COVE STREET CAPITAL

Some Things Really Do Change

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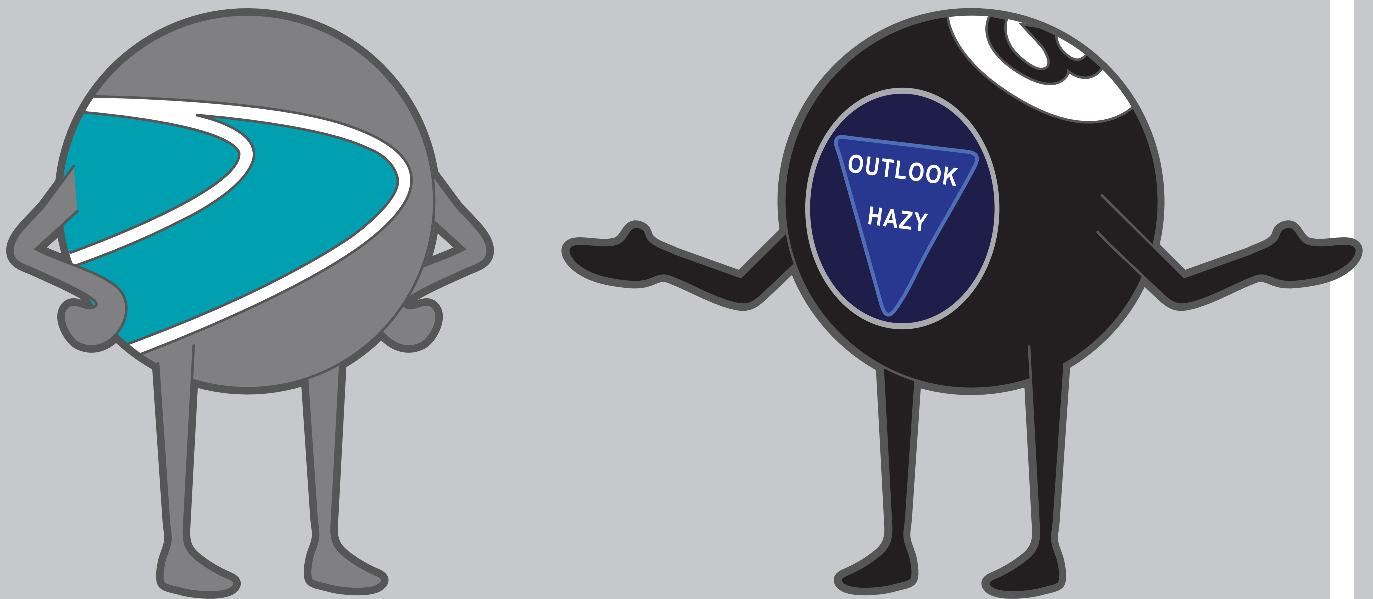

