COVE STREET CAPITAL

Not Going Gently into the Night: Active Management and Electric Guitars

Number 29 | June 2017

"We have adopted something of what we'll attribute to infectious disease specialist Justin Graham: Don't Just do something. Sit there."

Not Going Gently into the Night: Active Management and Electric Guitars

JUNE 2017 — As the year toils forward to the halfway mark, we reflect.

Returns in the world of small cap have predictably ground to a halt after a torrid 2016. Strategies that include larger cap companies—particularly those that have benefited from the scorching performance of the favored few tech stocks—have shown excellent returns, both absolutely and relative to common indices, prevailing rates of inflation, fixed income competition, and common sense. "Growth," commonly abused as a categorization, continues to mulch "value." While reasonably outperforming a flat index is better than a sharp stick in the eye, it's no great shakes. Additionally, we are sick of talking about either Washington policies or Amazon.

While we are also tired of the next topic, it is much more relevant to our efforts to produce value for clients: the cascading rush of capital toward passive investing. Several things are crystal clear to us...and shall be repeated. With an acute understanding of the long history of financial markets and burdened by thirty-plus years of experience, I believe a massive move toward indexing from "faux" active management is an entirely rational idea that should be widely embraced. I don't see it "going back" and recent graduates should consider that statement carefully. So, if this is to be the state of the world, what does it mean for Cove Street and our clients—current and prospective?

We sometimes frame the spectrum of investing to include U.S. Treasury bonds on one end and Botswanan private equity on the other. These are two asset classes that arguably represent distinctly different opportunities for an active investor to theoretically add value, the latter being a much higher probability bet if you can stand the heat and are a seswaa aficionado. The differences between the poles represent harshly different environments of liquidity, familiarity, and broadness of participation. While we frankly know little about either pole, we would argue that being closer to the latter than the former is where you want to be if you want to be in the pole position to add value. Cove Street was designed from the ground up to be able to invest in what others "fear" by limiting asset growth, limiting the number of positions, and focusing on old school things such as company fundamentals. The last category inexorably includes an analysis of whether management and the board are stealing for us or from us, and what a security is roughly worth under a variety of scenarios. In other words, while we strive to be a superb fisherman, we are at least fishing in the right pool.

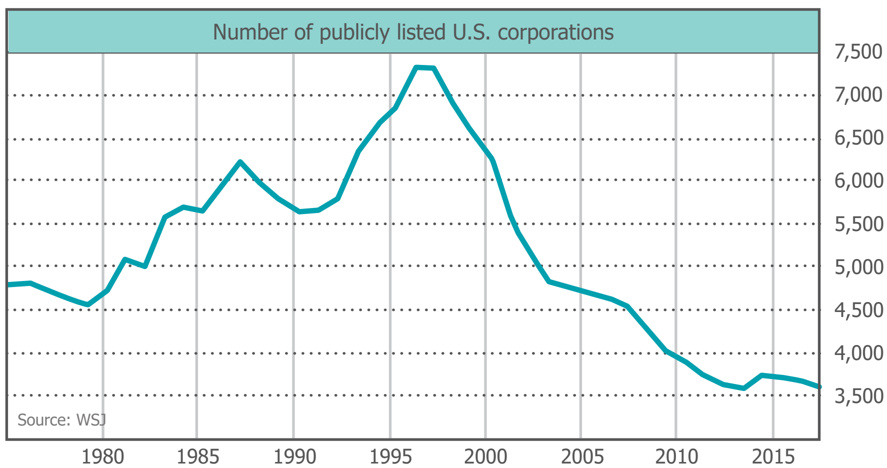
And that is a crucial issue. As interestingly documented by the ever-interesting Michael Mauboussin, there are a LOT fewer public companies versus twenty years ago—as in, nearly half. The two obvious reasons are the massive explosion in money to invest in private deals that both fund private companies and take public companies private, and the ever increasing regulatory and legal burden associated with being public. As a quick aside, what value is being derived for private equity investors who pay 2x to 10x the fees that most public managers charge in order to invest in companies that legitimately could be public? And "private equity" adds what management value if you are REALLY paying attention? And asset allocators are saving how much in fees by moving from active to passive in public markets while still paying exorbitant rates for the privilege of investing in private companies?

