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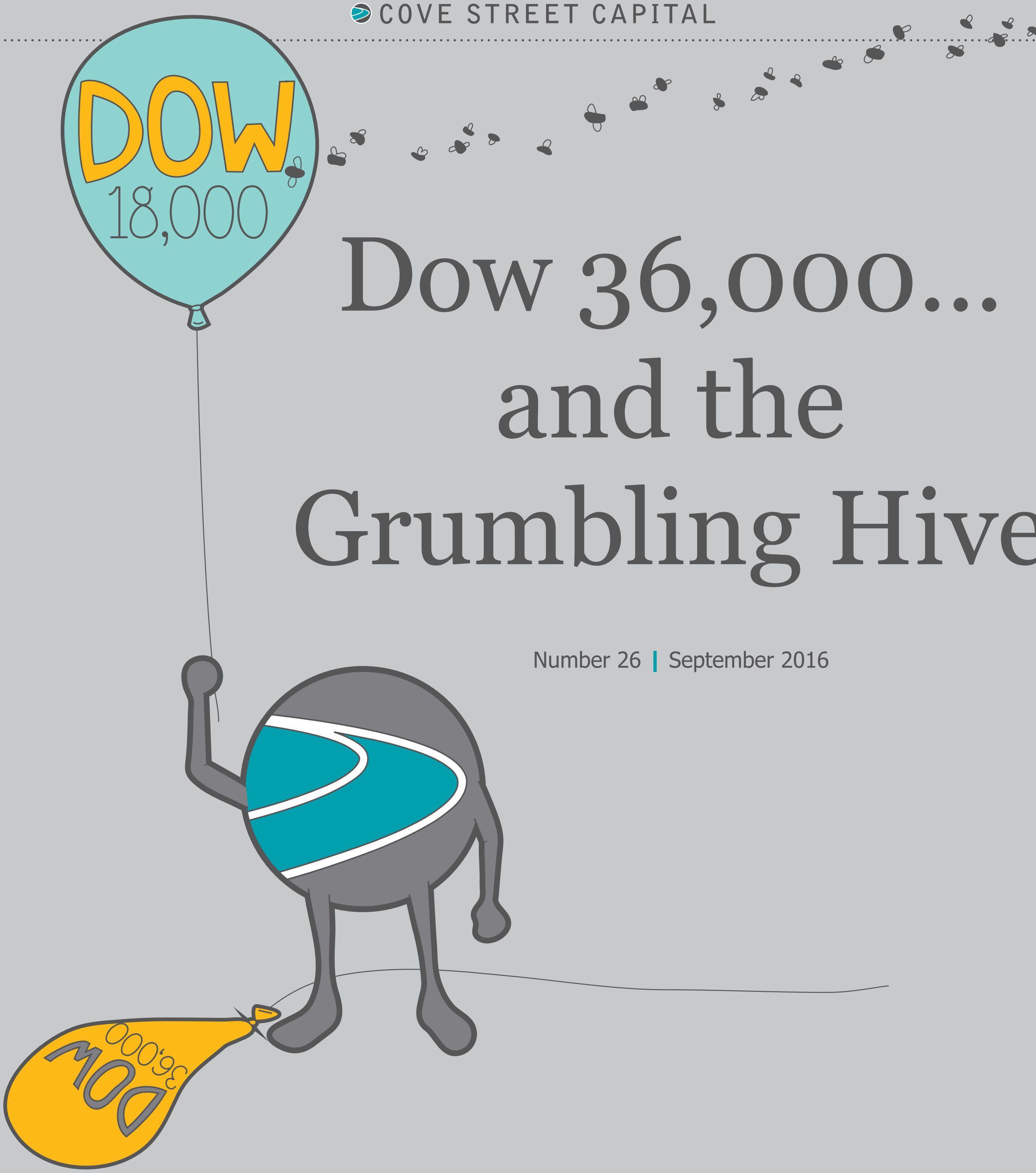

Dow 36,000... and the Grumbling Hive

Number 26 | September 2016

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SEPTEMBER 2016 — There is a lot that continues to be distinctly weird as it relates to today's financial world, with weird being continually re-defined by elected—and un-elected—officials around the world. This bizarreness in the political realm is in addition to the increasingly odd financial relationships that flow across our screens. That in and of itself should inspire some caution: if you don't recognize a large animal in the jungle, it pays to give it wide berth until you can Google it and discover it eats vegan.

