Q1 2021 Strategy Letter

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April 2021—Well, let's just say things are different in 2021. From an investing standpoint—and from our standpoint—it's obviously a lot better. While we invest in securities that represent ownership stakes in real companies run by real people, we are certainly not immune to the whims of "factor flows" orchestrated by people who have recently deemed "small cap" and "value" as factors with some redemptive value. In 2020, those factors were deemed near worthless. In 2021, they appear to be the equivalent of a hot fudge sundae with a COVID vaccine as the cherry on top.

"Not an obnoxious headwind" is our desired state of an environment in which to work, because our behavioral bias against buying stocks that go up every day—for no reason other than technical fund flows—is at the moment being tested.

Markets seem to be currently parsed into 3 distinct camps:

> 1. Ridiculously speculative concepts that are doomed to failure.
> 2. Real businesses whose stocks are grossly over-inflated and thus there should be high expectations for a divorce between business success and investment success for a decade.
> 3. And "all other."

We tend to operate more so in the third category, although we don't mind being early in category 2.

Accordingly, we have seen a number of holdings simply catch a bid after a severe languish, and certain holdings just resume where they were in 2019 after a COVID fall in early 2020. One nice thing about being in the "all other" category is the companies tend to be real businesses with a profitable niche that is deemed boring by those who ply their trade in momentum and excitement. When good things aren't happening for the stock (or worse) you can make subsequent buy/sell decisions based upon some semblance of fiendishly simple math, rather than stare into the abyss of being down 40% with really no idea what the heck you really own or what the dark, cloudy future holds outside of a Twitter feed. And as people are beginning to become painfully aware, being down 50% means nothing as far as where you are in relation to value. The beauty of performance math is how rates of return can converge. Specifically, the return from buying a 10 dollar stock that goes to 2 dollars is not terribly different from the person who paid $60. Stand in front of investment committee members and tell them how much smarter you are than the guy who paid $60 and let me know how it goes.

To wit, per a recent statistic in Barron's: there have been 302 IPOs as of mid-March 2021 raising $102 billion, 80% of which were blank-check SPACs. In 2020, there were 457 IPOs that raised $167 billion. Per a related note from banker/broker R.W.Baird, 81% of 2020's IPO crop were losing money on a trailing basis, a fact that makes "this is where we can see a bottom" a murky project. For those who grew up in a time before tattoos, the 1999 peak dot-com bubble saw 547 IPOs raise a mere $108 billion, 73% of which were money losers. We will get you the statistic of IPOs that actually don't have any REVENUE. Noted investment pro and professor, Joel Greenblatt had an apropos comment on the equity world today, "There were 359 companies that lost money in 2019 that now have market caps over $1 billion. If you bought every one, the median return was 65% and the average return 120% in 2020."

Said another way by someone else in the occasionally readable Financial Analysts Journal:

> *"The big market delusion arises when three ingredients come into play. The first is the existence of a BIG market, perceived or real, that draws in businesses intent on exploiting this market for growth or profit. The second component is OVERCONFIDENCE, a key behavioral characteristic possessed in disproportionate quantities by the entrepreneurs and venture capitals who are drawn to big markets, leading them to overestimate their chances of—and the payoff from—success. The final piece of the puzzle is pricing, whereby investors attach values to companies based upon what others are paying for similar companies, allowing for a disconnect between the company's stock price and its underlying*

> *fundamentals."*

This leads to the fun math in today's world where seven companies each have a market value equivalent to the entire TAM expected by each player.

