

When asked how he became so successful, Buffett answered: "we read hundreds and hundreds of annual reports every year."



With
John Mihaljevic, CFA
 Managing Editor,
The Manual of Ideas
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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Top 5 Ideas In This Report

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About Portfolio Manager's Review

Our goal is to bring you compelling investment ideas on the basis of intrinsic value versus market price. John Mihaljevic, editor, is a fund manager, former banker and analyst. He is a member of Value Investors Club, an exclusive community of top money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude*, from Yale and is a CFA charterholder. He resides in New York City with his wife and two kids.

THE SUPERINVESTOR ISSUE

- ▶ Snapshot of 100 companies owned by superinvestors
 - ▶ 30 companies profiled and analyzed
- ▶ Proprietary selection of Top 5 candidates for investment
 - ▶ Plus: Latest holdings of top investors
- ▶ Plus: Exclusive Interviews with Zeke Ashton, Igor Lotsvin
 - ▶ Plus: Notes from Value Investing Congress

Superinvestor companies mentioned in this issue include Alexander's, American Express, American Railcar, AmeriCredit, AmerisourceBergen, Amylin Pharma, Apartment Investment, Ark Restaurants, Borders, Bristol Myers Squibb, Burlington Northern, Canadian Natural, Capital Southwest, CarMax, Cemex, Chesapeake Energy, Coca-Cola, ConocoPhillips, Consolidated-Tomoka Land, Costco Wholesale, Coventry Health Care, Cresud, CSX, Ctrip.com International, Deckers Outdoor, Dell, Dillard's, DISH Network, Dr Pepper Snapple, Eaton, eBay, EchoStar, Einstein Noah Restaurant, EMC, Facet Biotech, Fair Isaac, Fairfax Financial, Fidelity National Financial, General Dynamics, Goldman Sachs, Greenlight Capital International, Harvest Natural, Health Net, Helix Energy Solutions Holdings, Hess, Horsehead, Ingersoll-Rand, Intercontinental, Jefferies, Johnson & Johnson, Leucadia National, M&T Bank, Moody's, Mosaic, PDL BioPharma, Premier Exhibitions, Procter & Gamble, Rockwell Collins, Ryan's Family Steak Houses, AeroSystems, STS Airframe & Engine Components, TAL International, Target, Teledyne Microsystems, tw telecom, URS, USG, Visa, Wendy's Arby's, Win

Inside:

Exclusive Interview with Zeke Ashton, founder and managing partner of Centaur Capital Partners

With compliments of The Manual of Ideas

(profile)

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Exclusive Interview with Zeke Ashton

Zeke Ashton of Centaur Capital Partners spoke eloquently on the topic of value investing and risk management at the Value Investing Congress in Pasadena earlier this month. We found Zeke's presentation enlightening and asked him to elaborate on some of his key points. A week or so ago, we conducted an exclusive interview with Zeke, and it's our pleasure to bring it to you here.

Before we proceed to the interview, we should point out that Zeke's approach to risk management has worked. In 2008, the Centaur Value Fund was down 6.9%, trouncing the 37.1% and 40.0% declines of the S&P 500 and Nasdaq Composite indexes. From inception in August 2002 through the end of 1Q09, the Centaur Value Fund gained 134.6%, net of fees and expenses, versus returns of 15.1% for the Nasdaq Composite and -0.3% for the S&P 500 Index.

MOI: You spoke recently on the topic of value investing and risk management. The “backdrop” was the somewhat surprising fact that a number of prominent value investors suffered debilitating losses in the market collapse of 2008 and early 2009. Adherence to “margin of safety” principles apparently didn't help. Why?

Zeke Ashton: I think that is a very good question, and I don't think there is any one easy answer. Part of it was simply because very few investors were prepared for such an extreme negative scenario as the one that ultimately played out. I know we didn't foresee things deteriorating as much as they did. What transpired in late 2008 and early 2009 was so far outside of the range of experience for most people that it didn't seem like a plausible scenario twelve months before. With perfect 20/20 hindsight, of course, it is easy to see the warning signs that were present, but most investors simply continued to do the things which had rewarded them in the past, not knowing that this time might be different.