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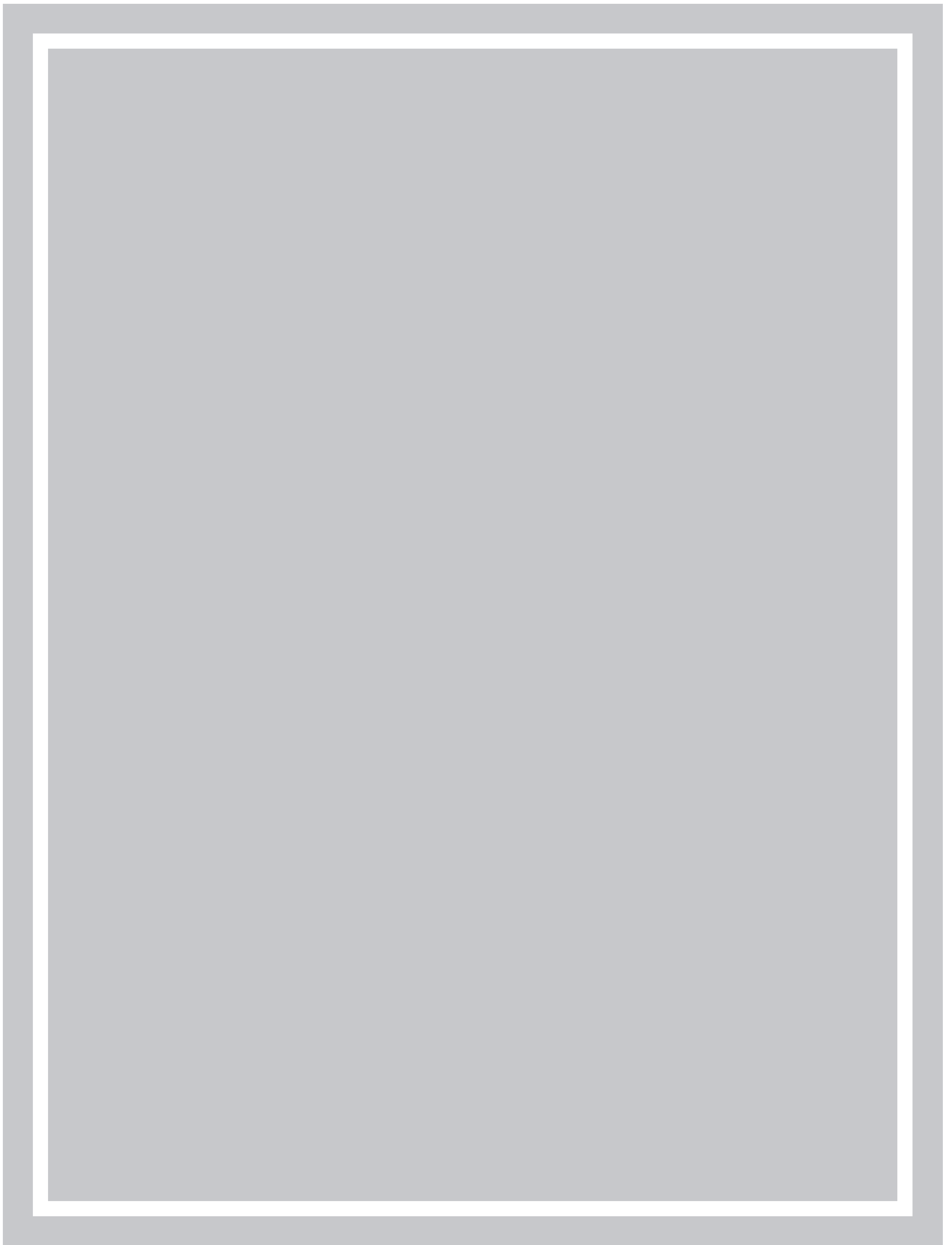


Some Things Really Do Change

I was going to start with my French stalwart, "plus ça change, plus c'est la même chose," but the probability that things have really changed post-election has risen closer to 100% than to 0%. And that is us talking, not a poll or prediction market.

Like it or not, I will half-heartedly do my best to eliminate all personal bias and focus on a cold-hearted analysis of how the election impacts our search for greater wealth for our clients. Beginning January 20, 2017, the Presidency will be occupied by a Republican, a majority of the Senate will be Republican, a majority of the House will be Republican, a majority of the governors will be Republican, and a majority of the state legislatures will be Republican. The Democrats will not have a majority of anything—except Facebook posting—per my unofficial canvassing of friends and family who reside on the coasts.

In theory, the knee-jerk reaction of financial markets is long-term correct: this change should enable a pro-growth, business-oriented agenda that historically has created more wealth and reduction of human suffering than any system devised by man—since the dawn of time. As recently departed economist and writer Charles Wolf Jr. noted, "The rhetoric of decline is wrong because it portrays a past that wasn't, a present that isn't, and a future that probably won't be." The obvious conclusions are that growth is going to accelerate, taxes are going down, equities are to be bought, a historic low in interest rates has officially been made, interest rates and inflation are going higher, and bonds should be sold.