And this math remains relevant as the topic du jour gets endlessly debated: what's with this value renaissance and is this a "bump" or something resembling a multi-year trend? (Insert the "well, their opinion is certainly biased" caveat here.) We postulate that we are just getting started on the "relative trade." Price movement without consideration of underlying value means nothing. Viasat being up 70% from yearend lows means nothing, just as something that is "worth" $5 but just went from $100 to $60 means nothing. Go nose around some GMO or AQR research on their websites. It is not that "value" per se is that cheap, it's that growth and silly are so expensive. And what I can tell you from fund flows is that as is often and usually the case, people are afraid to be early, usually miss inflection points, habitually miss the big part of the first move, are always afraid to top-tick a recent move, and thus wait for the pullback that sometimes doesn't even happen, and then finally pile in and make a top. The world is clearly in the "waiting to buy the pullback" brain set. But we think this train has left the station and continue to see enormous relative opportunity and reasonable absolute opportunity in a focused portfolio of curated companies. And the answer to the question that has been posed to us recently, we remain useless as to "timing." We just want like-minded and long-term clients who won't give us money "exactly" at the top. Translation: leg-in and give us half now. Operators are standing by.

"Where ignorance is bliss, 'tis folly to be wise" is a line from British poet Thomas Grey. (Thank you Jason Zweig.) We remain plagued by and anchored to that damn risk-conscious/conservative thing. As noted in the great and worth rereading The Money Game by "Adam Smith," the idea was postulated that by hiring younger people unburdened with a painful experience, we could be talked into doing stupid things during periods of market hysteria but still retain the wisdom, style, and good looks not to be swayed by them at the tops of big market cycles. Nope. Although we have a mix of "age and experience" on our investment team (okay, everyone is younger than I am) it hasn't "helped" in the short run because we just seem to have a collective aversion to preposterously ambitious investment schemes. We have done extremely well the last six months on a "self risk-adjusted basis" which factors in a bunch of things we passed on that turned out huge winners from a pretty binary set of circumstances that could have gone either way. Again, we don't think the definition of success as a long-term value oriented investor is buying every stock that day before they don't go bankrupt.

Patiently Searching For Contrarian Opportunities

As we have noted many times in the past, we eschew labels. Buying crappy companies that are statistically cheap and having 30% in banks so you can look like the Russell 2000 Value index does not make you a proud and successful value manager. Ok, owning banks helps during one quarter out of every 4 years. We will simply note on this topic since it comes up every 4 years that smaller cap banks are essentially geographically concentrated pockets of real estate exposure with single-digit ROEs. In most environments, we think we can do better, and yes, a basket of these was very successfully buyable during the spring 2020 COVID lows and we ignobly stared down the opportunity with panache after much research. But there were a lot of other things to buy that we think have more durable and better business models. Rising interest rates and a steeper yield curve certainly are better than are zero rates and a flat curve, but we continue to argue that bank regulation still stinks and smaller banks do not possess J.P. Morgan's diverse tool kit with which to navigate and make money. And there are other neat ways to garner "higher rate" exposure with better business models—see our large position in StoneX (Ticker: SNEX).

While we delight in spending all day talking about satellite technology and salt mining, some newer ideas that have garnered some capital have been in "long term growth and consolidation in medical technology that has taken a severe breather in COVID-world" and "yes, we will be flying in emissions spewing planes for a really long time and thus the Boeing food chain will not entirely die on the vine." These are in the midst ideas and we are operating from the "an old guy once told me to finish buying the stock before talking about it" so there will be more details to follow in the months to come, but Viemed (Ticker: VMD) comes to mind.

We have also been putting our toes in the water in several areas that some might consider to be more thematic than usual: energy in the ground and a precious metals royalty company. In the former case, we are painfully cognizant of the factoid that knowing the price of a commodity is worth 30x that of other factors rational people may consider, such as cost of production and capital allocation. But it is our firm and documented belief that there is enormous pressure, actual or imagined, NOT to invest capital in carbon production. It has been our experience that years of capital deprivation in a legal, and in this case, mission-critical industry, will produce consolidation and upward pricing in the commodity in question. We think that the "headline" time horizon for massive and essential use of carbon-based energy is grossly underestimating the cost, logistics, technology, political will and if I may be so bold, ethical considerations in the immediacy of a fairytale ending of carbon-based energy. As of today, the gas/no gas-powered cars in the U.S. alone are roughly 279mm to 1mm ratio. We got started in some low-cost natural gas, which is by ANY rational discussion the gateway energy supply to a different future, but we continue to spend time in the legacy carbon world. We will note again that some things are harder in smallcap world and energy investing is one of them as far as margin of safety and quality and diversity of assets.