We and many other value investors have historically been rewarded for buying in times of fear and uncertainty, as well as for purchasing stocks that were cheap relative to asset values or normalized earnings power. However, in 2008 it wasn't enough to buy stocks that looked cheap based on low multiples to book value or normalized earnings. Many companies, particularly in the financial sector, won't get the chance to recover to normalized earnings because they got wiped out or were forced to dilute their shareholders to the extent that the losses are effectively permanent. In the end, it appears to me that when faced with an extreme environment like 2008 and early 2009, there are really only two things that can save you: the luck or skill to see it coming and get out of the way, or a portfolio structure and risk management approach that is specifically designed to promote survival in a catastrophic scenario that you didn't see coming. I feel very fortunate that we had a portfolio that was able to take some hits and survive to play another day.

MOI: You have stated that top-down risk management policies “can make the difference between survival and failure in a year like 2008.” What do those top-down policies look like at Centaur? What factors would cause them to differ from one investment manager to the next?

Zeke Ashton: Well, first of all I want to be clear that we didn’t get everything right, but I can think of a few specific policies that helped us in the past year. The first was to introduce sector risk limits when we noticed that we were coming up with a lot of retail long ideas in late 2007 and early 2008 as that sector became hated and feared. And though not all retail businesses or retail stocks behave the same way, we felt that it would be wise to limit the overall retail basket to no more than 20% of the portfolio. This was both to respect the uncertain economic environment and due to the fact that exposure to general discretionary consumer spending tends to show up in a lot of other sectors besides retail.

I am convinced that had we not set a hard limit, we ultimately could have justified owning a lot more retailers than we did and would have been hurt far worse in the sell-off that followed. Having a limit meant that when we wanted to buy Target at \$40, for example, we had to replace something in our portfolio that we thought it was better than, which for us meant selling Sears Holdings at \$90. It’s not important whether Sears ended up falling more than Target; what is important is that none of our retail stocks did particularly well and the decision to limit our exposure to the group allowed us to keep our overall losses to a bearable level. In turn, that enabled us to hold on to our positions long enough to see some of them eventually recover in price. We have now adopted 20% as our de-facto limit to any one sector, though we will likely modify that limit up or down for specific sectors over time as we gain more insights.

The second example was our decision way back in 2005 to limit our portfolio-wide exposure to stocks with limited liquidity. If it’s hard to get into or out of a stock without moving the price, we simply go smaller on the position size at the individual idea level. In addition, we have limited the percentage of our fund that can be in low-liquidity stocks to no more than 30%. This was helpful to us in mid-2008 when we identified new risk factors emerging and were able to exit some of our less liquid ideas in a timely manner and without hurting ourselves in the process.

As far as differences from one manager to another, clearly what might be appropriate for one manager or shop might not work for another. For example, a broad sector limit likely won’t be useful to a fund manager who specializes in only one or two sectors. The specialist manager will need to develop a risk management framework that is quite different from a generalist shop like Centaur. Risk management isn’t all about setting hard quantitative limits; each manager needs to consider the nuances of his or her strategy and investing process and implement whatever policies make the most sense. When it comes to risk management, I think the simpler the better.

MOI: Prior to 2008, many value investors did not give sufficient thought to portfolio management as a source of risk-adjusted outperformance. Thoughts on position sizing often referenced the so-called Kelly Formula, which seemed to justify taking very large positions. You have stated that, “Investors who rely on the Kelly Formula as intellectual support to take excessively sized bets will accelerate gambler’s ruin, not avoid it.” Is this because most investment managers must contend with the capital outflow risks of open-ended funds, or because the odds of success are more subjective in investing than in gambling?

Zeke Ashton: I think it’s both of those things. The Kelly Formula is a useful concept, and the book [Fortune’s Formula](#) by William Poundstone is one of the best financial books I’ve ever read from the standpoint of pure enjoyment. The idea of the formula is to find the optimum bet size to maximize gains and minimize the risk of going broke. But I think that the formula’s utility to stock market investors is limited due to the much higher level of complexity and uncertainty that exists in the real world.

In addition, as you point out, the Kelly Formula assumes that one has use of the full bankroll until it is exhausted. In the world I live in, investors get scared and will want their money back once they’ve reached a certain pain threshold, and I don’t know exactly where that threshold is. Obviously, the investor with truly permanent capital doesn’t have this problem, but as a professional investor with a fluid capital base, it is a limiting factor for me.

