing money, and the first step is severing prior disappointment and time from the current, "what is the risk reward from here, on an absolute and relative to other alternatives basis?" That caused us to sell half our Viasat (ticker: VSAT) in between failures as the inflection to free cashflow moved out two years, and math is simply math. Down another 30% to stupid-levels, we subsequently reloaded and have made it a "simply top ten position" vs. the missing link between our clients and a private jet. The bonds and the stock are both buys if you are asking.

We will get to the usual bugaboos of inflation, interest rates, credit and energy, but here we relate some tidbits from a recent in person canvassing of some of the usual suspects of global asset allocation. Spoiler - I don't think it is unfair to qualitatively suggest that the asset classes of public, value and smallcap are at generational lows of representation in most family office, endowment and corporate pension plan assets.

Cry for us Argentina (and BTW - if you are whining about rising interest rates, their Central Bank just went to 133%) but one can either view that as a generational opportunity or a recipe for career suicide. Let's go with the former for a moment. The bold headline in the WSJ recently was "Smallcaps are Almost a Buy," which sums up the investment world neatly -

very few want to be first, much less be early. You aren't early with us - that was four years ago which we have been hard at work fixing.

So we are asked: what is the catalyst for change to make value and smallcap an investable asset class? Arguably not that much in terms of dollar flows. There are seven stocks each of which has a larger market cap than the entire Russell 2000®. A simple campaign for every American citizen to sell 100 shares of each is probably a 15% gain on the Russell. Said another way, the history of financial markets is trend, inflection and then change - the latter two are clearly indicated by dog whistle. Trends and appetites just "change" as they always do on the basis of what seems obvious in retrospect. Paying attention to absolute and relative valuation of individual securities or markets at large is often a good signpost of obvious future change, but it provides little help on timing within one's career arc. One thing we would suggest is past the dog whistle phase is the interest rate trend. We would argue - again - that the forty-year lower interest rate trade is irregularly over, and with it the era of free money and any idiocy goes. We would note that everything that got dragged along with it as relatively attractive in a near zero rate world - real estate, VC, "private credit" et al - is a good bet for underperformance over the next decade. No one can tell you definitively "why" until it's in the rear view mirror, but it might help to read words aggregated on clumps of paper that discuss the history of financial markets and the behavior of those who take on professional titles within it.

Our investment process tends to result in owning businesses that are left standing when the tide goes out on silly. Very few things we own have made the meme list or reside in the ARK ETF. (What the hell!) That bodes well for at least relative performance. And as we will note again, we are more concentrated than most of peers - 30-something holdings - and thus you are not buying just beta with CSC. We will have "marks outside our control" in a negative headwind that are more immediately visible, but we don't need a world of wonderful to deliver competitive results.

One more mini survey. We have a peer who recently lost a large account and we are copping their recent canvas of some of our common peer world, using mutual funds as a proxy. The median market cap in our eyeball of said world is close to $4 billion. Ours is $1.4 billion. There is nothing fancy here. The world of smaller cap investing has been essentially abandoned and the money of those still in the game are told not to bother unless you manage X billions, which necessitates lots of stocks and lots of larger stocks. We will resolutely stick to one of the only "rules" that always works in investing - the less trailing money flow and the fewer eyeballs in said asset class means more future return potential. Commercial over.

On the subject of interest rates and "the highest 10-year Treasury rate since 2007," we suggest the metaphor of a slow-moving bulldozer. The issue is not that the world can't breathe on a 5.5% ten year Treasury; it is the problem with business models and leverage that have been built on a continuation of zero interest rates, a proposition that was always foolish, but hell, there was a buck in it. This reckoning will be multi-year still-to-come as Fed policy works with a lag. And management likes to stay employed, often at the expense of their investors. Things like the balloon in PE-led Life Insurance assets and the entire Japanese financial system to name two off-Fed regulatory purview sectors where murkiness and six sigma events beckon?

The world is ever more interest rate sensitive and oblivious to it. To wit, we have Treasury Secretary Janet Yellen who missed it entirely at the Federal Reserve and is now reinforcing the idea that "the structural forces that led us to believe interest rates would be low are alive and well." Ok, she has VanHoisington.com on her side. They had better be for Ms. Yellen…and us…as there is very poor arithmetic that inures to the US deficit and taxpayer from interest rate increases. There is simply not enough space here to math out the relative size of our deficits and the interest expense associated with it. Let's just say "unprecedented" and "a lot." Requiring the acquiescence of strangers to fund an unaffordable lifestyle has ended badly for every person, corporate entity and sovereign nation...except ours to date. So yes, in the short-run, the financial world seems to hinge on the perception of when the Fed is done tightening.

The CSC position remains - a decade-ish of irregularly higher inflation and interest rates. We simply cite: the long-term deflationary effects of outsourcing vs insourcing; wages and strikes; energy costs; and the "nothing is more inflationary than a political movement attempting to be an idiotic energy economics revolution" along with the non-zero probability of "fear of debasement by barely elected officials." Lovely.

And then we have really good coffee and get to work.

