COVE STREET CAPITAL

Another Lap Around the Sun

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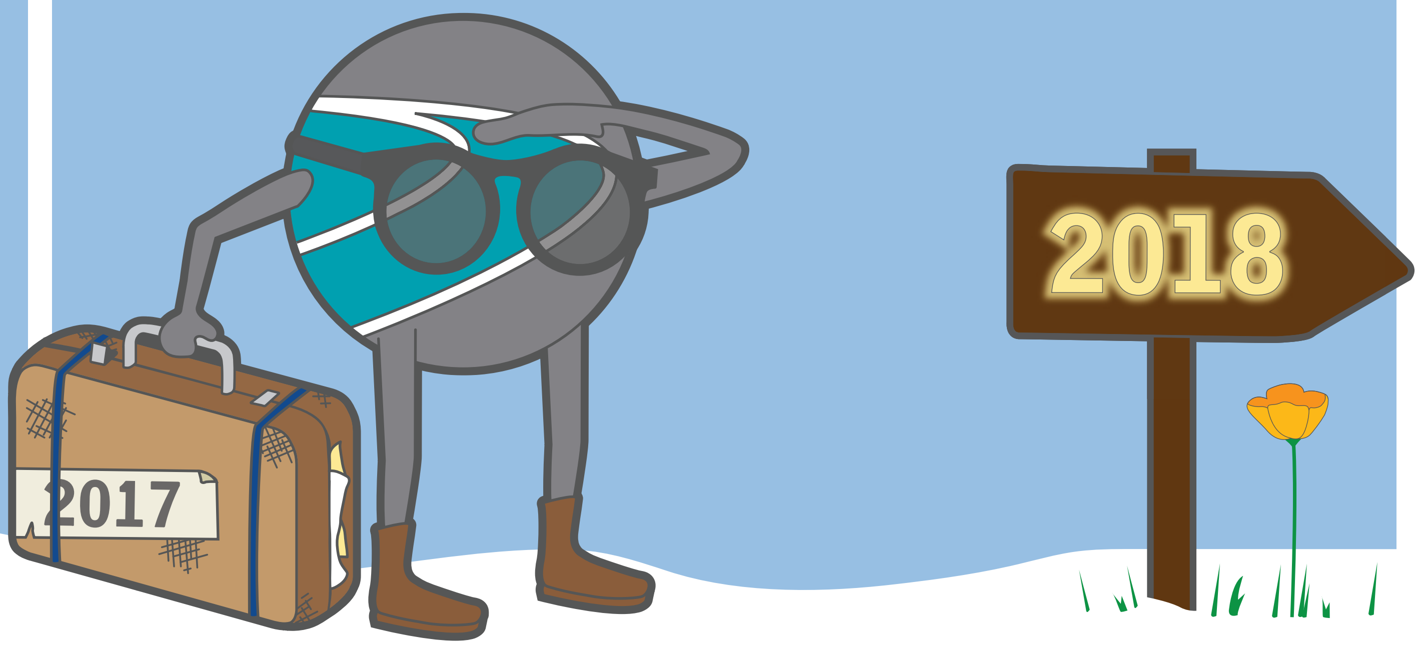

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Another Lap Around the Sun

JANUARY 2018 — Spoiler alert—we did not own Bitcoin, Cannabis-related stocks, large cap tech stocks and we weren't up 20% in 2017. You are forgiven for moving onto another Twitter feed.

As opposed to yet another outlook piece cluttering your inbox—and life—in 2018, we would prefer to spend some time on more of an inward look. As such, we will discuss our views on what is happening in our portfolio as well as on some of the more conceptually seismic issues that could really mean something to a client rather than the annual coin flipping or pontificating about our rhetorical other hand. Our annual forecast, for whatever it's worth, remains unchanged. We think the long-term nominal average expected return for U.S. stocks is somewhere in the 7 to 8% range. It's never 7.5% in any one year. You can temper that view based on a personal gauge of where we are in an economic cycle and the relative state of valuation. We think late and high.

Moving on: "The market has never done better" was a quote from the *Financial Times* recently, and the reference was in regard to the 2018 production of a 20% return in the S&P 500 with exceptionally low volatility. That is the classic financial free lunch that we apparently were educated, through practical and historical experience, not to expect. The stock market behaved as if the results were scripted by the Board of Federal Reserve academics…hmmm.