Finally, it is my understanding that Kelly assumes a series of bets with independent outcomes, and therefore fails to account for the correlation of positions inherent within a real life stock portfolio. There is an old saying in the financial markets that in times of extreme stress, the correlation of most investment assets gravitates to one, and I think we witnessed the closest thing possible to that in late 2008 and early 2009. All that said, my only point in mentioning the formula in my recent presentation was to voice my opinion that some people just got a little carried away with the ultra-concentration thing. The book and the Kelly Formula may have been a source of unintended encouragement in that regard.

MOI: Is there a danger of overreacting to what happened in 2008? After all, many value investors have achieved superior long-term performance because they have avoided the closet-indexing style of a large portion of the active management universe. How do you ensure that risk limits and diversification don’t become unnecessary drags on risk-adjusted performance?

Zeke Ashton: I think there is a danger to extracting lessons that would have been useful in pain avoidance during 2008 that may not be applicable going forward, and certainly could result in sub-optimal performance in the “normal” investing conditions that prevail 95% of the time. However, I don’t think it will cause an unacceptable drag on performance to establish reasonable total exposure and position size limits, appropriate sector limits, or to be prudent in terms of how much of one’s portfolio might be invested in illiquid assets.

Just as an example, we haven't changed our portfolio structure much as a result of recent experience. It was pretty standard for us to have 50-60% of our assets invested in our top ten ideas prior to 2008, and we aren't likely to change. In fact, we actually have a bit more than that invested in our top ten long ideas today. Around the edges, though, we might be a little more sensitive to nuances such as balance sheet risk at each idea than we were before, or to correlation amongst our top positions. But I don't think 2008 has brought wholesale changes to our ways of thinking about portfolio risk management. It's mostly been refinements based on having witnessed a real life stress test and learning what helped us and what we might have done better – without changing the philosophy and approach that define us as investors. The core elements of value investing will still always be about valuing businesses and assessing risk. The environment of 2008 and early 2009 served to shine a brighter spotlight on the risk assessment component of the game.

MOI: You have differentiated between the “home run” and “high probability” styles of value investing. Eddie Lampert has succeeded at home run investing, while Seth Klarman has excelled at high-probability investing. Assuming that each style represents a legitimate approach, what are the key differentiating qualities of a home run investor versus a high-probability investor? Why do you favor the high-probability approach?

Zeke Ashton: My categorization is a bit simplistic, but I do think some investors are naturally wired to take a high-percentage approach to beating the market through the accumulation of small advantages over time. Others are naturally more inclined to take the proverbial big swings in an attempt to hit the home runs that can really move the needle and drive outstanding performance. As you say, both are legitimate approaches to beating the market.

My preference for the high probability road is mostly because it's more compatible with my personality and risk tolerance. I find it comforting to know that over a large enough sample of decisions, luck tends to even out and one is left with a track record that more or less reflects one's skill level. For the same reason that a skilled sports team playing a less skilled team should prefer to play a seven game series rather than a one-game playoff, we want our results over time to reflect our skills and not our luck. We also have made enough mistakes to know that we are fallible. We don't want one or two bad outcomes to define our results for any meaningful period of time.

I think it's important to point out that one factor in favor of the high probability style for Centaur is that we have a co-portfolio management system. My business partner and co-manager Matthew Richey comes up with ideas that are independent of mine. Matthew would probably be fine with either the home run approach or the high probability approach, but since it is easier for him to adapt to the high probability approach than it is for me to adapt to the home run approach, that's what we do. In addition, in 2006 we added a third analyst to our team, Bryan Adkins, and he produces a number of new actionable ideas for us to consider each year. So with three analysts actively hunting for bargains, chances are that we will dig up enough good ideas to populate a 20 or 25 stock portfolio. Our goal is to deploy capital when we see an idea that we think can allow us to produce a 20% IRR with acceptable risk. If each of us comes up with six new

compelling ideas per year, that's eighteen ideas, not including any previous ideas that are still sitting in our portfolio. Many times, we have way more qualifying ideas than we have room in the portfolio, so new ideas often are competing with existing ideas for capital. I think that is a healthy dynamic.

I also happen to think that the high-probability style is better suited to managing other people's capital than the home run style. For example, let us say you happen to be a young Eddie Lampert and 2008 was your first year as a fund manager. You have a five stock portfolio, and you are unlucky and have a -60% year. You probably don't get a second year, unless you managed to convince your investors to give you a three or five year lock-up. On the other hand, let's suppose you are a young Seth Klarman and your portfolio has enough ideas in it to allow your skill to work for you a bit more. You probably didn't have a great year, but you also likely beat the market. So it's not a great way to start, but you probably get a chance to stay in the game for another year or two. This is a critical difference — you can't succeed in the long term if you don't stay in the game.