What seems obvious to us on the ground is that recent advances in the prices of many assets have reduced their intermediate attractiveness, mostly due to increased expectations for a longer period of suppressed interest rates, rather than any noticeable improvement in the underlying cash flows these rates are discounting. Corporate America remains properly terrified of regulatory morass, retroactive executive orders, and an ever more hostile labor situation, both at the government level—state and federal—and the one playing out literally in front of their establishments in the form of people carrying placards. As a result, economic conditions remain tepid in the U.S. and mostly worse around the world. Thank you, Brexit panic, which induced global central banks to once again hit the panic button and thus reinforce the widespread strategy of immediately accepting any yield greater than 0% and the belief that the longer the implied duration of that asset, the better. That has been the basis of the 2016 performance of equities, AKA the New Fixed Income.

So although the future remains its uncertain self, and we don't go into a tizzy over a bad Friday or the "first down month in equities in several months," we are simply seeing less margin of safety resulting from higher prices. And the weirdness in our minds actually harkens back to…1999.

No, that is neither a sneaky Prince reference nor a reference to unease about a software upgrade, but a funny little thing called Dow 36,000. In a story that used to be told often, authors (and economists) James Glassman and Kevin Hassett released their Dow 36,000 book in 1999, and let's just say it didn't go so well, as the Dow Jones Industrial Average found itself at 7,400 within two years of the book's ink drying. But what's fascinating is that their work represents almost exactly the prevailing argument for why the Dow is 18,000-ish today.

To review, Glassman and Hassett (G&H) made a variety of math mistakes, as well as some general philosophical mistakes in their work. But at its core, they argued that there is no reason why the earnings from stocks shouldn't be discounted at an interest rate that was simply the risk-free rate from longer-term Treasury Bonds, which—LOL—yielded close to 6% at the time. The prevailing and alternate theory is that stocks are "riskier" than bonds and thus an investor should require a higher return hurdle to invest, and from that idea evolved the concept of the "risk premium" required to own equities.

In a nutshell, (and by the way, Warren Buffett has suggested this as well—MY stocks aren't riskier), G&H took the earnings of the Dow Jones Industrial Average, roughly $360 at the time, used a 6% interest rate instead of a more standard "risk-adjusted" 10%, threw in a 5% expected growth rate and plugged it into the classic Gordon Growth Model, which is taught in freshman Economics classes as we speak:

> Value = Earnings / (Required Market Return – Expected Earnings Growth)

The answer was Dow 36,000.

Before fast forwarding to today, I would point out that the model is mentally correct if, of course, you had perfect insight into the correctness of your inputs. Let's just say while this is a LOT easier than climate model forecasting (try modeling cloud cover), the stubbornness of the future's willingness to submit to rational analysis remains intact. And G&H made the core mistake, which many still make, of using GAAP earnings as something real and tangible. Those of who us who conduct our daily affairs in the real world recognize how difficult it is to pay a restaurant bill with something other than cash. And focusing on net income ignores the necessity for businesses to reinvest their "earnings" to maintain or improve their competitive position or to achieve their expected earnings growth—the original Gordon model used dividends, not earnings. And it ignores the "management vig" in the form of options and restricted stock, and egregious bonus plans that subtract from actual growth.