We have had better relative and absolute years than those we put up in 2017, and our All Cap strategy put up better numbers than Small Cap on an absolute and relative basis. While there were a few specific errors of commission, there were more instances of omission. Small Cap underperformed Large Cap, Value underperformed Growth, New and Shiny outperformed Solid and Dull. The second half of the year in particular felt dully reminiscent of 1999, when we were buying fast food restaurants and insurance companies while all the other "cool" kids were having the time of their lives.

The apparent suspension of the Herbert Stein's "if it can't go on forever, it won't" rule—which we would postulate as still being as inviolable as are the basic rules of thermodynamics—simply makes life on a relative basis more difficult for us. As a firm that seeks to buy a legitimate dollar of future cash flow, we require some combination of obfuscation, confusion, and price volatility that comes about due to issues ranging from short-term fundamental disappointment to sheer panic-selling. It is within this murky fog that we can formulate a differentiated viewpoint with a large enough margin of safety to be convinced to commit someone else's money in sufficient size to make a difference. There was not a lot of that over the last year, as the S&P 500 put up 12 months of consecutive gains—the longest streak since 1958/1959. So, thorn in our side number one in 2017 was erring on the side of caution in any number of security-specific instances when, in retrospect, we should have stepped up and been rewarded by the short-term direction of the tide. This has been a perennial mistake of this portfolio manager in his career, a fact that his colleagues regularly point out with disdain. In fact, the post-Trump election period has mostly been a fantastic time to just shut up and buy stocks, and stick with them. And if you had been willing to "pay up a little" in 2017, you would have been rewarded.

There is a major difference—as we have become painfully aware over the last 33 years—between the investment management "business" and the act of investing. The latter values patience and understands the unpredictability of the timing of return realization, a result that has a very low R-squared to the calendar year. The former wants to know "what have you done for me lately," and the answer is simply "Not as much as we would have liked." Being competitive in up markets and outperforming in down markets pencils out marvelously on paper. It's just less fun in practice in a very strong upcycle.

But as we will get into more below, being annoyed with the short-term is quite different from a number of behaviors we typically see during times such as these: quitting outright, throwing in the towel on longer-term, value-based investing, changing stripes to play catch-up with the prior year, or believing that the game is now "rigged" against careful, concentrated, fundamental, value investing. 2017 was not the first year when things "seemed" very different than they have in the past. "**This time is different**" is a very important statement to consider before full implementation. We are always re-underwriting what we own at marked-to-market prices, just as we regularly reconsider ideas and values that we don't own.

But, our continuing bet is that people don't change nearly as much as markets normally vacillate. To suggest that one should simply extrapolate recent trends as the proper expectation for the future has a material non-zero probability of being very wrong, and therein lies our own mean reversion. In the meantime, we have lots of interesting things going on in the portfolio that have their own engine of growth or change and don't require much help from the overall state of the equity market to produce very satisfactory returns. Although, I am not sure if that will add up to 20% compounded in the intermediate run.

So, big thoughts. There remains the big fat hurdle of starting from what are—by any standards—historically high equity valuations, but of course, those have to be judged relative to interest rates. Just how much is valuation supported by unprecedented suppression (using any variety of techniques) of global interest rates, and how much innate caution has been thrown into the wind by yet another year with so little consequence for those actions? Dunno, but the statistical history of starting at high valuations has been impressively robust in suggesting we are in for lower returns going forward. As noted many times here, investing is fiendishly simple: be greedy when others are fearful and vice versa. Based on our relentlessly bottom-up basis, we continue to see a lot that looks expensive to us.

That brings us to the real bubble in the world worth watching—fixed income. It remains a great mystery of the world how ten trillion dollars of sovereign debt has a negative yield, and that number is a lot bigger than the greater fool theory ongoing in crypto-currency. Thus, it matters much more if things change in the interest rate or credit extension world. Who cares if the shoeshine guy or the digital millionaire camping out at WeWork gets digitally marked back to whatever some think constitutes a true market? Being marked down suddenly—and hard—on trillions of assets held everywhere is a special unknown, and is worth some sort of embedded risk premium which does not seem priced into markets. Specifically, any scan of past historical unpleasantness often starts with unusualness in interest rate change and subsequent changes in the availability of credit. But, to set a record for scientific references in a financial piece despite having zero background in the physical sciences, Newton's law of inertia is in effect here—equities have continued to move higher because things have not changed. The music plays and people dance until they don't. Timing remains uncertain.

