

THE ENDLESS SUMMER



The very long cycle of ridiculousness continues in financial markets as judged by investor behavior in the usual suspects of “meme, crypto, return of the Spacs, credit recycling vs Chapter 11’s, the blind acceptance of Continuation Fund pitches and Washington DC output.” To paraphrase Churchill, financial markets are a “long, dismal catalogue of the fruitlessness of experience and the confirmed unteachability of mankind.” But we hope you had a wonderful summer.

We have benefitted from some collateral goodness in the exuberance of summer, although it remains head scratching why some of our holdings double or triple in six months versus simply compound at 30% annualized over the past four years. Let’s just label it a return to normalcy – for us. Re-note to self: financial markets occasionally behave in a linear, neatly momentumish fashion, but earthquake like non-linearity is equally prevalent. Said another way, things change.

Which brings us to four topics that are changing, or historically are prone to change, and then an interesting idea that derives from “I know something about that because I have owned it on and off for 20 years”...

First is naturally Federal Reserve behavioral expectations, because if you really ever had to follow one cliché in an investing career, it’s Follow the Fed. Much of the aforementioned rally in “whatever” can be reasonably attributed to expectations that the Fed will be cutting short term rates. We can all agree that this process is “data-driven” by the Fed’s own words, and that as an

independent institution, outside politicized forces have little ability to influence the decision-making.

We have noted many times in this space that the Fed is not any better at reading economic tea leaves than say, [Psychic Michelle](#), who dispenses wisdom about 30 yards from our new offices. Therefore they should simply stick to a slightly negative but consistent policy of depreciating the dollar by 2% annually per stated policy vs any number of side hustles in climate change, volatility truncation, employment preferences, capital allocation and alleviating the pressure on the average Princeton Grad to assess counterparty risk.

The Federal Reserve’s annual Nerdathon in Jackson Hole became the Hunt for Stag-Flation, but unless you tell me Jay Powell held court at the Mangy Moose on Old Fashioned Night and spilled some real beans, Fed policy remains in flux. It’s become a very 70’s thing to debate the stagflation concept today with all sorts of crap economic statistics underlying some unusually strong headline numbers. Numbers, which may or may not be accurate depending upon for whom you have voted, Gold and every other “alt-currency” vehicles are trading at record highs which traditionally is not the time to roll out of bed and cut interest rates. Are tariffs really inflationary or deflationary consumption taxes? What we have seen so far is that most things in the world have high elasticity of demand — except energy and woman’s hand bags. (As usual, for further reading https://hoisington.com/economic_overview.html).

It’s not an easy job, but it matters more today given a US equity market that seems overvalued by almost any

measure ChatGPT or Goldman Sachs can generate. The point is that minimal changes in interest rates — or any other bullish narrative — is required to knock asset prices off a higher ladder. With clarity only in the nature of the barbell world today — employment and spending pressure on the bottom 50% and massive speculation in financial markets, gold and crypto — the solution should likely be sitting tight and making lunch plans. And from the Old Guys Rule T-shirt gallery, whatever happened to that other cliché, if you are going to be active away from a baseline of neutrality, then sometimes you must take away the damn punchbowl. Not every leveraged deal is entitled to a trophy, some should fail badly.

We habitually note in this space and have now booked a Starship flight to take the argument to outer space because it has not seemed relevant for a decade on this planet, credit is arguably more important than the level of interest rates to equity markets. Canaries are apparently extinct as well as coal mines. This summer had record junk debt issuance at spreads as tight as they have ever been. Apollo, Blackrock, KKR, Blue Owl et al continue to raise dollars with impunity.

Topic two: the government under any administration becoming an active investor in private companies is just clown show stupid. It is worse when it looks from the outside like political extortion. Intel lost relevance a decade ago all by its incompetent self and neither a Biden bailout or a Trump equity stake is going to change the vector. Ditto US Steel now that it has been rescued from the clutches of the “scheming Japanese.” Targeting specific industries to access tolls and tariff exclusions — Nvidia/Advanced Micro? MP Materials because we fear X raw material shortages from situations we self-create? We have Berkshire with 5% of the entire T-bill market and PE with trillions and these companies cannot find competent money?

It might also be worthy noting that this country has presidential elections every 4 years, however whiny and contested they may seem to be. Is it not possible, as a variety of elected officials are finding out these days, that what comes around goes around? Cannot a dubious headline today touting how Federal investment in private companies as another example of this administration’s pro-business stance become a labor/socialist guaranteed government board seat in the next administration? Can one not see the previously impossible in the New York City mayoral race? Let’s end this soapbox with the very low probability that any of this is good for this country and the long-term investor and a hopeful probability that excess in the government arena tends to get voted away.

And something important to re-note: businesspeople are not caged animals irrevocably subject to the whims of elected officials. We wake up every day adapting, moving, creating, deflecting and occasionally rebelling. Some people run companies that are publicly traded. Some are very good at this process. We seek to find them.

In a classic case of regulatory and client guideline arbitrage, most institutional managers cannot own, and their custodians cannot settle cryptocurrency, so money is thrown at available ways to gain exposure. This too shall pass painfully.