Digression aside, and moving forward to today, if you averaged the past ten years of DJIA earnings, you would come up with something approximating $950 per share. The U.S. 10-Year Treasury is 1.7% as of this writing. Corporate growth overall is…stagnant. Take out your iPhone, click on the calculator app and start playing with some of the implications using the handy model we provided above. Conclusion: either the earnings number is too high, interest rates are way too low, or we are truly in a Twilight Zone of trying to grapple with how to value things at these levels of interest rates.

Now pretend you are a local Swiss investor, who has seen a 10-Year Swiss note trading at negative rates for 13 months in a row, and whose earnings stats, inflation, retail sales, and GDP have basically been flat to negative for the same time period. How would you value stocks? Put another way, what stock price cannot be justified at negative or zero interest rates? Weird.

We are not blessing the earnings model as noted above; but what it does is show the intensity of reaction to minor changes in interest rates when rates are this low. And it shows how possibly ephemeral this environment might be, given the conceptually proper argument that to even think about long-term valuation of the equity market as a whole requires being long-term right about inputs, not the 3-month moving average of interest rates. We continue to place a low probability on the U.S. market repeating the now 20-year-old Japanese experience... and counting. But that outcome has a non-zero probability and its vector of recognition points north within our walls. In case you were wondering, at CSC we continue to use discount rates north of 8 percent, which may be wrong, and may account for the dearth of new ideas. But it helps us account for the distinct possibility that we could be wrong in all our other assumptions in valuing companies. All in all, weird—and weird should mean cautious.

On a related theme, it is also important to remember that for much of corporate financial history until the 1950s, the dividend yield on stocks exceeded the yield of bonds. This was due to the difficulty investors faced in actually getting real data on the particulars of a company as compared to the theoretical mathematical certainty in a bond (credit being money good). And of course investors were investing with the very real wounds of the depression singed on their foreheads. That this phenomena unwound itself in the 1950s in what became "The Great Inflation" and the "Go-Go Years," leading to an influx of new investment professionals and new investment theories, and a generally more efficient market, changed the stock-bond relationship. And here we are again today, with stocks yielding more than bonds. Weird and speculatively interesting.

As it relates to the Federal Reserve, our mini-thought update simply includes more data that we don't like, such as the fact that the Fed has a Facebook account. And it meets with "activists." In addition, the evidence supporting the "Paradox of Thrift" continues to grow. This concept dates back to "The Fable of the Bees" from the 17th century and states that the lower interest rates go, the more people save in order to maintain the same standard of living—and this applies not just to people but to pension plans and healthcare funds. In other words, low interest rates only stimulate the economy to a point, and we have safely blown through that point. So, are interest rates low everywhere in the world due to weak economic growth, or is weak economic growth everywhere due to Central Bank attempts to suppress interest rates? And to counter any number of loonies out there, the Federal Reserve Bank is not a secretive cabal that represents the interests of the rich and clandestinely attempts to oppress global masses, although that might seem like the outcome of their academic policy choices. If there really was a "they," they sure as heck would be issuing 50- and 100-year maturity bonds to take advantage of the lowest interest rates in recorded HISTORY. That they are not supports our contention of cluelessness and politics reigning over evidence.

We naturally are not going to talk about the election except to refer you to the "weird" statements above and ask that if we are going to build a wall, can we please start with the Harvard Economics Professor's Lounge and 620 Eighth Avenue, New York, New York? It would do us a lot of good and be more energy efficient.

Which brings us to Gretchen Morgenson and the latest attempt by the New York Times Business section to steal thunder from the editorial page. It may just be a sign that the market is truly so picked over that I think it is a worthy use of my time to write about a "GM" (not the auto company) column that has been trudging along in my notebook for the last two months—but regardless here it is.

