COVE STREET CAPITAL

The Great Complacency ...Continued

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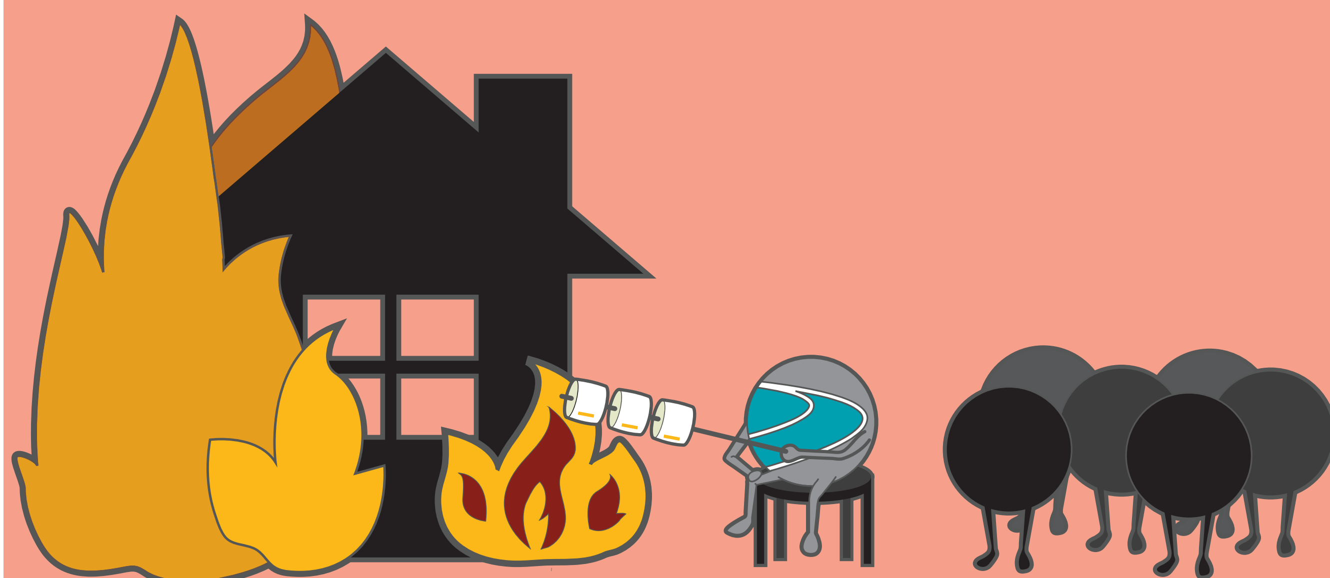

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The Great Complacency ...Continued

JANUARY 2015 — At this point last year, we were effusively cautious after a period of terrific performance. We suggested that while we considered a material number of portfolio stocks to represent "solid" values, their near-term appreciation was going to be limited after the big numbers of 2013.

I have never found a correct prediction more unsatisfying. Our performance hovered around unchanged for most of the year, representing "outperformance" versus the Russell 2000® small cap index, and then we simply had a lousy fourth quarter—unchanged again—that made 2014 a resounding dud. Interestingly, most of the portfolio performed somewhat as we expected as we really did not have many major "issues"—we just mostly plodded along as underlying growth and improvement in the value of our companies caught up to the price appreciation of 2013.

The big exception to that statement was our adventures in energy. While our holdings were seemingly limited in number and portfolio weight, they unfortunately occupied a fair amount of gray matter during the latter part of 2014.

Before I espouse "theory and life" thoughts, let's not be cavalier. There is a big difference between enduring the wrong end of volatility, and permanently losing client capital in an investment. We have two positions in the small cap energy space where we arguably have lost permanent capital and that is simply a painful mistake. It is a most common behavioral bias to take credit for internal genius when you are doing well and blame external factors that of course were beyond any reasonable assessment of mortal comprehension when you are not. This would be an easy time to trot out any number of quality alibis to address the whereabouts of our common sense, but we are not going to do it.

So I will say this: In 30 years in the investment business, I would rank the sheer breadth and speed of the collapse of oil and gas pricing and the hundreds of billions of dollars of value that melted away as one of the great conceptually interim disasters I have witnessed; a true stunner that ranks with the mortgage mess and the dot-com blowup, just to use a few recent examples. (Both of which were self-evident in real time as well.)

