COVE STREET CAPITAL

Can You Walk Past the Doughnuts?

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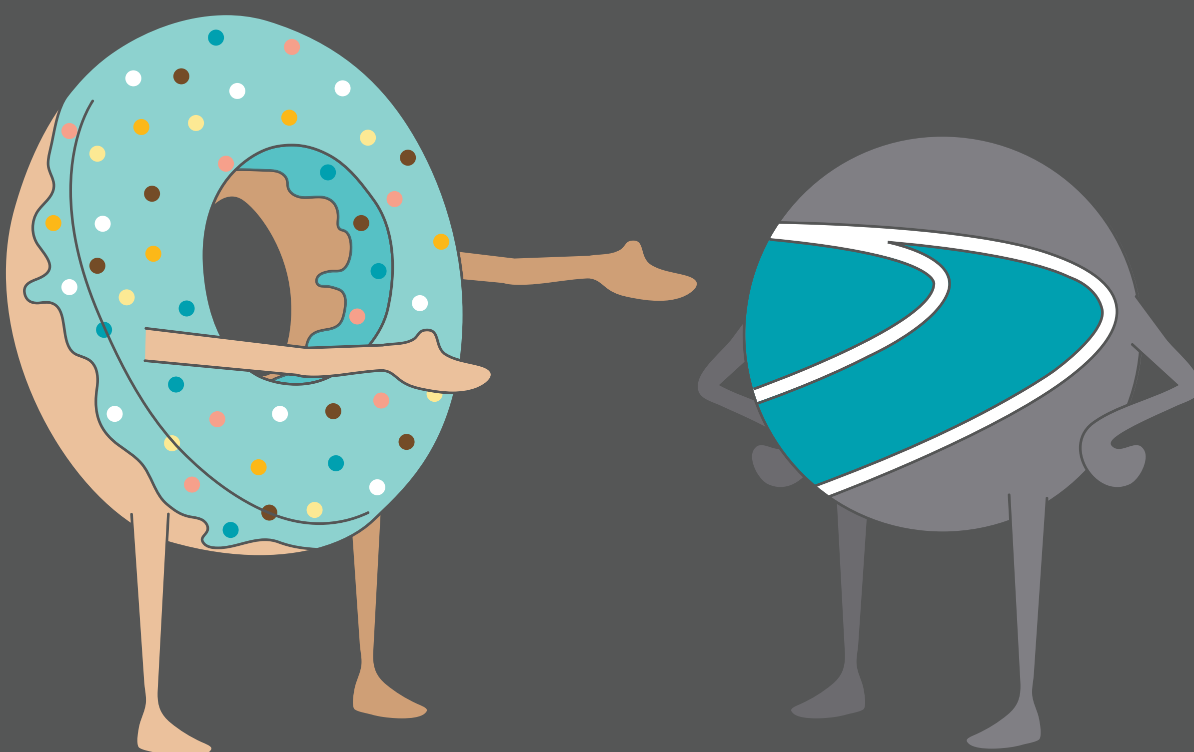

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Can You Walk Past the Doughnuts?

OCTOBER 2017 — Slogging through is an apt description of the third quarter of 2017, and it can apply to the whole year as well. Our Small Cap performance is "okay," as defined by year to date returns that are trailing those of the Russell but are somewhat better than those of the Russell Value indicies.

Our investment philosophy and process are centered on finding businesses whose intrinsic value differs materially from that suggested by the prevailing value offered by the stock market at large. We have rehashed many times the classic Ben Graham quote that in the short-run, the stock market is a voting machine, and in the long-run, it is a weighing machine. Fantastically ironic political comparisons to the present world aside, many of the cross-currents with which we began the year remain omnipresent:

- Most asset classes remain expensive by most historical measures, suggesting muted future returns.

- Global Central Bank policy remains accommodative, interest rates are low and stable, and credit is easily available for nearly any investment scheme. All of these are good things in the short-run, but it would seem to us that they are unlikely to represent a permanent state of affairs.

- "Orange Swans" (defined as the promise or fear that any number of bold policy changes pushed by the new administration in Washington actually get enacted) remain dormant despite much chatter. It is beyond our paygrade to speculate with your capital on political "what-ifs," other than to say lower and simpler tax rates would be nice.

- There is a small cadre of high growth, high valuation stocks that, until a very recent spurt late in the third quarter in non-large cap tech stocks, seemed to occupy every waking hour of the investment management industry's day. That is not our sandbox.

- There remains a large trend of dollars into "passive" investment vehicles, the practical effect of which is to create unusual movement in stock prices that can either exacerbate fundamental changes or obscure them—in the short run. We continue to think that this will eventually present a large opportunity for those who can afford to be picky in the face of a massive wall of indiscriminate money.

On a day-to-day basis, a lot of this year has been like going to a restaurant that has great reviews and a world-class chef, yet when you look at the menu, nothing jumps out at you. Quoting one CEO for whom we have a lot of respect and who is also paid to come in every day and "add value":

> So when things are being priced in the double digits of EBITDA as a multiple, you have to have realistic synergy plans or you're going to have a more permanent impact to your return on invested capital as a company. And so I feel that there's a lot of...it's a good time to be a seller, you have to be very picky if you're a buyer, if you're going to maintain discipline around return on invested capital. But there are things out there. We're fortunate enough to play in enough fragmented spaces that there are things we can pursue.