But we digress. For the record, we calculate 2,284 stocks (at current count) with market caps between $100mm and $3.5 billion that are U.S.-based and trade on major U.S. exchanges; 262 more if you add non-U.S. domiciled firms to the same screen; and 4,397 if you include the farther reaches of Over-the-Counter. That is still plenty to choose from IF you limit your asset size and concentrate your positions. We have 33 in small cap. You should have fewer the larger your target market cap universe. The other point that is somewhat neglected is that while there are fewer stocks, there are arguably also fewer people paying attention. And here we insert [the requisite guitar/active management analogy](#).

Our point is that we are suited up for a legitimately different game than that of 20 years ago, but I am not so sure the "client world" is as willing or quick to follow. You have to be willing to be different to position yourself to earn an active management fee. You must be prepared to take short-term lumps to earn the "time horizon value" being handed to you in a short-term world. And you must have pretty tough skin—and the clients to match your process and time horizon—or the task becomes more problematic for the manager and distinctly less profitable for the client, which is of course the historical record in institutional money management.

We continue to think this is an excellent opportunity for those willing to differentiate by focusing on value, business quality, and management as opposed to a weighting in the index and/or trailing three-month performance. There are a lot of applicable metaphors here. For instance, did you pick a spouse by gender identity at birth or did you decide to put in a little time and date first? Did you buy a car simply because it had four wheels? Do you listen to music or U2? Do you live in L.A. or just any city? Are you buying a piece of paper or a business that happens to be publicly traded? Are you buying a commodity and a number on a screen or an actual business? There is long-term advantage to viewing stocks as publicly traded pieces of real businesses run by real people, not packaged commodities with "factors" based upon trailing criteria. We think.

The Death of the Corporation?



There is some marginal point in an economic or investment cycle at which the benefits of less active and less expensive investment management are overwhelmed by the anchor of over-valuation. Note to self: you will not hear that bell ringing at the inflection point. We utterly get that there is some inherent value in a strategy that identifies "important factors" such as value, size, and momentum, seeks to quantify and commoditize it, and then lets the algorithms run. But as Amazon so brilliantly shows, the innate nature of utilizing data-mining is that it quickly ruins the idea it was trying to capture in the first place. ([See our take here](#).) And what is the historical record of the world's smartest men very publicly throwing billions of competitive dollars into an arms race toward devising the perfect quantitative model? It's not good.

I would also argue that X% of what we are seeing today in financial markets and money management is related to 8 years of the Federal Reserve's not so subtle attempt to stand on the neck of interest rates and to promote the goodness of near zero volatility and certainty, a concept that has been near universally embraced. At its zenith, which is arguably somewhere around NOW, we have stories in the Wall Street Journal about Chinese regulators responding to prodding from President Xi Jinping, who issued a call for financial stability ahead of a major power reshuffle later this year, and warned finance officials not to miss "a single risk" or "hidden danger." Uh...huh.

There is factoid after anecdote that can be piled onto the spine of low volatility Camelus dromedarius about equity market volatility reaching the lowest levels ever recorded or the costs to hedge downside equity risk being the lowest on record. And there is John Bogle and Robert Arnott having a public spat about whether the massive flows into quantitative funds pursuing "low volatility" have made low volatility a very expensive asset class.

We think "calm and collected" is an unnatural state of the human condition and it is still humans who are the beneficiaries or loss sufferers of changes in the prices of financial assets. In fact, a drop in stocks affects everything from paying for college to maintaining a roof over your head to trying to get re-elected with a massive actuarial hole eating into your ability to throw money at your constituency. But the absence of financial comeuppance breeds complacency. Hence the success of the ultimate low volatility investment program popularized by Bernie Madoff: 1% a month, rinse, repeat. Having a plan, as noted by philosopher Mike Tyson, is a lot different than stepping into the ring.

Identifying what it will take for things to change is sadly above our pay grade here at Cove Street Capital, although we suspect it comes from the same source that created the current environment, namely attempting to control interest rates and the business cycle. Our guess is that there will be some bumpiness that results from the removal of quantitative easing and the reversal of zero/low interest rate policies, although we note with some irony that the Federal Reserve is finally trying to move off a zero interest rate policy at exactly the time when economic indicators look questionable. What we do know is that nothing seems easier than picking up collective basis points of performance in front of the last innings of a momentum-led steamroller. Or employing policies that effectively sell volatility in search of what appears to be utterly free money, until it isn't...in a hurry.

