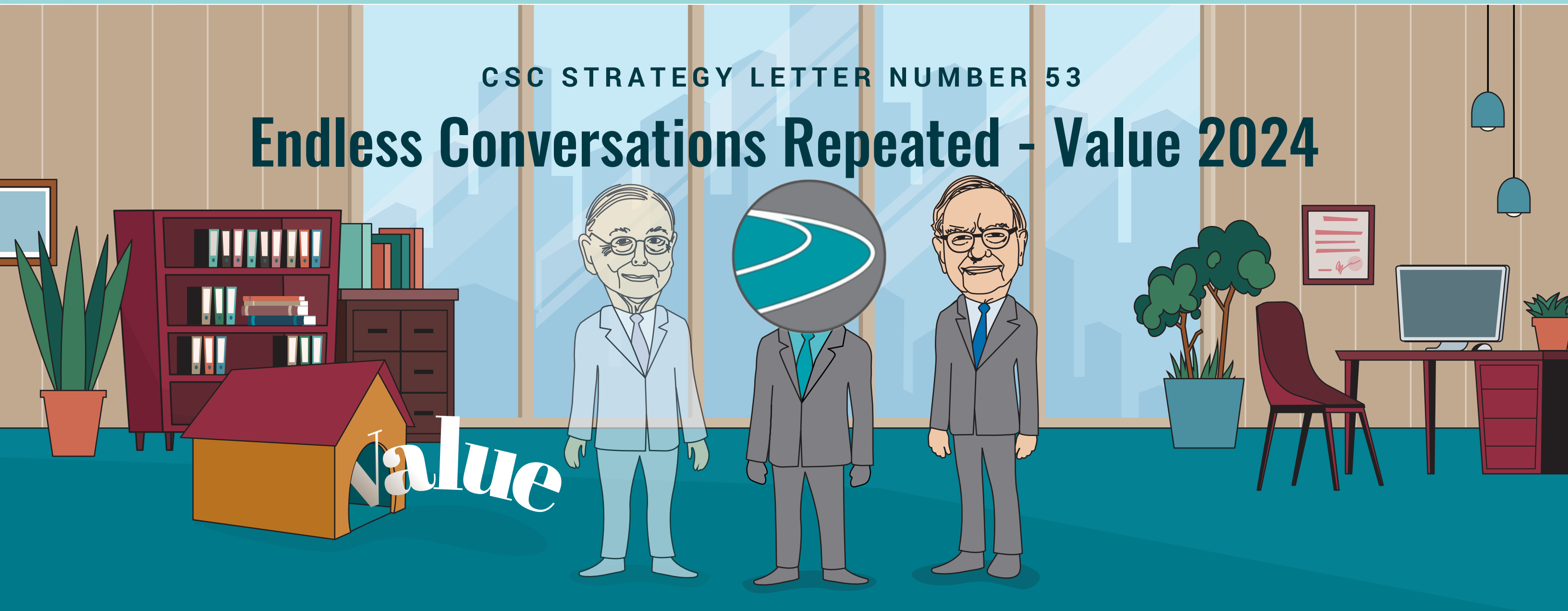

CSC STRATEGY LETTER NUMBER 53

Endless Conversations Repeated - Value 2024

The coast seems a little clear, Monster Truck Rain excepted. Since I dread writing this time of year from the standpoint of "predictions for any one year are, at best, entertainment value," I will first wade back in time and then sneak in some clarity into Cove Street's present activities and direction. That's an ADHD test starting with 2400 words.

With the passing of Charlie Munger at the end of 2023, there has been endless regurgitation of Mungerisms about life, learning, and investing. Most of this is worth reading and understanding if you have not been exposed to the corpus; some of this is worth re-reading as classic and important; and some of it is just eye-blindingly awful, repetitive, not relevant, or being applied by third parties to the wrong examples or without, dare I say, "context."

