2020 Is Cancelled

April 2, 2020
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This is obviously a difficult letter to write for a number of reasons, the most important being the amount of other people's money "lost" in the shortest time period of your portfolio manager's 36-year career. I put quotes on "lost" because there is a world of difference between "we have been marked-to-market to a world class panicked market" and "we have permanently lost your capital." Timing aside, most of what we are staring dumbly at represents the former and not the latter. But it doesn't feel any less painful or embarrassing as of this writing.

I am only going to use the word "unprecedented" once because it is trotted out at every market inflection point, and after a few decades of seeing new and unprecedented things, you begin to once again appreciate the old bag of a saying, "the future will always be uncertain." Asset markets in general were expensive prior to the advent of COVID-19, and expensive markets tend to get knocked off their pedestal by something "unprecedented." What aggravates and disappoints the investment team here at Cove Street is that what was expensive in many cases has stayed expensive and what was inexpensive—small cap value and what we owned—became even cheaper. Cash and gold were the only real sources of shelter and neither are long-term holdings for us.

We are going to skip the "top 5 and bottom 5" analysis we usually do because in general the shellacking was thorough and broad enough to make the exercise useless in explaining the past. We owned small cap stocks and in the short-run they went down. Aggravating factors in the short-term—dynamics that are actually positive factors in the long-term—include: the disappearance of the sell-side in both coverage and market making capability; the mass movement in recent years into passive vehicles which crushes "curation" in both up and now down markets; and the consolidation of firms on our side of the table, a state of the world that has the effect of nudging "small cap" investment up the capitalization spectrum. Great points for starting an investment today—much less so 6 weeks ago. Instead our focus will be on 5 things we think are important for our investors—and we will tell you how our decision making is working and what we have actually done in the portfolio.

1. The first item is that Cove Street Capital is 100% in business and working well in a dispersed fashion. Maybe a little too well. Your portfolio manager lives close to the office and is in every day…alone… which seems to be doing wonders for a marriage about to turn 30. Our firm inherited and built upon an operational and compliance infrastructure that punches WELL above our asset level. It is tested annually firm-wide, and I am proud to say on behalf of non-investment team Cove Street, we haven't missed a beat.

2. Secondly, there is a huge difference between an analysis of "risk" versus "uncertainty." Paraphrasing a variety of decision-making research, "risk" involves unknown outcomes, but the probability distribution governing that outcome is known. Uncertainty, on the other hand, is characterized by both an unknown outcome and an unknown probability distribution. The latter is what we are dealing with and it just punishes markets and is legitimately emotional. As always, how well you compartmentalize your emotions and avoid eviscerating long-standing investment principle and process is a noteworthy endeavor.

The key variable in that equation is clearly "for how long?" Our viewpoint is simply that this will inevitably be over, a statement that is not as overtly helpless as it seems. If we view the world through a tidy and invisible discounted cash flow calculator, "canceling 2020" lowers the present value of what is being judged, but for those entities that make it through, the discounting mechanism and risk analysis will resume, the canceled year of 2020 will drop off, and "we" and "our portfolio" will resume a semblance of proper valuation and growth. It just happens.

What is crucial is that, for better or for worse, there is a near-term playbook for the "uncertainty" factor (2009) as central banks across the globe are working on the "plumbing" of financial systems. While this is not the space or time to argue Hayek versus Sanders, or to introduce the elephant in the room of the cost/benefit analysis for humanity, the fact is that the liquidity of the system's plumbing appears to be moving from none to some, and that is a start. The rest will simply be solved by the passage of time with all its variables, both innate to the Coronavirus and associated with the luck and capacity of our elected officials to manage human reaction. One of those really scares us.

You don't need us to "track" the virus for you: there are plenty of scientific and statistical sources of information that are tracking and speculating on the progression of the numbers. Different countries are experimenting with different versions of virus management and all remain experiments to date—with viewpoints differing on health, economic pain, and politics changing daily.

3. This brings us to the third point. You have to be there when things turn. That statement applies both to being mostly invested per your long-term plan, and to the actual businesses we own.