I have generally shied away from commodity and energy investing as a mental guideline for decades because I have found it problematic to rely on my guesstimate of a future commodity price as the key determinant of the potential success of the investment. That we don't "have" to invest in anything remains a key tenet of CSC investment philosophy. From time to time though, opportunities do present themselves. (Remind me to tell you about our Argentinian oil and gas takeover in 2014.) What we look for in this industry is the following: pain and suffering of others; a change in capital allocation—such as a new management team that emphasizes improving returns versus a mad dash for growth (something that seems to plague those from Texas); or the combination of a good balance sheet with low finding costs, a compensation structure that encourages management to live within its cashflow, and a "manufacturing" play versus expensive wild-catting. In other words, the "good management" play.

What was reemphasized in 2014 is that it barely matters what is happening at the company, or if there is shrewd management, if the commodity is going to drop 45% in 3 months. We have a process for recording decision-making here at Cove Street and part of that involves distinguishing the four or five critical variables that determine success from the muck of all our research, facts, and opinions. In the context of energy and commodities, numbers 2 through 5 add up to about 1% of materiality in the world we have seen.

What I also think is particularly fascinating about the move in energy is its material relevancy as we look at global interest rates and the "surprise" move by the Swiss Central Bank to take down the entire currency dike overnight. Excluding the 2008/09 "technical meltdown period," you could have gone around the world and found near universal consensus that carbon energy was getting harder and more expensive to find—remember the exciting "Peak Oil" debate? The industry—and its investor backers, the collective "us"—then convinced itself of the utterly rational idea that since the marginal cost of finding new oil was concluded to be "$75-ish" per barrel, ergo that was the bear case used for every dollar of investment that was considered. Yours truly sat in a number of meetings listening to this and that idea pitch and when I asked "why does this $75 bear case really represent the worst case scenario," I was looked at like an intern helpfully offering his opinion at a Fortune 500 board meeting.

The simple fact, as noted by Lord Keynes almost one hundred years ago, is that "the market" can price things many standard deviations away from what you think is perfectly reasonable even in a well-functioning market. It can take years for dreams to be shattered, people to be fired, rigs to be laid down and finally scrapped, leases given up on, the first bottom-fishers to have their money lost, and the drumbeat of steady demand to dent the intermediate term prospects of over-supply. What is also interesting in present day is while there is lots of debt tied to this industry, the advent of "covenant-lite" means bondholders can't hasten the cycle until someone actually misses a bond payment as opposed to the old school covenant breaking that likely would have been occuring soon. While there is going to be a lot of interesting math when the big lending banks redo their reserve analysis and recalculate credit lines this spring/summer, as a group the banks want to declare someone bankrupt as much as our President would like another country in the Middle East to blow-up.

On the other hand (as everyone asks "now what?"), the amazing thing about how quickly the shale revolution seemingly became the great worry of Saudi Arabia...is how quickly it became the great worry of Saudi Arabia. But this rapid ascendance means it "can" quickly be reversed. When Exxon is playing around in the ocean a few hundred miles from anything, it is putting in $200mm and when that goes on line, it stays on line. Shale is a "manufacturing" play and rigs can be laid down quickly and wells can be plugged at little marginal cost due to their low pressure nature. This is happening as we speak.

But as painful as it is to state the obvious, the obvious here needs to be stated many times: this is a cyclical industry, and thoughtful attempts at "timing" can be the most dangerous of sirens. About the best we can say in the near-term is that prices will fluctuate. While there undoubtedly will be some interesting energy plays in distressed debt or new fund strategies involving buying a basket of small cap energy names and giving it a high risk/high return whirl, we prefer to stroll toward the burning house with a long stick and a bag of marshmallows as opposed to donning the fireproof suit and oxygen mask and running in to determinedly find survivors. We are holding what we own and we have a list of others that we are considering. At the present time, it seems extreme to ask my colleagues to bind me to my desk and cover my eyes and ears with beeswax as Odysseus asked of his mates.

Three other thoughts are relevant as we conclude on energy. The first is that nearly every other stock in our portfolio benefits from lower energy prices. Second, if you think carbon assets are stranded assets and thus giant investment liabilities, I would like to ask Al Gore what the heck is more stranded than nearly ANYTHING that was built under the heading of "alt-energy" over the past five years if current energy prices hold. The last thought is that a great opportunity is emerging in 2015 in some otherwise excellent manufacturing companies who are about to get crushed due to a decision to "move our widget making excellence into the obvious growth industry of the next 20 years—energy infrastructure." There will be pain and suffering, and acquisition write-offs coming down the pike, but 20% of your otherwise excellent business in something that just is a lot more cyclical than secular as previously thought is not the end of the world. We have a list.