We have followed the royalty gold trust industry for years. To reiterate, it has been hard to invest in the small cap world in something suitable, and it can still be argued there is a world of difference between “big boy” companies like Franco Nevada (Ticker: FNV) and Wheaton Precious Metals (Ticker: WPM), and say, Sandstorm (Ticker: SAND). But properly executed, the royalty and streaming business represents a fascinating set of good economics that is helped by but is not directly keyed to the price of gold, and enthusiasm for precious metals has clearly been tempered by Twitter-led Bitcoin aficionados. So we think we are paying fair value for an interesting kicker in Sandstorm and we are sniffing other related ideas. Did we mention Federal Reserve policy, money supply growth, and 3 to 6 trillion dollars of new U.S. federal government spend? Yes, that could all be deflationary. Or not.

On the “now what” part of this letter, we will again repeat ourselves, there is simply a LOT that hinges upon the sustenance of low-interest rates and unprecedented availability of credit. We continue to think that this is problematic as the soporific nature of nearly-free money remains an outlook iceberg— and there seems to be a lot of unknown unknowns in the probability ice patch. Little cracks like margin calls in the Archegos “family office,” the Greensill Capital Ponzi-esque scheme, and Turkish devaluation are visible symptoms of problems. It is not so much the idea that a 2.5% 10 Year Treasury bond on its own is going to produce Armageddon. But the question is, “how many leveraged financial structures have 1.5% interest rates and low volatility baked into them and thus a 70% move blows it out of the water?” These are risks that we smell are out there after 30 years of interest rate and inflation expectation declines.

And credit follows. People are accepting exceedingly poor structure and risk-reward because there ain’t nothing else. If the risk-free rate backs up, credit spreads will as well. And is fixed income really “risk-free” when you can be down 15% year-to-date in a long-term Treasury?

Other Interesting Tidbits

Year-to-date treasury issuance is at $4.1 trillion, up 50% from a year ago, and, that’s before the new administration became the Monopoly banker. To be fair, this administration has simply upped our elected officials’ commitment to wasting tens of billions. Monetary policy works with a lag? The leading proponent of, “no stupid, all this debt remains deflationary” remains convinced of its 30-year genius trade. (Please see Hoisington.com.) And then there is this guy’s comments after the last Federal Reserve “here is how it is all going to work” conference: “It was a clean break from past Fed practice,” said Lou Crandall, Chief Economist at Wrightson ICAP LLC. “They’re willing to take the risk of being behind the curve. They don’t think the risk is particularly severe and they don’t think the costs of a miss on that side are as large as the costs of suppressing economic growth unnecessarily.” We watch and wonder.

One tends to compensate for the unknown via pre-work, the goodness and sustainability of the business model, and some comfort in a reasonable price paid. It is the latter that seems to be hi-jacked from us. For many things we see, there is a giant “0 for 3” going on, and we have enough experience to appreciate the pain of being singed by inane activity going on around us. Like the motorcycle that clipped me on the 405 last week when sneaking between lanes.

And we are calling it: there is simply and literally stupid activity swamping financial markets as a result. Timing aside, we will look back at “COVID investing” as representative of the most ridiculous and foolhardy ways homo-erectus has managed to squander hard-earned, or merely given, money. It seems bizarre that much of our world seems to talk the talk of equality of outcome when online trading apps like Robinhood and social communities like Reddit seem destined to create more inequality as only a precious few will emerge at the top of the food chain.