Ignoring the debate of whether someone should be listening to their gut or their intellect (and if you actually read some of the holiday books we are sending out, you would realize that this is not as easy a choice as it might seem), the financial debate now gets more complicated. Some of these complications are neatly tabulated on our website — **CoveStreetCapital.com/Our-Current-Thinking** — if you would like our first take on it. (Or if you would like to sign up for more frequent updates.)

Let's start with this: the proposition of investing in themes based upon the divination of potential Trump administration edicts seems to us to have as much value as does listening to a public company CEO talk seriously about the merits of going to Mars. (Oh yes, there is one of those.) It is VERY early goings, and the target is completely redefining Newton's first law of motion: an object constantly in motion will constantly redefine motion at differing speeds and directions while at the same time being acted upon by unbalanced forces, all the while tweeting. We will simply note that this country has somehow survived civil war, influenza, economic depression, Nazis, nuclear proliferation, OPEC, Japanese economic dominance theories, Richard Nixon, Barry Manilow, the Big Short, Elizabeth Warren, and any number of other dysfunctional public figures and attempts at dysfunctional policies. And the Dow Jones

Industrial Average is at 19,000. And what if something really good is happening economically? What if Donald Trump will merely be the pen and Paul Ryan & Co. the writers?

Our focus is unchanged—identifying combinations of business model, intrinsic value, and management teams for which the risk-reward prospects differ materially from those suggested by their valuation in public markets. We look at what is offered—and at what price—by the daily vote of the stock "market" and make decisions accordingly with as little emotional baggage as we can manage. Frankly, we would have rather had post-election mess and chaos that overestimated headline issues and set us up for some terrific bargain hunting. Instead, we simply participated, and now wonder, have expectations blown past most realities?

Said another way, we love the idea of Paul Ryan crafting economic and tax policy and somebody in the White House signing what comes out of that process. There is no reason NOT to think the Republicans will not be Going Big and Going Early and Not Going Home for at least two years, and we would bet directionally it will be the right prescription for economic growth; but change is change and markets are mixed on aggressive change. We also think financially speaking, it is simply nuts to suggest that globalization and global trade are bad ideas and put that down as a distinct negative to consider going forward. Throwing in another surprise Newtonian quote, " 'Tis much better to do a little with certainty, and leave the rest for others that come after you, than to explain all things by conjecture without making sure of anything."