And yet, what we face as human beings and in particular, human beings who come into the office everyday confronted by endless "noise" and surrounded by hopelessly ambitious, high IQ's, is a classic example of a dystopian decision fatigue zone.

While neatly popularized by social psychologist Roy Baumeister, who himself drew from Freud's highly speculative work on mental activity and energy, there is no better space (outside of working in a doughnut shop) in which to consider the mental fatigue concept than that of the investment business.

For the better part of seven years, we have postulated that the force feeding of zero interest rates into the intellectual gullet of the collective crowd of asset buyers has bullied valuations almost across the board into something unquantifiably higher than "fair." This process happens every day on the margin as people with intellect, real professional goals and objectives, demanding bosses and/or clients, highly competitive peers, and enormous financial incentives come to work and face THE DOUGHNUT. As a result, every single day your intellectual defenses around what you philosophically believe to be the right thing to do as an investor get weakened in an environment of low volatility that continues to stretch on…and on...and on. Before you pick up the phone to fire us—no, the portfolio does not have any obvious unicorns or a new allocation to bio-tech, nor do we discuss "momentum" or "how the quarter is going." But clearly, the day in and day out of what we consider to be a narrow opportunity set wears on us. The conversations about cash levels become a little sharper every quarter that a zero return does not represent outperformance. Conversations about "value" expand, and valuations we were selling into ten years ago now present themselves as "the dip to buy." We get emails touting an amazingly cheap piece of orphaned corporate debt, only to step back and say that spread may be *wide*, but it's still only yielding 2.8% over ten years. Short-term underperformance can turn into intermediate underperformance, and I don't think we need to expound further on the turmoil that is causing within the investment management world today.

And this process is how markets reach tops, as things inevitably change and mistakes are belatedly acknowledged. We do our best to be self-aware and maintain discipline through a consistent process. And for the record, the portfolio manager has lost 23 pounds this year as of this counting. But it is extraordinarily difficult to come in every day and stick to your guns when markets don't seem to be "acting" the way you think they should. (Note to self: it's what you DO in these kind of environments that sets up your long-term success—the "Capacity for Frustration" variable.) And in fact, if you look back at nearly every great inflection point in investing history, the right move—in retrospect—was uncomfortable, usually early, and felt quite lonely.

Since we only tread lightly in credit, and we don't use derivatives or leverage (making us of course dumb and underpaid), the levels of frustration and the pain from weaker moments is—and will be—muted. And to reiterate, our investment actions are driven by bottom-up due diligence, and the summation of these actions creates a portfolio of eclectic opportunities from which the portfolio manager then concocts an erudite and interesting narrative regarding what we own. To paraphrase both Blade Runner and Jim Grant, the future remains something that is imagined versus real, and thus we have found that focusing on security value and identifying sturdy business models is preferable to relying on eloquent theories on what is to come. That is where we spend most of our time and that is how stocks find their way into the portfolio. As desperately stumped as we might be for "something to do" on a Tuesday, that can ALL change in a week, subject to the movement in the price of securities. And since we run fairly concentrated portfolios, we do not need "a lot" of things to fall our way. But a few more would be nice.

So we would argue that we are some distance away from what seems to us crowded and risky: quantitative strategies predicated on trailing correlations; anything involving the continuation of low financial market volatility; and using "artificial intelligence" to discern fleeting short-term movements of stock prices that generate good returns only with the use of leverage.

And we would advocate being long human judgement, judicious lowering of fees (naturally your hedge funds and "private" pitches for what are really vanilla products with great marketing come first), strategies that emphasize fundamental work rather than flow of funds analysis, and as best as one can pursue, absolute value versus relative value.

Specifically speaking, two of the larger mistake categories with which I am intimately familiar involve buying "Graham stocks" with an under-appreciation of balance sheet woes, and being hesitant to pay-up for what we call the "Buffett stocks." So, we ask every day, are we making the latter mistake here? Are we being too cautious? In each of our investments, we ask: how confident are we that our risk is nothing more than a short-term market move versus a permanent impairment of capital? As always, the answers reveal themselves with the passage of time. We are focused on eliminating "Eclipse Investment Ideas"—bright and shiny ideas that loom large in our sky and blot out all rational thought for four minutes and then are forgotten.

So, we have done relatively little recently. There are some interesting values in television broadcasting that remain interesting (translation: have not worked yet), as this is an area in which legitimate changes in the Federal policy have actually been enacted, events that we believe will result in a flurry of M&A activity. We are spending more time in restaurants than retail. We have a number of what we perceive to be nearer-term catalysts for value in some of our larger holdings that have the potential to drive material performance, but I am sure we would have told you the same thing earlier this year. We have tightened up the idea list and raised position sizes for things we actually do like judiciously in the midst of deploying cash. We like GE and Level 3 in our All Cap strategy.

Going forward, we continue to be vigilantly careful with your money in what we consider to be a difficult and hazardous environment. Contrary to any nonsense that can be generated by a PhD who has gone to Wall Street, the history of markets as far as you can go back, is that....markets fluctuate. That they haven't recently is not a reason to change stripes—sorry Mr. Grantham. To rehash yet another quote from Omaha, we seek to be greedy when others are fearful, and fearful when others are greedy. We have built a firm structure that can await change with patience.

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