"A Simple Test to Dispel the Illusion Behind Stock Buybacks" is the column we are choosing to pick on… from many. Now to be "fair," we feel compelled to write on this topic once every 18 months because it remains one that apparently very few in the financial press, the finance industry, and corporate America understand. Yes, we have the moral and intellectual high ground here and we are going to mercilessly defend it. To wit and once again:

A company that generates free cash flow can either reinvest in its core business, buy another company, or return cash to shareholders. It can do the latter either by paying dividends or through repurchasing shares. Here is the not-so-easy rule: if a company is in a "reasonably" predictable business, whereby the management team can have some sense of either the value of the assets or what a competitor would pay for the whole business, and can reasonably approximate 10-years' worth of cash flows or parlay their insider-ness well enough to predict an impending inflection point, then management should be assessing the company's intrinsic value and comparing it to the market value. If it's cheap, buy the stock. If not, pay a dividend or wait.

We do not think it is smart corporate finance to buy back stock at any price, regardless of value. We do not think it makes sense to willy-nilly buy back stock to offset the issuance of options and restrictive stock. We do not think it makes sense to buy back stock every month on a program. We do not think it makes sense to buy back stock to boost earnings per share just to hit targets within the management compensation plan.

The latter are all points that GM has and can make regarding corporate inanity that is not "fair" to the shareholders. But she cannot quote an obscure (ok, at least to me) Professor of Economics at the University of Massachusetts (again with the wall idea) who basically supports a very specific argument that says greedy American companies are not reinvesting in their businesses—particularly those located in America—and are instead resorting to financial tricks to maintain and further their position in the hallowed 1%, all at the expense of working Americans. GM then continues with a gentleman who appears to have found the holy grail of investing—that all you have to do is compare net profit growth with net EPS growth to suss out what will or will not be a successful investment. (No evidence is presented that this method would actually be helpful in finding a successful investment, but it nicely fits a narrative.) According to the article's math, GM says that if companies had merely earned a "nominal" 5% on reinvestment, it would have been better than shrinking the share count of a flat-lined business—like say Target's. Now it is clear that Target shareholders probably would have been better off with management paying out $11 billion in dividends than buying back stock in a retailer that has nearly mismanaged itself into a mess in a world that also includes Amazon. But it is certainly the opposite of smart to suggest that Target should have committed $11 billion to build more Target stores. And if you stick ANY ten people in a room today with GM, and ask them what a large national retailer should do with all of its free cash flow in an Amazon world, I would think GM would take a solid intellectual beating. And we will repeat that in our experience, 98% of CEO's would rather throw money at almost anything other than share repurchase if they can employ a non-secular minyan of MBAs to create a sheen of plausibility regarding the potential returns on an investment or acquisition. Per our Glassman narrative, even for a receding business model like that of newspapers, 5% is also an absurdly low hurdle rate with which to judge the success of an investment return.

What GM does not talk about is the fiscal mess this country is in, partially as a result of retroactive executive orders that are hostile to businesses on labor, tax, and regulatory fronts. Also not mentioned is the fact that we have two candidates espousing economic ideas that a reasonably-read high schooler would laugh at. The marginal dollar in corporate America should be husbanded even more than the New York Times thinks it is today if you are doing some basic math off an editorial page in an election year. The aggregate PIE will continue to increase at a sub-optimal pace under a continuation of the current regime, and who knows what will happen if the other guy wins. Intelligent economic growth cannot be conjured. It is something that is hard-fought to achieve, it is not a goal to be achieved at any cost, and it is not the sole determinant of what makes a successful investment. In the absence of something intelligent to do with shareholder funds, the concept of "do nothing or give it back" closely approximates how rational corporate finance should be employed, assuming that is even the relevant topic.

So we plug along holding some cash. We hide in some safer ideas, which oddly enough, are not the traditionally "safe" sectors such as bonds and consumer staples stocks—as they have been bid to the moon by Wall Street's latest go-to product, the "Low Volatility Fund." We are highly confident that there will continue to be enough randomly generated disappointments in the future to create compelling opportunities for new value-oriented shareholders, and we are confident that most of what we own will grind higher in intrinsic value and eventually be properly valued by others.

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