That equity investors like low interest rates because they can justify any investment on a relative basis is not a bold statement. In fact, it is essentially the academic argument behind central bank policy across continents for the past 8 years…or 20 if you throw in Japan. What is interesting to watch today is that the complete morass in Washington over most of the past nine years in regard to fiscal policy has left monetary policy as the only game in town by which to "do something" about the perceived need to "do something" about the economic world in which we live. That has clearly changed with the Trump Administration, as we now have a new tax code and a legitimate grinding to a halt of 8 years of regulatory nonsense. What if this is the magic key to a more robust economy? To quote old school tax-man Phil Gramm:

> "The question, then, is: How reasonable it is to assume that the American economy might actually experience a growth rate of 2.6% or higher over the next decade? From the end of World War II through 2008—including 10 recessions and the first half of the 11th one—the American economy grew on average by 3.4%. In only one period in the entire postwar era prior to the Obama presidency did the economy fail to grow by at least 2.6% for a decade—during 1973-82, when the economy experienced three recessions, four years of negative growth, and only 2.3% average growth. In every other decade from the end of World War II until the beginning of the Obama presidency, the economy grew by more than 2.6%. Compared with the projected 1.9% growth, 2.3% growth would generate some $1.3 trillion of extra revenues, enough to cover almost 90% of what's needed to offset the static cost of the proposed tax reform."

All great stuff if you are writing from nearly anywhere but California. The big questions are: (1) are we staring at the end of 35 years of lower interest rates and inflation, and thus this tax bill at this point in the economic cycle is the dog whistle we are straining to hear? and (2) what weird things might happen at the end of a cycle that is truly beyond the scope of study given the unprecedented novelties created by years of interest rate manipulation and asset-buying programs?

While this tax bill violates almost any common sense test of simplicity, fairness—as defined as rational economic thinking versus what can be bought and sold at the last minute—and some defined sense of strategic direction, it does have "lower" going for it, and that is an important improvement over prior years. Combined with the promise of less regulatory silliness, you have a pretty decent backdrop for economic growth and improved corporate cash flow. Is that effectively priced into equity markets as of this writing?

On a much minor note, and this will be addressed in only one paragraph—the current fascination with Crypto-currency is as dumb and crooked as nearly anything I have seen or studied in my 37 years of career and schooling. The Long Island Iced Tea Company (Ticker: LTEA—really?) changes its name to Long Blockchain (Ticker: LBCC) and goes up 5x in one day? This lunacy will end the same way combining stupid and money always does—stupid loses. This statement has nothing to do with the technological innovations now possible in many industries due to the advent of blockchain as a service. And we are not commenting on the likelihood of Bitcoin itself retaining some value as a niche form of payment or cult form of value that exists for zillions of more years. Our concerns have to do with all the crap and outright fraud. To close this paragraph with a fantastic quote from "Mr. Just Close the Door Behind Me":

> "I'm concerned a lot of these token models aren't going to be sustainable," Vitalik Buterin, the 23-year-old creator of Ethereum, said at the Devcon3 Ethereum conference in Cancun on November 1, according to *Bloomberg*. Buterin said he wants to put his baby on sounder footing by imposing fees on applications that use the Ethereum network. Over time, the fees would destroy, or "burn," redundant Ether tokens.
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> "If the token is being burned, then you have an economic model that says the value of the token is the net present value of basically all future burnings," Buterin said. Otherwise, "it's just a currency that goes up and down. It feels kind of like voodoo economics, and the price of the token isn't really backed by anything."
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> "That's a very spooky thing," he added

Next on the hit list is the question of whether the massive move toward passive investing is a Marxian subterfuge designed to subvert the oligarchy of capitalism, gender oppression, and patriarchy. Okay, my college-age daughters were home over the holidays. But this is actually being studied by those with more time on their hands within the context of the percentage of public companies that are blindly owned by indexes. The associated risk, of course, is the impairment of the ability of "markets" to price risk and opportunity. I don't think we are remotely there yet, as it can comfortably be argued that there remain hundreds of billions of assets still effectively "chicken indexed" in the long-only active world or falsely being marketed as "alternatives" at oppressive fee structures. I would argue that corporate governance is more at risk in the short-run, as good governance cannot be practiced by politically correct asset behemoths who are rationally more interested in holding fee-paying assets and not offending a shadow rather than actually forcing change where change is needed. Hiring 80 people and creating a Corporate Governance Group does not create shareholder-oriented corporate governance; it simply kicks the can down the road in a respectable and consultant-approved fashion. Just go ask GE's outgoing Board for reference.