The second to last random thought surrounds corporate governance. It is a fact that four giant investment firms essentially are the largest shareholders in 80% of the Russell 3000®. We have actually seen arguments that BlackRock is "hinting" that maybe their index funds are not even the owners of their shares, but merely custodians for their clients. Passive investment has created a huge drive toward the outsourcing of corporate governance to a handful of "consultants" and this comes with truly awful implications as it relates to political correctness, painful fence sitting, and grossly self-evident self-dealing where the incentives are HIGHLY stacked against proper stewardship in favor of the innate desire to collect more assets and fees. And if few are going to pay attention as to who "owns" a company and how management can be held accountable for its actions, then why shouldn't every company try to reorganize with non-voting shares like so many Silicon Valley companies have chosen to do? Why even bother being vetted through an IPO process when you can just go "direct list" like Spotify is trying to do? Maybe being an ambulance chasing corporate securities lawyer is the remaining growth industry left in financial services. I have zero answer for this, but it is a sneaky and negative consequence of a massive move into passive ownership of corporations.

Lastly, one of the core functions of "markets" is to provide investors with a sense of the pricing of asset values so that they can make allocation decisions regarding their capital. For the moment let's ignore giant existential questions surrounding Adam Smith and the future of democracy and capitalism. Currently, investors are trying to answer simple questions such as: how on the margin are rational people pricing assets and estimating cost of capital and return on capital when ETFs are collecting x dollars per day and simply buying what is in a stated asset class, regardless of value? How can I evaluate what the market is telling me about credit conditions if I cannot price credit within a barely functioning corporate bond market, especially when trading is down some 70% in the last few years due to the giant sucking sound of central banks and ETFs? How does a CFO price an acquisition opportunity? These are weird questions and the answers probably contain unpleasant implications.

What pricing we do see and try to make sense of tends to be…expensive. We are as driven as is the next person to look for the next great investment; but trying not to do something stupid is a full time job in financial markets that have had a mighty impressive run since 2009. We have adopted something of what we'll attribute to infectious disease specialist Justin Graham: "Don't just do something. Sit there."

Our actual activity has involved selling a handful of stocks for no reason other than massively positive deals that have vaulted them way over any reasonable definition of "small cap." Goodbye FMC (Ticker: FMC) and Liberty - Formula One Group (Ticker: FWONA). Companies graduating, by the way, is the only intrinsic flaw in small cap investing for institutions. On the margin we sometimes end up selling our "best" ideas for uneconomic reasons. We have also been leaning into terrific winners such as Novanta (Ticker: NOVT) and Zebra Technologies (Ticker: ZBRA), both of which have fine businesses but trade at valuations that incorporate higher and higher hurdles of success. And then there is the improbable phoenix of Forestar Group (Ticker: FOR), a company that led us into our foray of legitimate activism (i.e. active defense in the face of an original mistake). We bungled the initial value due to badly misunderstanding energy exposure. However, our subsequent actions led to the ousting of management and certain members of the Board, and those who left were replaced with excellent shareholder representatives. Early in the quarter the company signed an agreement to sell itself to private investment firm Starwood Capital, a competing offer was tendered in June by public homebuilder D.R. Horton (Ticker: DHI), then a counter from Starwood, and finally a high bid from DHI. And voila—we sold our shares during a bidding war between two real bidders, and thus we can finally claim that every client actually made money in the stock from our highest cost basis. Let's just say accuracy on this task was not associated with the amount of professional experience of the judges, a great line which we hope not to use more frequently.

On the new idea front, we continue to increase investment in television broadcasting, arguably one of the only industries that the new administration has actually positively influenced, to date. We also are investing in 3 new stocks which we had barely touched before they took off and we would be forced to silence the reader permanently if we revealed them here. (That also accounts for our cash position looking "high.") This recent experience highlights a mistake we have often made and we are trying to fix. Doing a lot of work and finding a great idea but only ending up with 15% of the stock you wanted at a low cost basis is not as good as owning 100% of what you wanted at a price 15% higher—especially if the investment is going to appreciate 80% over 5 years. This is an innate behavioral finance problem for us and it is another factor that is currently impacting our perception of the proper size of our small cap strategy.

The future? It remains uncertain and we simply seek to invest with that very much in mind.

—

Jeffrey Bronchick, CFA
Principal, Portfolio Manager

Visit our weblog at CoveStreetCapital.com/Blog and sign up to receive commentary from the CSC research team.