COVE STREET CAPITAL

Harleys and Leather Jackets

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"You do not have to be born Steve Jobs or have shared hoodies with Brin and Page to create enormous long-term value for shareholders."

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MAY 2013 — We are just about done with Proxy Season and with summer in full swing, there is nothing more that we would like to do than kick back and indulge in the 75 pages of shame, greed, ignorance, and political correctness—with only the occasional bright light of shareholder friendly corporate governance—that make up SEC Form 14A, aka the Proxy Statement. I would postulate that this document remains an underrated and under-read part of the investment puzzle as it is the factual record of management's incentives. We must not forget that financial incentives remain the primary carrot for senior executives once they are done saving the environment, fixing the federal deficit, and shattering any number of diversity ceilings.

For innocent bystanders, let us backtrack a bit. We remain of the opinion that shares of stock represent actual pieces of ownership of actual companies, and thus investment success is predicated on a generally correct assessment of the interplay between the nature of the business (think Return on Capital); valuation (multivariate); and the competence of (and the incentives that motivate) the people running the company.

Now that we are comfortably ensconced in the 21st century, I think we can generally agree that people outside of the Nation's capital are pretty good at figuring out what is in their best interest. If you incent a CEO to aggressively grow sales, you don't have to lose much sleep worrying that he/she will not be out making acquisitions and throwing money at topline growth. If you incent working capital management, you can be pretty sure that cash flow will improve and debt will be paid down in the process. If your Change in Control Agreement gives the CEO $55mm to hand over the keys with a tax gross-up cherry on top, you better believe that executive will be taking calls from investment bankers.

So it is a key part of our process to actually read the document, understand and record the short- and long-term incentives, and compare them to those of their peers, as well as the multi-year history of the company to understand how incentives are changing or if they simply make any sense. It is astounding to me the hundreds of billions of dollars of assets managed by people who outsource the proxy analysis and voting to third party firms—companies that serve many masters other than those devoted to legal and superior investment results. We have a number of clients who do rank social goals alongside investment results and as noted below, that is their prerogative because it is their money. (At CSC to date, that has in no way been a performance impediment.) But if your goal is to deliver superior results in a highly competitive world and you think it is a good idea to outsource something as crucial as who makes up the board and management team, how they are paid, and the structure under which they operate, then we are glad to have you around for our competitive sake.

At Cove Street we rotate the assignment of detailing the proxy analysis every year among our team, a process I think leads to eye-opening discoveries if you have never done it. It's like making love or going to St. Louis—you can read about it all you want, but eventually you have to experience it yourself. Our man Eugene Robin was on point this year and some 100 proxies later had these general comments:

1 There is still a preponderance of executive compensation focused on "showing up" as manifested by an executive receiving time vesting equity grants versus true performance-based grants. Retention is important, so there is an intelligent argument for some time-based compensation, and there clearly has been a movement toward performance-based grants. But the hurdles are often so low that they seem to have been written with the Toddler Olympics in mind.

2 It is apparently commonplace for directors to be experts or at least knowledgeable in three different industries given that holding multiple board seats is quite prevalent. That sums close to $1mm in annual compensation, with Director's Liability Insurance for those "uncomfortable" periods and expense paid trips to desirable locations. Given those incentives, it is not clear that Board members are always friends of the shareholder.

3 Return on Invested Capital appears to be almost a completely unknown concept within compensation committees. Per share value creation is also a rare incentive. Instead the focus is mostly geared toward gross income statement numbers. There is a very important difference.

4 It isn't a real car allowance unless you also have a chauffeur.

The proxy statement also details "corporate governance," a topic that provides a neat example of the blind man and the elephant. As we begin our book review of this summer's must-read for both investors and corporate executives—*The Outsiders* by William Thorndike—and what we hope is our last defense of The Reign of Jaime Dimon, we must reiterate that what a real investor wants is superior long-term returns without taking on undue risk. What is fabulously detailed in this book is that a key factor often correlated with success is the presence of a small group of highly motivated executives and Board members. What has not been demonstrated in any remotely meticulous way is that superior performance is derived from any number of "veneering" efforts to look good in front of the *New York Times* corporate scolding committee. Repeat this sentence several times.