So yes, our own lives are harder, our fees are under pressure, short-term moves are exacerbated and extended, and having a mediocre year never does wonders for intellectual forcefulness. It is absolutely correct to note that we run concentrated, index composition agnostic portfolios that should in no way be considered beta machines. And thus in a year when the S&P 500 went up 12 out of 12 months (the longest streak since 15 months in 1958/59) with historically low volatility, no one should be surprised that Cove Street is unlikely to be a performance leader in that environment. Despite understanding this intellectually, my competitive nature remains unsatisfied with last year. But we will restate what we think should be obvious: the fewer people paying attention, the better for us; the longer we can look out, the better off we are; the less we look like an index, the better off we will be in the longer run.

We would also like to note the cacophony in regard to "Artificial Intelligence and Big Data" and how that might affect the management of assets. As Bloomberg breathlessly summarizes the issue, the ability to process large amounts of data efficiently and rapidly through artificial intelligence and machine learning is changing the nature of financial research and making it harder to "surprise" markets, and thus dampening volatility, even around known events like economic releases. Hmmm…

We would note we have great technology internally, and we have our own in-house computer scientist, Eugene Robin, CFA who can evaluate raw technology in conjunction with possessing a terrific BS radar. But it's not clear to me that a lack of data is the problem for any investor today who has a Yahoo Finance account. The issue remains interpretation. The history shows that huge amounts of dollars being thrown at quantitative strategies in a large institutional rush has rarely led to a permanent advantage or sustained value-add. I have evaluated a dozen "cool" Fintech toys oriented toward research in the past year and each one is primarily focused on predicting the next quarter. Paraphrasing Jeff Bezos: that's what everyone is doing and it's a hard game to play that is getting harder with more tech advancement. In the meantime, less attention is paid to "the next 7 years," and getting that right seems like the place to spend time.

Looking ahead, we would note that a constant process applied to a time-tested, value-oriented approach has worked for a really long time, but it doesn't work every time as defined by annual counting. We would also add that what didn't work last year, in some ways increases odds for it working this year. This is known colloquially as "the spring effect." In golf, it's not over if the other guy still has a club in hand. The indexes are still on the proverbial course, and given they have only one club in the bag, a strategy that admittedly has worked well off the tee, we look forward to seeing them play a tough 30-yard pitch with that same driver.

We think most "markets" remain expensive and largely indifferent to risk. We remain relentlessly bottom-up in our focus—as well as concentrated—so we don't need much new to generate returns. But, as noted, we need our largest positions to work a little harder. Small cap as an asset class, despite being absolutely as expensive as is anything else, became a relatively better value as the year went on. We continue to have a big position in old school media that could work nicely this year due to what we selfishly hope will be an election full of awful meanness, and crass and misleading television advertising. In the meantime, the broadcast TV deck chairs are likely to move around in an aggressive M&A dance toward higher margins. We have concentrations in things that are benefitting from digital change and the unrelenting demand for bandwidth. We have bets that Amazon will not be 110% of all consumer and business needs and services. We have bets on more snow and crappy weather and agriculture coming through what seems to be the middle of a biblical seven-year cycle. We also have a handful of "woefully early but not nearly that bad" stocks that can produce great performance in 2018 and lead to a handful of clients saying "well that came back," and another and newer handful of investors patting us on the back for brilliant timing. We have some "sum of the parts" valuation exercises with great potential and uncertain time horizon. We own a handful of high quality, Buffett-esque businesses that are on the north side of fair value and lonely for company in a generally expensive world.

So, more of the same at Cove Street midway in our 6th year and $1 billion in assets. 81.8% of our team members are now partners in the firm and are invested along clients via our mutual fund. We work and wait for opportunities and wish you the best of health and wealth in 2018 and beyond.

Jeffrey Bronchick, CFA
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