



Who Are You Going to Believe-These Non-GAAP Numbers or Your Lying Eyes?

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Great performance in the short-run-either absolute or relative-is a mixed blessing. If an investor owns a portfolio of stocks that is embedding 30% undervaluation, and voila, finds himself up 30% (this is a hypothetical number for the purposes of this example but it's not far from recent reality) in six months, without a concurrent upward improvement in underlying fundamentals, you have to be a regular on CNBC to expect another 30% return over the next six months.

We do expect our initial valuation assessment to be revised upwards in many cases, as we again note that stocks are real pieces of real businesses whose management teams are usually doing their best to move per share values higher. But that is not always the case, especially in 90 day increments, and for the kind of businesses toward which we gravitate, the value accretion is highly unlikely to be 30%. Said another way, today's success is stealing from tomorrow's performance unless we magically can replace the entire portfolio with new stocks that have managed to escape the upward bias of the recent past. On the margin, that is what is slowly happening position by position-but that dynamic does not lead to anywhere near 100% turnover. Accordingly, what that means is that we own some great businesses that are well-run, but whose valuation is now at a level that makes us question the margin of safety.

I have tried to answer the following question many times over the last 29 years: what is the proper tolerance of short-term pain for the long-term investor? To try and quantify a precise numerical level with thoughtful analysis is almost failing the test outright. The simple answer is that I don't know; the amount of downside I am willing to endure varies with the nature of the underlying business, a sober assessment of the world around us, and frankly, it can involve a host of not necessarily economic factors that must be mostly resisted. I can only conclude with what I consider to be as much of a constant as anything that can be held to be true in long-term investing: the biggest money is made by getting the long-term business/people equation right and spending less time wondering about what happened last quarter. After-all, how does one wake up with a ten-bagger in the portfolio? By not selling the two-bagger. One's time should then be spent reading relentlessly, meeting business leaders and industry contacts in order to understand motivations and incentives, and intelligently attempting to handicap risk/reward-recognizing the limitations of our innate abilities in a world that is always uncertain. We win by taking advantage of other's fears of short-term issues, and by being thorough enough to avoid permanent capital loss that results from simply being very wrong on the nature of the underlying business.

That said, there is always an inflection point where a good philosophical idea starts to lose its marginal utility of worthiness. We are a money manager, not a rock band and we do not "win" on style points or style purity. Cove Street is also not being run to attract massive asset flows that make it impossible to retain flexibility, and thus we have the ability to "lean" into price movements that can very easily divorce themselves from fundamental reality. And there have been an unusual number of such instances since the bottom in 2009. I also think many investors over-interpret the pronouncements of some of the more famed practitioners in the industry (like those in Omaha) and don't realize that many grand and eloquent "rules" are derived from a certain firm's position of massive size and notoriety. In other words, they would if they could but they can't; so the pivot is made to accommodate the asset bulk. We don't have that problem and thus from time to time we can and have tactically "flexed" a position, particularly in light of the volatility in the past few years. We have been handed some "gifts" as we have watched stocks fluctuate wildly around our estimate of the fair value of the business, and we have and will act accordingly.

I have also evolved thinking over the years to frame a company's stock at initial purchase in terms of "Buffett" value (franchise, compounder, growth) or "Graham" value (deeply discounted value, mean reversion). In the case of the former we are more likely to tolerate "fair value" and "might" flex the position size as we want to compound our way to a great long run return. In the latter we are most likely out at fair value. We accept both propositions as "value investing." Again, it's not about style purity; it's about taking advantage of risk/reward opportunities. We would also reiterate our commitment to clients that we will not accumulate assets in excess of our ability to retain a competitive advantage through being more petite-sized than many of our peers.