So if the secular energy investment story that seduced a lot of the world's smartest men, and consumed the intellectual thinking of the Fortune 500—and the consulting industry that feeds off it—was completely and utterly wrong as it was consumed by an oft-repeated complacency, then what might we think about the consensus on interest rates?

To that point, what bigger complacency has driven financial markets for years than the idea that the Federal Reserve and now the ECB have it all figured out and just need to concoct schemes that seem "clever" on the surface to address the near-term issues, and if further near-term issues arise, well then why not create another new scheme? This simply fails the ultimate sniff test that frankly I thought was debunked around a keg freshman year—that a group of our best and brightest can divine the future more accurately than can a reasonably functioning marketplace. I think the decision by the Swiss to stop "fighting" the market and allow the Franc to rise to the level where people are willing to buy and sell it every day indicates that a huge and differently shaped cloud is on our horizon.

The global level of interest rates has been neatly manipulated for the past five years and it is difficult to find an asset class or a currency or a country in which "money" has not been swayed by the logic that nearly any financial activity makes sense if the investment hurdle is a near zero rate of interest. This is the Great Complacency. "We" have all gotten used it and hugely benefitted from it. The collective we (the ones not in quotes) are also very aware that this state of affairs remains tenuous.

But apparently not as tenuous as we thought three years ago when we said the same thing. We carefully consider the possibility of simply being wrong…or even stupid as MIT Professor Jonathan Gruber would argue. There has been a pervasive and very successful theme of investing in the expectation of deflation and owning 30-year Treasuries that continues to hold the day. A five percent rate of return on acquisitions might actually be a great thing if the real rate of return on assets is zero… or less. Japan has been Japan for a long time despite continuing monetary and fiscal stumuli. Similarly, the U.S. has relentlessly pursued every avenue of possibility in fiscal, tax, and regulatory policy over the last six years to assist this state of affairs. We just don't like the risk/reward of playing poker with barely clothed emperors.

As English Victorian poet Arthur Hugh Clough noted, "If hopes were dupes, fears may be liars." Humanity seems to relentlessly challenge the existing order in so many different ways—and places—and thus the past remains a poor guide to our individual or collective futures. Predictions of mechanistic models of overall economic growth, investment returns, or global warming—Piketty's, the Chinese government's or anyone else's—are not much better than coin tosses. That much we know.

So we at Cove Street move forward in a sedulous fashion. To paraphrase the longtime leaders of an Omaha-based former holding, on a day-to-day basis we are simply looking for companies that are: (**1**) constantly improving the basic earning power of their operations; (**2**) further increasing their earnings through bolt-on acquisitions; (**3**) repurchasing shares when they are available at a meaningful discount to intrinsic value; (**4**) making an occasional large acquisition; and (**5**) maximizing results by rarely, if ever, issuing shares. We try to buy them when their stock prices are cheap relative to a reasonable estimate of intrinsic value and we don't buy them when they are not. And of course we desire to sell them when the price is unreasonable. Fiendishly simple.

While we enjoy repeating ourselves as much as the next guy, we do like this quote from Martin Leibowitz in the *Financial Analysts Journal*:

> "The great ones share a number of positive characteristics—focus, patience, a clear-cut philosophy, a willingness to go beyond the diversification mantra, an innovation-prone attitude, the organizational sponsorship and personal fortitude to endure significant periods of underperformance and a disciplined process for pursuing goals."

That's us. We are warily unsure about the future, but we are very sure about us. We don't use leverage, we have a common sense value approach that has delivered a track record that has stood the test of time, and we have a talent dense group of smart and young (by this writer's elongating standards) people who are committed to the long run.

We are willing to take personal risk by following a contrarian path rather than simply focusing on avoidance of career risk. The latter produces over-diversification, index hugging, high turnover and statistically-proven mediocre results. The former is infinitely better for a client/partner, albeit occasionally painful to the manager. The world is a relatively efficient place and we have chosen to stake a claim in the world of less traveled, less liquid, less known securities in which our efforts have a higher probability of making a differerence in the long run. My career is littered with "foregone income opportunities" that came about because I refused to take actions that seemed to not be in the client's best interests. We believe this is the way to manage money for other people.

We look forward to an always fascinating and prospectively profitable new year.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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