Call Him Ishmael

March 27, 2013

by Jeffrey Bronchick

of Cove Street Capital

"The great Leviathan that maketh the seas to seethe like boiling pan." - LORD BACON'S VERSION OF THE PSALMS.

One of the hardest things to conquer as a value investor is the concept of "price." The industry remains mired in fascination with abstract prices like 100, 1,000, 14,000, previous highs, new lows, etc. The stock is up x% from x dollar price; it is down x% from x price. There is also much in print and general fretting in regard to "price action," with lots of attention paid to where the stock has "been" and how this move relates to other "moves," as in "the largest move since last December 12th."

Even if this is complete nonsense (and if you disagree you are welcome to put this down and turn on CNBC), there remains a behavioral finance tendency to anchor an investment decision to an irrelevant price point. Here is a simple example: let's say the manager buys Hewlett Packard for Client A at $24 thinking it easily represented value in the mid $30's. Six months later, he buys the stock at $15 for client B who just walked in the door. With the stock presently at $22, rest assured there will be two very different discussions at upcoming client meetings, even though little has changed regarding the original assessment of value. The range of emotions, both internally and externally driven that can potentially intrude on the most rational course of action is wide and potentially counterproductive. The mini-takeaway is that an investment firm needs to be intellectually structured to feign indifference to the original cost basis as long as the thesis remains that the valuation at current prices represents enough of a margin of safety to justify an affirmative answer to the question: would we buy it if we didn't already own it at this price?

On a related note, Mindy Grossman, the CEO of The Home Shopping Network, came into my office in the summer of 2009 with HSNI at $16. I was intimately familiar with the home shopping industry via a large (and continuing) investment in Liberty Interactive's QVC entity and I continue to think it represents a superior economic retail beast vis-à-vis brick and mortar stores. While the distribution breadth of QVC creates superior margins to those of HSNI, there was a perfectly rational path to narrow the difference. Mindy said all the right things, seemed perfect for the job and a valuation in the low 20's seemed very reasonable given a reasonable upward margin path. It was one of those meetings where you felt like running to the trading desk and buying after its conclusion-good business, good value, good people-and it fit right in the middle of the competence roadhouse. It all made sense until someone raised his hand and said, "but the stock was $1 five months ago…shouldn't we wait until it pulls back?"

Anyone who has been in this industry long enough knows investing is not a purely rational process and you could just hear the mental wheels turning as that statement floated in the ether. The principle at hand here is that in a pure vacuum, there are only two things worth knowing: what market price is available today to buy and sell, and what is the security reasonably worth? What it was and where it came from should not matter. But we don't live in a vacuum and both the current price of a security relative to a personal anchoring as well as our imprecise estimate of intrinsic value incorporate some bias as to whether we feel bullish or bearish. It's annoying but it is a fact to be reckoned with as part of an investment process.

Every institutional investor feels slightly smarter than the average bear and there is nearly infinite temptation to express this Wobegon DNA in an attempt to "add value" through being slightly cuter than one should be. So yes, I talked myself out of buying HSNI at $16 on the premise that I would "buy it on the next dip." The dip came 18 months later at $22 down from $30. We still own the stock today at $55 in small cap portfolios. The huge takeaway is that doing serious work and getting it right is more important than playing around for a 6% tactical move to make yourself feel like the smarter bear this week. Note to self.

This is all quite relevant within the grander scale of global asset allocation in today's world. How should investors view the attractiveness of stocks versus fixed income and a number of other asset classes, given the terrific absolute and relative performance of equities over the past 18 months? Substitute S&P 500 for HSNI and I think that pretty accurately describes the mood of the investment world today. The Cove Street anchor is: What is it worth? Where is it trading? Is there a big enough difference between the two to suggest activity is worthwhile? Repeat note to self.

That is somewhat all we have to say on the matter, since in the absence of any custody arrangements in Cyprus, much of the current investment universe looks very similar to that discussed at length in our

January letter. (CoveStreetCapital.com/Thoughts) The world remains an oasis of economic oddities and conundrums with any variety of unpleasant outcomes still possible. But Stocks always lead fundamentals and thus we are not particularly perturbed by the handwringing that "stocks are ahead of themselves." Either we are going to have better economic growth in the next 18 months and thus stocks are pricing correctly…or we are not. If we don't see the growth then stocks will fall somewhat, and we would frankly welcome the opportunity to back and fill as to make the value-focused life a bit more rewarding. (See note to self.) We have not built wildly bullish growth estimates into our numbers nor are we discounting cash flow at the Fed's 2% suggested discount rate. We also have a number of internal improvement candidates that we think can produce returns even in a less than benign environment. We continue to look askance at predictions that US equities have the lowest expected return of major global asset classes, particularly when its major progenitor and his daughter were protesting in front of the White House recently to stop job creation in the form of the Keystone XL Pipeline. (GMO's Jeremy Grantham and his daughter were arrested, but according to Pension and Investment Age, Grantham himself was not.) Equities as an asset class seem to us reasonably valued on absolute terms and very attractive vis-à-vis many alternatives. The much ballyhooed flow into equities, if indeed a fact versus a theory, remains in the early innings at least given what we see in our institutional meetings.

If we had to opine on the one issue that really gets our goat philosophically and has very obvious negative connotations on economic activity, it is the unceasing efforts of chattering classes-elected and otherwise-to continue to fight the last war and attempt to impose impossibly narrow rules on the financial system. Despite strong statistical support for the inverse correlation between regulatory pages written and positive results rendered, the hordes plunder onward to fight the last war. I think this folly is perfectly summed up by two recent events. The first is the Melville-esque spectacle foisted upon us by Senator Carl Levin, who mercifully has announced his retirement and thus may gracefully recede into the graveyard of partisan nonsense.