The list of what we would deem crazy is seemingly endless. Trading bankrupt equities? Playing short squeezes? Nonsensical valuations and I mean nonsensical when referring to “barely or pre-revenue” company analysis at large? An ETF called BUZZ that simply tracks social media mentions? SPAC promotion?

Here is a fun one to watch: in 2018 delivery service Waitr (Ticker: WTRH) folded into a SPAC sponsored by Landcadia, which had the requisite billionaire backing: Tilman Fertitta of casino fame and Richard Handler who runs Jefferies (Ticker: JEF). The deal closed two weeks before the money had to be returned—recall that most SPACs’ have a two-year life. And we will note—because we have taken these meetings—that nothing or no one in life is more seductively promotional than a management team within two weeks of losing a 20% carry on a $250mm deal. Well, a few funny things happened on the way to the bank in 2019, including a 96% decline in the post-deal stock price, and voila, the lawsuits are a-coming. So, were promoter projections fraudulent or just aspirational? As we have noted, it can be a fine line. But with $80+ billion raised last year in SPACs, and another $40+ this first quarter, this is not the last of the lawsuits. We will mention here that one of the negatives argued against the Cove Street way of life was the paucity of the public company universe per the monstrous private equity trade. Well, I think that has been fixed given the enormous influx of IPOs and cash-outs by private equity sponsors. Hundreds of new and highly valued and promoted ideas have been floated recently. This crop of future disappointments is our 2022-2024 universe of ideas.

And stock promotion via Tweeting? Given how much true garbage we go through to put out a simple letter to shareholders in our mutual fund that makes sense and conveys real thought, the idea that prominent billionaires can just Tweet the crap out of something and watch the minions drive up a stock price is stunning. No doubt a complex SEC issue.

We will end this thread with the concept of ARK Investment Management and its $6-to-$60 billion asset rise in mostly ETF assets. Congratulations of course are in order because you do not have to manage $60 billion for very long to appreciate the lopsidedness of the risk/reward for promoting a highly promotional investment position. Although it is crazy fun to go to their website and look at their Tesla model and how it has changed over time (not necessarily for the better), one of the reasons most successful investment (which is different than successful fund-raising) is done quietly involves the very human ability to be wrong, and to recognize mistakes without very real human fears of public humiliation or death in certain societies. Current and historical financial history has tended to be unkind to those it carries on its shoulders the day before because it gets harder and harder to think more clearly in the midst of massive publicity and public commitment to positions. And what works early and in small size is even more difficult to change once you are at massive size. So, anything associated with that ETF is on suspect ground in our view—it went up a lot because it went up a lot, and we suspect the opposite thought will hold as well. To wit, in a recent filing with the Securities and Exchange Commission (SEC) the ARK removed language from their prospectuses that limited the ETFs from investing 30% or more of assets in a single company. The updated prospectus also no longer contains a restriction on the funds owning 20% or more of a firm’s shares. Translation: we are getting big and crowding more in the goodness of our great previous winners.

So yes, two good quarters and not having $60 billion in assets might be weak ground for being this splenetic. But we continue to cling to quaint ideas like long-term-oriented investing and reasonable analysis of the probabilities of an uncertain future that looks weirder and more uncertain than ever. Buying fears of uncertainty is at the heart of what a value orientation suggests. We see incredible pricing of certainty in many areas. But there continues to be an exodus of people out of our space (the machines and AI continue to rumble around nearly unmolested) and we see less focus on actual research on actual companies versus analysis of the next 30 days of popularity/momentum. Also, there are fewer people who seem 100% focused on making money rather than saving us from the soulless depravity that seemingly was rampant until about 6 months ago.

There remains a fair amount that is unpopular or simply too boring for words. These companies have decent businesses that grow reasonably, generate cash and have a pretty good chance of still being here in 7 years. We would be lying if it were just that simple to protect capital in the midst of silliness blowing itself up. But to reiterate, we remain extremely confident in the legs of value versus silly on a relative basis, and confident that team Cove Street is structured to execute.

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