Topic Three begins with the buck passing for another day as to the acceptability ethics of separating the artist from the art, but it is clear that cryptocurrency in whatever form one might say has firmly passed the George Soros Theory of Reflexivity test. Bitcoin at writing is at a \$2 trillion market cap, Ethereum is at \$450 billion, Tether \$163 billion and Fartcoin is wafting around \$1 billion. President Trump authorized the Strategic Bitcoin Reserve and a U.S. Digital Asset Stockpile. So it would be fair to say whatever your strongly felt opinions on the matter, something new is here to stay in some form and seems intent on becoming an investible institutional asset class. The timing may be unfortunate but who are we to say.

What is not new is the idiocy around something new. I reference the absolute Charles Ponzi-ness of companies issuing securities, often debt, at 2x the value of the underlying assets in order to establish a crypto treasury strategy, which to date has proved ingenious for those who were early and really obnoxious to listen to for those who weren’t. In a classic case of regulatory and client guideline arbitrage, most institutional managers cannot own, and their custodians cannot settle cryptocurrency, so money is thrown at available ways to gain exposure. This too shall pass painfully. Throw in the explosion of single day options, sports betting, repeating meme stocks and the wonderful technology to enable it. To paraphrase noted jurist and stock market bubble pontificator Justice Potter Stewart, “I can’t describe it, but I know signs of overt speculation near market tops when I see it.”

And lastly, we have our day job efforts to make long term money. We have generally made a living ignoring how erudite and thoughtful big picture thinking can be, given the high probability of being thoughtful, interesting and wrong. In fact, I have almost made a career vacillating between 5 year periods of being considered a "good investor who writes well" to a "good writer who also invests." As Jorge Luis Borges noted, "I consider myself a Poet, although my friends might think otherwise."

One thing that has changed is we have a mess on a much bigger scale as Six Flags and Cedar Fair merged last year, bringing together a management team that couldn't run a theme park with a management team that can't run an integration.

There is a deep well of research at Cove Street into a wide swathe of companies, focusing on the business model, valuation and assessment of the incentives of people running our enterprise. This writer would also argue on the side of "experience, pattern recognition and a nose for the folly of man operating under uncertainty in financial markets" which from time to time provides perspective, however imperfect. We are also not "burdened" by \$100 billion under management, so we don't have to be fully committed at an X sized position forever. In man's search for "compounders" that can be bought at any price and held in any size forever, it seems that one forgets that business fundamentals can fluctuate. And the stocks that represent ownership to these businesses fluctuate even more.. Ok, they used to.

Which brings us to Six Flags Entertainment - FUN. This has been owned on and off for 25 years along with a few of its peers from time to time. It has cyclical in the business and how investors value it. We would and continue to argue that a well-run regional theme park business is a solid moat business with high margins, returns and solid free cash flow. But it is not a straight line due to "need something new" capex spending and the vagaries of attendance, which can be affected by general economic conditions, gas prices, and the relative insanity of management on how they price tickets. But somehow, here we are 25 years later making

almost the same pitch. We see higher labor costs as real, but much of the rest is the same. This is a place for kids under 21 to get the hell out of their parent's Dodge and for the next generation of parents who have exhausted every other entertainment option for their kids. You know who you are.

One thing that has changed is we have a mess on a much bigger scale as Six Flags and Cedar Fair merged last year, bringing together a management team that couldn't run a theme park with a management team that can't run an integration.

Naturally, we think we know better. And we aren't tied to legacy acrimony. So we are sticking our nose in the mix here and being public with this [Letter to the Board](#). First a word to the math. Take the trailing 12 months and add 20% to it and put a ten multiple of EBITDA. Then take the [Aspirational Plan in the Sky](#) and take 20% off it and put on a ten multiple. That will give you roughly 39 and 77. That is unadjusted for nonsense or stock comp and uses the current debt level. The stock is 23 as of this writing. Different fun can be had taking capex down and making attendance projections on a DCF. And there is arguably well north of \$500mm of potential asset sales that will barely dent operating earnings. One of the funny things about theme parks is many of them were built "way out of town" 30 years ago. Now, they are right in the middle of high-end suburban construction where "higher and better use" may be a value add.

Read the [letter](#). We have a "guy" who sits on the Board with a non-theme park background. That background was CFO for a decade of what has become ABInBev, so he has the ability to set in place proper integration at a pace that is not the current pony trot. This is not "activism," this is simply paying attention to what you own and helping shorten the road to the bank.

The work in recent weeks in Six Flags is oddly reminiscent of the world in 1999 when efforts were focused in

The work in recent weeks in Six Flags is oddly reminiscent of the world in 1999 when efforts were focused in "insurance and food" as the natural antidotes to the dot-com craziness on that time.

“insurance and food” as the natural antidotes to the dot-com craziness on that time. I “feel” a whiff of that pattern today. I think I have used this Walter Lippmann quote before, but I still like it.. “I am ashamed,” Lippmann wrote of his post-World War I idealism, “all the more so because I had no excuse for not knowing better.”

In closing, we continue to hate many things we see about the world at large and continue to see places to put fresh money. Yes, we still own a LOT of Viasat and are happy to chat with whomever wants that update, but \$45 is a first stop for us. New ideas include more Aerospace and Defense, more AG Chemical, and an influencer marketing company. And activity has included reducing what has suddenly become more popular beyond its means and paying attention to position sizing.

4

While I doubt smallcap will take the throne of the Mag 7, there remains a lot of room for improvement. We welcome new interest from committed and like-minded Partners.

Jeffrey Bronchick, CFA

Principal, Lead 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>.