This Wall Street Journal piece encompasses all versions of the preceding paragraph.. Can Charlie Munger's Investing Playbook Still Work? Which is not as definitive as a "Death of Equities" headline in what was the Businessweek cover from years past. But it is at least a natural occurrence, vs. a recent and related piece from whomever Furey Research Partners is, entitled, "It is time to face the facts—the 'Death of Small Cap Equities' is upon us." He continues, "All of us here are tired of writing the essay that says 'here's why small-cap is going to work,'" said Jeff Burton, co- founder of small-caps specialist Furey, who says he penned the note with a whiff of melodrama in mind. "Our clients are well aware of some of the problems. They hear it from investors all the time." But we are ahead of ourselves.

Any discussion that begins with "so what is value and how do you define it" is my personal version of "and now the bass solo." Leave the room and come back with an empty bladder. The obvious should be restated—investing life is a see-saw with "good business" on one end and "valuation" on another. It is a relationship doomed to permanence as to shack up exclusively with either side has proven problematic. Not everything priced wonderfully for future perfection sustains its wonderfulness long enough to earn through the starting multiple, as our behavioral flaws often focus current attention on the ones that have, and conveniently misplace the other generational "can't misses."

So Mr. Munger. As repeated in the WSJ article, Munger is alleged to have been the primary critical variable in the Buffett/Berkshire decision to focus on "better business models" vs traditional "cigar butt value" investing.

While not without truth, I would also argue that circumstance materially dictated this change. When markets were small, technology didn't exist, and very few had any idea who Buffett was and what he was really up to. And Berkshire was small, enabling a much larger palette of activity. When you run $500 billion and are petitioning the SEC to hide your every trade, things are different. The natural and obvious motion would be toward fewer investments, larger investments, and dare I say one of my new favorite hated phrases…compounders. You had no choice.

Munger's insight into his best friend might have also included the concept that Buffett in some ways was

always the consummate value junkie in love with the process of finding something cheap. He has always speculated—and still does—nosing into arbitrage, sum of the parts (Japanese conglomerates), distressed investing, etc. He has tossed off bon mots like "if I wasn't running $400 billion I could be up 50% a year" through smaller cap and what we call "Ben Graham" ideas. He seems like a guy who comes into work looking for sneaky value, and Munger had to persistently try to beat it out of him for mostly all the right reasons.

So, as an investment manager without the "burden" of Berkshire's hundreds of billions, our palette can also encompass a wider spectrum of color. And there is a heck of a lot more chatter about "Buffetts" than there are "Grahams" which seems reasonably a priori as a place to look for investments, rather than disdain them.

And once again if you are asking, "value" based investing is simply multi-variate measurement of backward-looking data with an X factor of the future. To roughly formulize, we have (CFCO/WACC) + PV(Stuff that will earn great or awful returns on investment in the future). It's the latter part of that sentence that gets all the brouhaha, whereas the former saves your ass from something stupid.

It's not all about the same 4 ratios relying on measures of GAAP accounting uniformly across an industry-wide board. Establishing historical baselines to evaluate the probabilities assessed to the myriad BS we encounter is crucial, but it is incomplete. You might have noticed some change in the world since the 1972 to 1982 US equity market (to pick randomly from a long time ago) which means your keen eye should be focused on properly identifying the rhyme rather than the cast-in-stone mold of "what is a value." Anything formulaic in investing is a formula that will need to change, which is why any quant shop charging 5 and 50 spends a LOT of dollars on new computing power and new mathematicians or physicists or marine biologists.

So, a business model might look currently expensive today, but if you correctly assume a longer duration of goodness than others do, your "that isn't a value stock" that goes up ten-fold over 12 years sure as hell was a value if you bought it. Conversely, a statistically cheap stock today with a negative present value of the future will "not" be value worth buying as its intrinsic value degrades.