The topic du jour is "Legacy TV Broadcast Affiliates and Their Relationship to the Nonsense Propagated in Green Transition Politics." In English, what we are suggesting is that the investment community can effect 40 year themes instantly via financial market technology, and thus, something that might directionally make sense over a generational vector looks like it is happening in the next 18 months. Yes, the world loves a good disrupter, but from time to time the disruption is not sitting in your living room and raiding the fridge - it's a distant glimmer. Our world loves to hype eight disruptions for every real change, and to not understand that is to understand the really bad marks ahead in a lot of 10 year VC funds.

Our own mental process for correctly assessing future trends is as flawed as the next pronoun, so we "invert" as the Berkshire kids say. What does the present value of the company's cashflow suggest about the future? Does that make any sense vs. a baseline of history? If there is a legitimate secular challenge, what decline curve is suggested by the current valuation? Does that make sense? What are some rough probabilities we can attach to "likely", "too bullish" or "too bearish"?

So let's use E.W. Scripps (ticker: SSP) as a broadcasting example, even though Gray (ticker: GTN) and Nexstar (ticker: NXST) fit the same bill and can also probably be bought here. And we would but we are up to mental limits in "yes, we have recently bought ad spend cyclicality via SSP, InterActiveCorp (ticker: IAC) and Outfront Media (ticker: OUT) and that's enough for now."

SSP has a long and storied history, but for clarity's sake, let's move to today. Unlike the pure plays, Scripps is roughly 70% local broadcast and 30% "Networks," which we would summarize as presently expensive attempts to escape the potential bondage of being a secularly declining local broadcast business. The latter was acquired in a deal for $2.6 billion partially financed by Berkshire - the Ted Weschler version - with the traditional 8% preferred by warrants for 25% of the stock at $13 per share. It seemed expensive at the time, but that was when actually paying interest on any debt seemed expensive. We will leave that be for now, other than to note this also made Scripps the largest owner of Broadcast spectrum and enables some very interesting things vis a vis Scripps' attempt to present itself as a player in Sports in the current "jump-ball" of sports rights post the Diamond/Sinclair regional sports disaster.

Turning back to local broadcast, what we think is grossly underappreciated is "Retranmission revenue" (retrans) concept which is a series of contractual 3-year deals where local broadcasters are paid a fee for their designation as "must carry" by the FCC. This has gone from $0 to $750mm for Scripps in 15 years and in our view, materially changed the model from completely cyclical to something a lot better. They just announced agreements with 75% of their subscriptions for cable and satellite with a "plus 15% mark" without a Disney/Charter "messathon" and as importantly, a plus 40% retention on that increase, which suggests interestingly strong strategic positioning in the mess of the media world. Scripps also took advantage of the consolidation window in the prior administration and bulked up to be a top-four owner of local TV and has done a reasonable job moving margins in the direction of the really good operators.

So getting to the point, if you "average the two years" for an EBITDA number of say $550mm (political ad spend averaging) and you do the same for say $225mm of real free cash, and you compare that to a market cap of $500mm and an enterprise value of $3.9 billion, you get some interesting math with 88mm shares outstanding. Like, I am creating $2.50 a share of new equity value every year on average on a stock that is $6?

Which comes back to the bigger picture investing point: how sustainable is that math in the future? And if the bearish case is the real case, what is the decline curve implied by the stock? Are all ads moving to search? Are all eyeballs moving away from local TV? Will retransmission dollars look like ESPN math and are poised for decline? The enterprising analyst models the three scenarios…and finds it hard to lose money here.

Gray Television has better IR. This presentation is interesting. We pull a few lines from it:

> While broadcast retrans revenues have grown significantly from roughly zero in 2008, retrans revenues today still only accounts for 22% of all linear channel programming fees paid by MVPDs while delivering…43.5% of all linear television ratings in September 2023. Broadcast stations also boast high intensity, loyal viewership 365 days per year, which cannot be said of most cable networks or any RSN.

> Migration of professional local/regional sports games to broadcast television provides a further opportunity to grow retrans revenues including by reallocating programming fees from cable nets and RSNs to local broadcast stations.

One other point. Our world likes to take a bearish argument and bundle it as an omnipresent Death Star with a company or industry incapable of doing anything to mitigate potential extinction. In fact, management is usually waking up every day, reading the same things we are and actually working on pivoting or minimizing real or imagined threats. Most of them. Some of the time. Occasionally successfully. So yes, part of our job is curation.

And one last point, the Charter/Disney "messathon" illustrated many things, one of which is that at the end of the day people are loathe to blow up a 50 year ecosystem that has handily supported the private jet industry. They tried with an enthusiasm for streaming, but there is no God omnipresent enough to part that sea of red and thus we witness a universal scale-down and drive back to profitability, albeit less so. We think the same applies here.

In closing, more of the same, Find a good business, be patient for the valuation to be reasonable and then be a judgy judger on the people. You will never make the bottom or the top consistently, so leaning in when the math is on your side is what a disciplined process for the long run suggests. And in the words of Munger, "In the 58 years I have been running Berkshire, I would say there has been a great increase in the number of people doing dumb things. And they do big dumb things." We aim small in this regard.

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