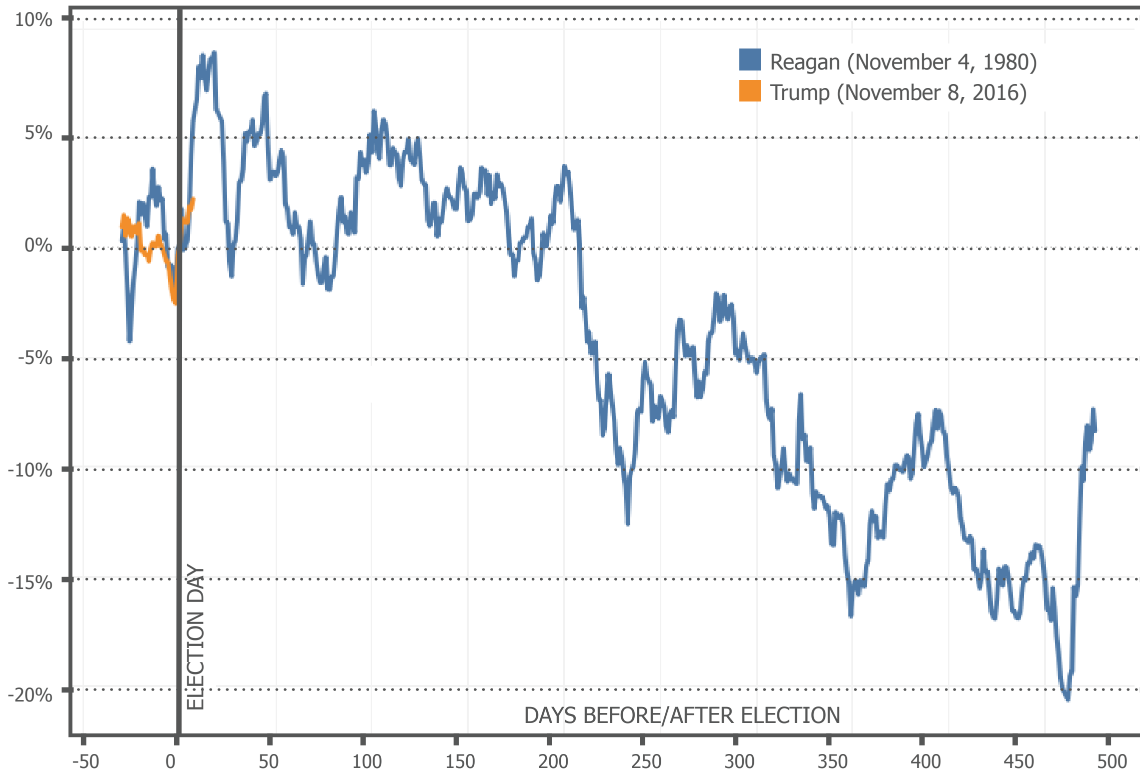
We think it is fair to assume that EVERYTHING will be different over the next four to eight years—relative to the prior eight years—as far as "money policy." What might that mean for an investor? One question is, what is better for asset prices: faster growth or lower interest rates used to discount prospects of lower future growth? Ben Graham famously noted that obvious prospects for physical growth in a business do not translate into obvious profits for investors. This has also been supported by a trove of academic research that has found a very poor correlation between expected country economic growth and returns to an equity investor. (Answer: rearview mirror statistics and a complete inability to forecast the future completely derail the correlation.) In other words, is it possible that Main Street enjoys superior economic growth than was demonstrated in the prior eight years and yet "Wall Street" produces worse investment returns? Will Donald Trump morph into the international savior of the left for fixing the headline canard of income inequality?

The related part of the preceding premise involves the possibility—strongly held here for at least two years—that we have truly reached "regime change" status with respect to a bottom in interest rates and a related move from reliance on uncharted monetary policy to reliance on fiscal policy. And fiscal policy does not just involve "infrastructure spending." A sharp cut in corporate income taxes that benefits fat-cats with 401ks and teacher's pension plans due to the rise in the value of after-tax cash flow also falls under the rubric of fiscal policy. Both of these constituents would benefit from improving incentives to save and invest, and more good old-fashioned supply-side thinking that is results-oriented, not intention-based. That is what stocks think they are smelling.

All of which supports a big fat bottom in interest rates and another strongly held related mathematical statement: a major reason behind big returns in most asset classes over the past 7 years has been flattish cash flow being discounted at lower and lower rates. Will stocks go up in the opposite environment? If rates are going to rise, you are going to need a lot more growth and a lot lower taxes to make up for extraordinarily high percentage changes in discount rates. Financial history is neutral on the answer. There have been distinct environments where stocks rise with rising interest rates and environments in which the opposite has occurred.

And just as rates did not fall in a straight line for 34 years, they will not rise in a straight line. But our bet is the change is in: sell rallies in bonds. We should also note the high likelihood of a changing of the guard at the Federal Reserve, and again, that people should not overly focus on the person, but the movement behind it. What if the Federal Reserve was actually run by people who thought that market forces should determine the proper clearing price of interest rates? What if market participants can't rely on the so-called "Fed Put" in times of market volatility? How will this oh-so-tiresome millennial mindset deal with the resultant stress and uncertainty?