So it's fiendishly simple: create a margin of safety at current values and don't be terribly wrong about the future. Which of course is the rub, because the world does bias on both ends on the spectrum: overestimating just how good the future will be for x amount of companies—it's a magnificent 7, not a magnificent 75. And who is in the 7 d'jure tends to look very different from decade to decade. Conversely, not every problem in today's Wall Street Journal is a permanent graveyard as implied in a stock price. So yes, buying things with a fundamental mindsight and putting up good long-term numbers isn't easy...but it never has been.

There are newer issues that come up in conversations about what kind of morons we might be that don't include why we don't own the Magnificent Seven. Massive capital inflow into private pools seems annoyingly sticky despite very real fee issues, liquidity issues, governance issues, and a big question mark on sector performance measurement. Nonetheless, it is true that on the margin, there is less in public equity than in yesteryears. Are we seeing not only less but are we also being adversely selected with what is left? The number of stocks in the US has fallen 45% since their 1997 peak, with the small-cap count down by 60%, according to the Center for Research in Security Prices.

This is a legitimate factor that can be minimized with asset focus. Yes, waking up tomorrow and evaluating the implementation of $27 billion into value and/or small-cap is a challenge. But choosing a handful is always opportunistically there… as things change. In reality, some clients DO get tired of large PE firms trading private companies back and forth to each other (or to different divisions of the same firm) and force a legitimate end to a stated fund life. This is creating flow back into the public form, as well as great one-offs for us to take large positions in good businesses with governance rights attached—call us to learn more. Additionally, there is always the ebb and flow of larger companies breaking up into smaller ones: new businesses are created, bankruptcies get fixed and re-trade, and things just generally change.

And the awful "value death trap"? Important. In addition to other multi-variate considerations noted above and below, key issues in buying securities with which people appear to be presently un-enamored, is getting the "is this a cyclical or secular" question right, as properly defined cyclical problems, by definition, work out with a higher multiple on higher fundamental cashflow. Buying radio stocks in 2002 didn't. And to make life more fun, there is always dynamism. It was a surefire way to a private jet and a Caribbean island (which despite Jeffrey Epstein, is still a worthwhile goal) to buy the S&P 500

without airlines or the forest product industry for decades and put up at least great relative performance. And then, things changed. The remaining 3 corrugated box companies eventually were in a competitive position to push pricing and gush cash and voila, that game was over. On the other side of this discussion is how only "handfuls" of "Buffetts" really retain Buffett status over a decade/s and earn their current valuation over time. It can be painful.

And we would add to the CSC slate on this topic the do something about it argument. We have become materially more "active" in our holdings over the years as we correctly understand the limits of other people's money and patience. But "active" is another bad label for what can be intelligent behavior that can move the return math much closer to the present than whenever. We have a depressingly simple toolkit that involves compensation, governance, investor relations, and M&A analysis under a rubric of increase value PER SHARE. We have quietly gotten active in over a dozen holdings to eliminate their staggered boards without a public peep. While we don't rule out never in the future, "active" does not necessarily involve publicly shaming management and the Board, and it is not our preferred method of conduct. Being better at picking investments and properly gauging people to make money is our preferred goal. And there are things we can do with mostly rational people to help our own cause, which is avoiding the 7 year no one cares issue in value management.

The most proper argument against smaller cap and value that I can come up with is that when we research our way into a good one, it's hard to hold the 30 bagger, as one finds the argument of "we bought the $30 billion company when it was a small-cap" harder to say with a straight face. And it is also hard to just ignore stock valuation on a great business and absorb any variety of 50% interim declines on the way to the proverbial 30 bagger. It just is. We portfolio manage this issue and generally have some sort of barbell in that we have five "closer to midcaps" and five "closer to microcaps" that mean and median average out to a proper small-cap portfolio. Definitions of small-cap have also changed, as we have seen some industry competitors with hundreds of stocks and $10 billion in small-cap assets. I can assure you they are not playing in the same sandbox we are. Note to reader—asset growth is the death of all good investment strategies.