For the purpose of space and common courtesy, I will simply focus on the media circus involving Jamie Dimon and the call to split the Chairman/CEO role. This concept can make sense in a particularly messy turnaround, but it is grossly inapplicable here. The bizarre mix of nonsense that was thrown out by "reformers" and Professors of Corporate Governance as justification for this move (The key to bank reform? Executive pay referendum? The London Whale incident? Just because?) is an affront to common sense. Just as Warren Buffett cannot be held accountable for Treasury Bond auction rigging at Solomon Brothers, potential insider trading surrounding the Lubrizol deal, or questionable reinsurance deals at General Reinsurance, and President Obama (we hope) cannot be responsible for the actions of every employee of the Federal government, Dimon is not running every trade at JP Morgan. Accordingly, the fact that he has built a bank that can withstand a $6 billion mistake and barely have it impact JPM's capital or earnings is perhaps a good thing? What was fabulously ironic is that the likely Chairman in the case of a split vote would have been Lee Raymond—the former CEO of Exxon—who, despite having delivered off the charts performance and leadership, was probably the recipient of more hate mail from "reformers" than the Koch Brothers. One sidelight to the Dimon silliness was that proper attention was given to a relevant and interesting sideshow: the presence of directors who are solely "there" to satisfy non-economic functions. We would argue that regarding complicated entities like JP Morgan, there is no room for someone who does not have either very specific knowledge or is not "large" enough to command attention in an oversight function.

In this case it was great to see that hundreds of years of corporate legal precedent somehow managed to retain the seemingly quaint but innately important idea that OWNERS are in charge of their own capital and have the right to determine how it is run. And while I tire of writing it, just as you are tired of reading it, the problem in "bank reform" remains inane regulation. Drop deposit insurance to $50,000 per account and see how much help JP Morgan needs from the government. There are more banks that are "too small and likely to fail" than there are too big to fail institutions. The owners have spoken: Go Jaime!

This brings us to The Outsiders, which in an admittedly highly selective and slightly glossy way, highlights 8 CEOs in different industries that put up terrific long-term outperformance without spending a lot of time listening to "reformers." I have bought a dozen copies and have only thrown it at one CEO to date, but we look forward to seeing you in our office soon! To sum up, you do not have to be born Steve Jobs or have shared hoodies with Brin and Page to create enormous long-term value for shareholders. Here are the secrets:

1 Have as small a Board of Directors that consists of as like-minded people as you can get away with. Have a very small corporate staff. Committees rarely win and "we don't believe in staff…staff are people who second guess people doing the work."

2 Focus on generating cash, not beating EPS estimates. Cash is accepted everywhere—accounting-based earnings will only get you so far. And "adjusted earnings" are not better; they are usually worse.

3 Focus on per share values, not gross revenues or income. "I grew cash flow 50% in five years" is only valuable if debt per share and shares outstanding grow less than 50%. The corollary is that there is no shame in creating shareholder value by shrinking shares 50% if you are in an industry that is simply flat-lining on a secular basis.

4 Practice strategic capital allocation. Buying back stock is dumb if your stock trades at 15 times cash flow—you are better off issuing shares at that level. Know what your stock is worth, and since you have all the right numbers, buy it aggressively if it trades materially below your estimate. That is LEGAL insider trading. On the other hand, what is also a dumb idea that is sadly practiced quite regularly is buying back x shares a month regardless of price for the sake of hiding the dilution associated with executive equity grants.

5 Ignore reformers, management consultants, professors, and business section editorialists.

6 Have a great COO with a fanatical attention to costs and listen to him when he says no.

7 Focus on key variables versus 400-page PowerPoints. "It's about accuracy not precision."

8 Pay attention to valuation versus slavish attention to a strategic plan. If your plan is to move "uptown" into specialty products with higher margins and returns, but the price to acquire is bordering on absurd, might you be better off being the seller?

As far as the world at large, our well is beginning to run dry. We simply see a lot of stocks that could be down 15% without batting an eyelash. Great recent performance is simply stealing from the intermediate future unless you turn over your portfolio 100% every 8 months and I think there is plenty of historical evidence that suggests that has not been a good idea in practice. We will undoubtedly take a few short-term lumps in a proverbial "correction," but we will also be setting up a cost basis in new opportunities that promise good future returns.

This quote seems to neatly sum up consensus thinking in the world:

> "My stance on U.S. stocks is bullish owing to the monetary printing of the Federal Reserve. If that stimulus is withdrawn or looks likely to be withdrawn, my instinct would be to sell. In the meantime, I would welcome a 5 or 10 percent dip in the S&P in order to buy anew."

Yes it pains me that this gentleman is managing more money than we are, but a well-lived life is how one manages to deal with indignity.

As the experience of the last few weeks suggests, the market "may" have a short-term tumble when FROTUS, the world's largest and most levered hedge fund, decides a near zero interest rate policy is less than rational. But we find it hard to see how 1% short-term interest rates and a 3.5% ten year bond yield are practical impediments to longer-term economic activity. The Titanic risk here is that there are undoubtedly large financial entities out there in the world that are blithely determined to pick up the last penny in front of an interest rate steam-roller. Kidder Peabody, Goldman Sachs, Askin, Steinhardt, Bankers Trust, and Orange County are just a few of the names in recent economic history that had problems when the fixed income worm turned. Oh, and our fixed income radar has not gotten any better—we just "know" the risk/reward continues to be skewed against us.

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