Stocks will begin to recover long before the pandemic is on the wane as bottoms are made not on a plethora of good news, but on less awful bad news. Being there when things turn is crucial for investing any size in small cap, as one of the crucial return factors that favors small cap investing is being able to take advantage of others' fear of potential illiquidity. When the tide turns, the liquidity pool in which to make good investments dries up completely. It is exactly now that is ideal for us and new investments, subject to all the compliance rules that the industry can throw at us.

4. All of which relates to our 4th point: Here is what we have been doing. Our playbook for "crisis" has developed over any number of equally unpleasant environments across 4 decades. The first play is "some movement." It is human nature to freeze when there is so much to absorb and so much to look at and do. Think of an impossibly long task list on your desk, or staring at the cold medicine aisle in the supermarket. (Before it was cleaned out.) You have to chip away at the mental blockage, and for us it's an ingrained, three-part process: make what could be a bad sale; reorient capital into what you think are the best buys within the portfolio; and add something new that has been on your wish list for years. Oh, and call every client—and those who have expressed extreme interest but have not moved off the dime—to add new money.

Getting to the first part, selling things that are down can be both an admittance of a mistake and/or a realization that one does not have to ride the same elevator up that one admission down. While this crisis rhymes with other events in the past, it has a lot of fresh worms in the can. Given continuing volatility in markets, some of the tactical moves we note below are works in progress, but we thought it would be important and helpful for you to understand our thinking and decision making.

SALES / TRIMS / HOLDS:

We bought and continue to hold theme park operator Six Flags Entertainment (Ticker: SIX) and Cinemark Holdings (Ticker: CNK), one of the largest movie theater operators in the U.S. and Brazil. There is obviously severe exposure to the world in which we are embroiled, but we think there is staying power. These positions are also risk-weighted at 5% of the portfolio in aggregate. We have also made/are making 4 outright sales in the portfolio that either represent a "mistake" or "we can do better." We have an underlying barbell theme: small allocation to extraordinary risk/reward coupled with picking up "Buffett" businesses on the other end.

ADDS:

We added in size to ViaSat (Ticker: VSAT), Colfax (Ticker: CFX), Macquarie Infrastructure (Ticker: MIC), which are now among the largest positions in the small cap portfolio. We re-loaded broadcaster TEGNA (Ticker: TGNA) following a 50% drop—AFTER our full sale of the position—as 4 bidders for their assets dropped out of the mix for obvious reasons associated with this mess. It is one of four positions we own that had deal processes drop in the midst of the chaos, to which we can attest is painful in the short-run. We think all four will be revived once the dust settles and represent material upside for shareholders.

NEW POSITIONS:

Lastly, we added new positions in Sensata Technologies (Ticker: ST), Donaldson Company (Ticker: DCI), and Skechers U.S.A. (Ticker: SKX). The first two are "wonderful growth cyclicals" that trade at fat premiums to the market in most environments, but they will not have fun earnings with a global industrial shutdown, which is precisely why this is the time to buy. Skechers is a local oddity that has grown into a global brand seemingly alone beneath the industry behemoths of Nike and Adidas. It's a very cheap stock with great fundamental math and growth—once we get through the current period of fear and uncertainty.

5. Finally, we will close with our 5th point. We are living week-to-week on some things (like everyone else in the world), but in many things we are not. Good investing is not rapidly buzzing around the lightbulb like a swarm of gnats worrying about the next three months. As the yoga class teaches, it helps to slow down the breath and pace and think longer and slower than many around you. While industries and events and geo-politics are always changing, we have seen little evidence over history that "people" really change behavior. People do crazy things in euphoria, crawl into self-inflicted holes in a panic, and then swear not to do it again. People want to "signal" via cars, handbags, and houses—or tattoos, ripped jeans, organic supermarket bags, and Priuses. We humans want to be social, we want to travel, we want wonderful things for our kids and friends. And if anything, we are coiling like a spring to return to some semblance of "normal." This too shall pass.

Proper investment timing is only knowable in hindsight but we are quite confident that valuation tells us a lot about the future returns of our holdings. If we can do a decent job on valuation and business analysis, then we can properly anchor to the idea that "past pain" creates the opportunity for superior upside, just as great past returns sap the future from the investor. While this is always hard to write, say, and read, the current environment is a terrific starting point for future returns.

We wish you well out there.

Best Regards,
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Principal + Portfolio Manager