For the record, we are not succumbing to the idea that investing has been permanently transformed in a new age of technology and all company and industry fundamentals are now scale, winner-take-all battles that provide the incumbent with such advantage that all competition is doomed to failure and thus why bother to get out of bed to argue otherwise. It has "almost" always paid to look at investing life with a lens that does not overweight the very recent past, particularly when that past contained ten years of nearly free capital. The forecasting of the future remains as weird and prone to off-spreadsheet events as it ever has, and to be properly suspicious of what the faithful consensus considers to be an obvious continuation of the recent past seems warranted. And some simple math: grow the big six market cap(yes, we have thrown Tesla out of the seven and thrown it into the "should I short it in my PA category") and you start seriously running into some "bigger than GDP" math. And, anecdotally, back to the FED question—if the biggest beneficiaries of a decade of zero interest rates were Tech/Growth/PE, then anything "other" creates solid credence for a change in valuation and investor preference over the next ten years.

We would again note that there are arguably less people paying actual attention to actual fundamental investing. And there is always a time arbitrage available to those who can match investor tolerance with the investment strategy pursued. To quote Bezos: "a lot of people are trying to game next quarter…it is a lot less crowded out 7 years." We will leave the "why are the same clients committing to ten-year plus PE funds but in our meeting haranguing us for a quarter here and there" for another time.

We are also repeating that indexation is not always the solution for which you are attempting to solve. 40% of small-cap companies in the Russell 2000 have no earnings, so it isn't fair to say the Russell 2000 is cheap. You also can't say it's cheap if trades for 17 times earnings, ex-negative earnings because you own the whole thing, which arguably trades for something closer to 30x earnings. So we like the "curation and concentration" idea. The S&P Small-Cap 600 Index, which mostly eliminates the zombie, profitless stocks, is trading near the lowest valuations ever versus the large-cap benchmark in data going back to 2005, which despite being arguably a small data-set, we would take as a reasonable macro-argument that smallcap is generationally cheap on relative value, so we have that going for us.

And importantly for you the reader and prospective partner, we only see a "trickle" of institutional interest in the topics presented above. That is arguably the single best argument I can make to you to pick up the phone and call us.

We see the usual mess and risks in the world as you do, but we also are seeing more than enough interesting things in which to invest capital. To remind the world, we primarily run institutional value equity with a small-cap bent in separately managed accounts. We have a small mutual fund that follows said strategy. And we have an "ALT" partnership that is focused on a handful of our holdings in which we are closely involved in the governance structure and the have more ability to influence outcomes.

To paraphrase my favorite investment advisers from Shakespeare in Love:

Philip Henslowe: Mr. Fennyman, allow me to explain about the investment business. The natural condition is one of insurmountable obstacles on the road to imminent disaster.

Hugh Fennyman: So what do we do?

Philip Henslowe: Nothing. Strangely enough, it all turns out well.

Hugh Fennyman: How?

Philip Henslowe: I don't know. It's a mystery

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

Visit our weblog at CoveStreetCapital.com/thoughts and sign up to receive commentary from the CSC research team.

The opinions expressed herein are those of Cove Street Capital, LLC (CSC) and are subject to change without notice. Past performance is not a guarantee or indicator of future results. Consider the investment objectives, risks and expenses before investing.

You should not consider the information in this letter as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that any of the securities discussed in this report are or will be profitable, or that recommendations we make in the future will be profitable or equal the performance of the securities listed in this newsletter. Recommendations made for the past year are available upon request. These securities may not be in an account's portfolio by the time this report is received, or may have been repurchased for an account's portfolio. These securities do not represent an entire account's portfolio and may represent only a small percentage of the account's portfolio. Partners, employees or their family members may have a position in securities mentioned herein.

CSC was established in 2011 and is registered under the Investment Advisors Act of 1940. Additional information about CSC can be found in our Form ADV Part 2a, http://www.covestreetcapital.com/FAQ.aspx.