So we are comfortable proclaiming that this is an elevated market where it has gotten more difficult to buy

and much easier to sell on a valuation basis. You can see it in the disturbing number of air pockets that stocks have hit in the midst of the latest manifestation of the annoying quarterly earnings dance. Quarterly earnings are most often suggestive of nothing, but my sense here is that the massive moves relate to the topic of inflated value versus actual fundamentals. It also does not make us feel better about the torrent of insider selling or seeing very smart private equity firms selling their holdings back to the public in what one termed as a "nearly biblical opportunity." Good things happen to cheap stocks. But we must remember that the counterpart is at work in our world too.

While we are on the subject of quarterly earnings, when did the SEC fall asleep in the car outside JP Morgan's London headquarters and allow the rest of the world to explode the usage of "Non-GAAP" financials? What seems to have happened is that under a lawyerly safe harbor that mandates that public companies provide a "non-GAAP" reconciliation page to their quarterly financials, corporate accountants have gone hog wild in "helping" investors to understand how wonderful their adjusted business results really are. We have literally seen an example of a company that listed "adjusted" operating income that excluded all corporate expenses, a practice that is similar to a hedge fund listing only gross performance-it is a nice idea, but what matters at the end of the day is what reaches investors' pockets. We make our own proper adjustments to reach what we see as real cash flow, but the liberties being taken by the Fortune 1000 are approaching egregious levels. Historically speaking, liberalization of accounting presentation is not good news for the investor.

Given what we have postulated above, our current choices are several-fold:

1. Sit on our hands (and cash) until there is really something we want to do. To paraphrase Pascal, many investors' problems stem from an inability to sit quietly in a room and do nothing. I always like to ask: do you remember the third quarter of 2005? Neither do I, and we will unlikely remember any six weeks in which we held a chunk of cash as we transition to our next idea. To revive an old quote from Berkshire Hathaway's Charles T. Munger: "Experience tends to confirm a long-held belief that being prepared, on a few occasions in a lifetime, to act promptly in scale, in doing some simple and logical thing, will often dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to those who continuously search and wait, with a curious mind that loves diagnosis involving multiple variables. And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past."

We will always remind clients that to have the ability to sometimes sit with cash and do nothing until the fat pitch arrives is a rare gift to both of us. The fact that relatively few in the institutional investing space actually employ such an approach is supportive of its merit.

2. Run concentrated portfolios. We do not need that many great ideas, and if we avoid making terrible mistakes, the math of a concentrated portfolio can enable good results even in a difficult market. This statement of course embeds both a BIG 'if' and an acknowledgement that we are not so blinded by the wonderfulness of our process to suggest that we will not be immune to the receding tide of Federal Reserve policy. While a friend and oppressively successful investor has argued that if you don't do macro, macro will do you, I continue to retain a successful bias against leaning too hard on one's ability to read the future. The market looked reasonably priced in June 2007 and grossly overpriced in March 2009 if your methodology simply involved extrapolating the prior 12 months of corporate performance. It is no different now. What continues to worry us most is that we remain in truly uncharted and weird waters as far as global monetary policy. I do attach a non-zero number to the probability that Federal Reserve-created wealth-combined with seemingly global hostility toward business development and wealth creation-has produced a very disturbing state of affairs that will end badly, a taste of which was recently received upon the utterance of the word "taper." We find it somewhat stunning that the Federal Reserve is now just waking up to a fact of life with a very, very long history in the economic-political realm-that once one starts spending money for the alleged benefit of others, he/she gets quite attached to the idea and tends to react angrily when the suggestion is made that this should come to an end. Are they SERIOUSLY telling us that they didn't think through a proper exit plan for Quantitative Easing?

I will finish by reiterating the biggest positive we see: investors are still walking scared. Ignoring the speculative leveraged nonsense that passes for day-to-day market activity, a lot of big money has missed the rally that began in 2009 and plenty of big name investors are still calling for a calamitous future. This is not 2007 when nary a negative voice was to be heard. We also remain convinced that being an owner of businesses-versus being a lender to governments or businesses-will put us on the right side of the next ten years of investing history. We remain confident in our ability to sift through the volatility and put money to work in combinations of business/value/people that make for good long-term, risk-reward propositions.

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