It is absolutely fair to say that the "Whale Incident" was an embarrassing chapter for JP Morgan, as any $6 billion mistake would be. And any recap of an investment decision that turns out terribly will have some Oprah-like cycle of denial, obfuscation, acceptance, recrimination and slate cleaning. It is clear that this is the case here. And it is also fair to say that any company the size of JP Morgan operating globally has management challenges that despite best intentions, occasionally blow up into both reputational and financial problems. Our first point is that it is crucial to size problems relative to the core. While Levin's Senate report is fun reading, an institution with one trillion in assets earning $6.5 billion a quarter in pretax income does not instinctively jump up and down at a $300 million negative mark as an immediate sign of impending disaster, although seems like a breathlessly fascinating number to a reporter or a Congressional investigator. This entire event is not an earth shattering moment calling for a wholesale change in the entire global banking system, which will be forever plagued by the fear and greed cycles of bankers as it has been since the first shekel traded hands. Compare this $6 billion loss with credit losses on home mortgages in any of the last five business cycles.

As a holder of JP Morgan since March 2009, I would go to Melville himself for a comment on Levin and the Leviathan:

All that most maddens and torments; all that stirs up the lees of things; all truth with malice in it; all that cracks the sinews and cakes the brain; all the subtle demonisms of life and thought; all evil, to crazy Ahab, were visibly personified, and made practically assailable in Moby-Dick. He piled upon the whale's white hump the sum of all the general rage and hate felt by his whole race from Adam down; and then, as if his chest had been a mortar, he burst his hot heart's shell upon it.

We wish Levin a pleasant retirement.

The next piece of business for the intrepid bank investor was the release by the Federal Reserve of its so-called Stress Tests, which suggested that Bank of America and Citibank should get high grades and capital allocation passes while Goldman Sachs and JP Morgan are held back for review. Think really long and hard about that statement which suggests that a purely numerical analysis based upon highly arbitrary assumptions by an institution that has gotten nearly every major economic call wrong in the postwar era should take complete primacy over management quality and past track record. Seriously? B of A and Citibank versus Goldman and Morgan?

As we continue to note, there are simple steps toward implementing intelligent market reform that should be considered. Some examples are a staged reduction in deposit insurance, a repeal of regulation that has enabled "too big to fail" and an end to the legal and investigative witch hunts. All of these would be infinitely more effective at enabling a healthy banking industry and the healthy economy that follows than adding and implementing another few thousand pages of minutiae written by people who have never been effective at identifying the next banking problem. I would lastly add that many banks are not presently earning 10% on tangible equity and thus it is not in any way a viable solution to suggest that banks simply raise three times their current equity, as suggested in a new book, *The Bankers New Clothes.* Sell equity to whom I might ask?

As a P.S., we continue to have large positions in Capital One, JP Morgan, and the Bank of New York in our all cap portfolios and a single half position in First Financial Bancorp out of Ohio in our small cap portfolios. The former are destined to be high yield utilities at worse and decent cyclicals if the economy grows at an "acceptable" pace. The latter has already adopted the guise by paying out 100% of its quarterly earnings until management finds something better to do with the money. As the current regulatory environment is simply strangling small banks, we have seen worse ideas.

Lastly, what is likely the scariest thing we have seen this year is the re-emergence of James Glassman and his Dow 36,000 pitch. After neatly picking the top in 1999, and then abandoning ship in 2008, Glassman recently penned a piece in Bloomberg discussing the hop, skip, and a jump to 36,000 from current levels. "Numbers" aside, his reasoning remains premised on an extrapolation of artificially low interest rates and the utterly erroneous assumption that stronger economic growth correlates to a stronger stock market. (It doesn't-check it out.) What I have personally learned after 29 years of investing is that it is a fool's errand to seek a great stock market timer, but someone who is consistently bad is worth their weight in gold.

On the Cove Street Capital front, we have filled out our team to what we consider full battalion strength. Paul Hinkle was brought on with the title of Director of Client Portfolio Management. What that means for the non-cognoscenti is that Paul will be responsible for new business development, consultant relations and the maintenance of CSC's client relationships. This allows the investment team to focus 97% of its time on investing. Paul was an investment banker for over a decade with Guggenheim Partners, Bear Stearns and Needham, and utterly understands and speaks the language of a valuation-based investor. We could be not happier with his steely determination and first class demeanor, and we are willing to wager fees if you feel like a betting man on the golf course. (PHinkle@CoveStreetCapital.com)

We also just hired "privacy requested" as our new head trader and operations expert. He will start April 15th after giving proper notice. This gentleman was almost born in the trading business (his dad put in over 40 years on a desk) and has over 15 years of experience on both sell-side and the buy-side trading desks on both the long-only and hedge fund sides of the business. Importantly, he was around during the early days of the start-up of two firms and is intimately involved with operations, compliance, and the technology of the trading world, knowledge that is crucial in the increasingly bizarre world of computer generated trading and liquidity. He will remain ably supported on the desk by Mabel Gloria, who has done a yeowoman's job from the born on date of Cove Street.

These people moves complement our institutional grade infrastructure developed by President Daniele Beasley and we consider ourselves fully staffed to achieve our primary goal of $1.3 billion in small cap assets and close. With limited capacity in our strategies and a firm based upon delivering performance and not asset growth, we look forward to hearing from you shortly.

- Jeffrey Bronchick, CFA | Chief Investment Officer

www.covestreetcapital.com