Aside from the week post-election, there remains a distinct lack of euphoria being associated with major U.S. stock averages hitting record highs. That is a huge positive. The world's great geniuses are publicly negative on the market and clearly a lot of the populace is in shock post-election and is sitting on its hands. We will note that our friend in Toronto, Prem Watsa of Fairfax Financial, halved his long-suffering equity shorts and sold 90% of his long bond position; and Carl Icahn apparently called his brokers from a men's room at midnight on election night telling them to buy stocks. So, "someone" is sensing an inflection point, but it remains a minority



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view unless you tell me the Russell 2000® is going to go up 8% a month in a linear fashion.

To recap what we have said so many times and in so many ways: we try to refrain from calling the game; we merely hang around the hoop looking for stray balls. We profess to do asset allocation when called upon and base it on the relative attractiveness of equities versus other alternatives. Within that framework, equities remain the tallest height-challenged asset class in the room. But valuations remain north of average—on average—and low yields on fixed income are a very low hurdle for comparison. That is a combination of factors which is usually the opposite of what jumpstarts a big bull market. Barring a true miracle confluence of economic events which are beyond the purview of our shake-up of the Magic 8 Ball, we continue to lean a little cautiously in a year in which returns are beyond most expectations—including ours.

Under the endlessly pleasing activity of repetition, one of our favorite dialogues with the outside world is in regard to this question, "What is the proper benchmark with which to judge you?" Our standard answer is, "Benchmarks are like potato chips, it is hard to just have one." And focusing on small cap for this discussion, the reason why we always present both the broad and the style index—the Russell 2000® and the Russell 2000® Value—is that there is an inherent bias in index construction, just as we have our biases. There will be periods where specific stocks or sectors are hot or cold, and if those are heavily weighted in the index, it will likely make you seem smarter or dumber in the short run than reality might suggest. The Russell 2000® Value index has an 41% weighting in financial services stocks as of October 30, 2016. I can tell you many client investment policy guidelines won't even let us go above 25% in a sector without us huffing and puffing, a fact that has led to interesting committee meetings where we have been chided for short-term underperformance (yes it happens) and have to point out the inherent flaw in their guidelines that almost guarantees that under certain scenarios, we will temporarily look dumb.

And that scenario for small cap value managers is a giant and meteoric rise in financial stocks, which has been precipitated by "players" betting that a Trump administration will greatly ease Dodd-Frank restrictions and that a rise in interest rates will relieve margin pressure.

Outside of a few exceptions, I think small cap bank investing is best pursued within a strategy focused on banks, where proper diversification (owning 30 of them) can be employed by an investment manager that only looks at banks. They are out there and they are good, and I have found it is good to know who is who at the poker table before I sit down. There are hundreds of small cap banks and you need to cover a lot of ground to have any idea where to invest. I also think that small, regional banks are over-capitalized, geographically narrow lenders to mostly commercial real estate and are often run by slightly sleepy management teams incentivized to remain where they are versus doing something for us. We are not real estate fans at this point in the cycle and activist campaigns are often required to move the needle in this space. Plus, we don't wake up every day wishing we could be activists while we eat our breakfast. And I would argue large cap banks are the place to go if you want to bet on someone stealing float from customers in a rising rate environment. In other words, we are being smoked by the Russell 2000® Value this quarter— and will continue to be if small cap banks remain the place to be.

We will note one other thing going forward, and again it is a repetition of what has been said before. Near zero interest rates have made many "choices" universally unattractive, thus making a mockery of choice and diversification. This has accelerated a self-reinforcing wave of indexing in which sheer walls of money have flowed indiscriminately into a relatively limited number of companies that fit well enough within required liquidity thresholds or desired characteristics to sell a product. This too shall change. And note to self: day-trading ETFs to express the trend of the month is not what the founding fathers of index theory advocated.

As market forces re-enter the battle of ideas in the near future, our long-term record and focus on selective and fundamentally-based small cap value investing should comfortably debunk what the Wall Street Journal recently called "The Dying Art of Stock-Picking." Mark that as a bottom.

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