MOI: Your insight into recourse versus non-recourse leverage in an investment portfolio is enlightening. How do you approach leverage in general and how much exposure to non-recourse leverage do you typically seek?

Zeke Ashton: Basically, my view is that there are two flavors of leverage, and one is vastly superior to the other. One can take recourse leverage by going on margin to buy a stock, but the downside is that with enough leverage, even a moderate and temporary decline in the stock price can produce a very significant loss, and a significant decline can wipe you out. The other kind is non-recourse leverage, where you get the benefits of the leverage if the stock goes up, but at some point the losses become non-recourse to you in the event the stock declines significantly. The way to get non-recourse leverage relatively cheaply is through in-the-money call options (we favor long-term options going out at least 15 months).

As an example, in the summer of 2008, we decided that American Express looked cheap at a price of about \$37. Rather than buy the stock, we bought a long-dated \$30 call option, for which we paid about \$9. This means that our effective purchase price for the stock was \$39 rather than \$37. The incremental \$2 was about 5.4% of the stock price, and represented both the cost of the leverage and the cost of the loss protection if the stock were to drop below \$30. We felt it was unlikely that we would need significant loss protection below \$30 at the time. Luckily for us, we later sold Amex to buy something else that we thought was cheaper. Subsequently, the stock plummeted to under \$10. Had we not sold it, we would have lost the entire premium we paid for our Amex position but it would have been a fraction of the loss we would have suffered had we bought the common stock and ridden it down. We would have been stopped out below \$30, with any losses beyond that point having no recourse to us.

This brings me to the second part of the question, which is how we size positions when we use options. Basically, we size the idea in such a way that we economically control the same number of shares we otherwise would control if we just bought the stock. As an example, let's say we wanted a given stock to be

a 5% position. We would buy options on the exact number of shares that would otherwise comprise a 5% position if we bought the common. Now we have all the benefits of owning a 5% position if we are right, but we have limited the potential loss on the position to only a portion of that same 5% weighting if we are wrong.

At the portfolio level, we have a maximum long exposure of 125%, and we would consider our long exposure on the idea to be 5% whether we bought the common stock or we used the call options to control the identical number of shares. We don't use options to increase our idea-level exposure, since that would simply offset the benefits of the non-recourse leverage by increasing the position size. But using options does in part allow us to consistently run a portfolio that has true economic exposure that is greater than 100% of our assets on the long side if we want to, funded in part by the leverage inherent in call options and in part by the float created by our short portfolio. And we can do so without being at the mercy of margin calls or worrying about suffering outsized losses.

MOI: When it comes to stock selection, what are the key criteria you look for in long positions versus short positions?

Zeke Ashton: I think we are similar to most other value investors in terms of what we are looking for — we are looking for dollar bills trading at a discount, like everyone else. We tend to emphasize finding undervalued businesses based on low multiples to free cash flow or book value since those lend themselves a bit easier to analysis. But we are flexible and are always looking for stocks that may not appear to be cheap statistically but are nevertheless trading at significant discounts to true underlying business or asset value. We very much prefer our ideas to take the form of high quality businesses with excellent management that can grow value over the longer term, but we will buy mediocre assets if the price is right. We think being generalists can be an advantage, as we have the flexibility to go digging for bargains in whatever sector we think might be most out of favor or neglected at any given time.

On the short side, we are looking for the polar opposite, though our short ideas tend to fall into a few broad categories. Businesses that chronically burn cash represent one category that has worked for us over time, as are those businesses that have taken on more debt than the cash produced by the business can support. Finally, we will short fad companies, companies that are aggressive with the accounting and thus over-stating their economic value, or even good companies that are simply egregiously overvalued. In general, we typically have anywhere between six and twelve individual shorts in our portfolio at any one time.

MOI: How do you generate investment ideas?

Zeke Ashton: We get ideas from all sorts of places. We used to get a sizable number of leads from statistical screening, and we still use screens, but we have found them in recent years to be more productive in sourcing short ideas rather than long ideas. Nevertheless, we still scan through lists of stocks that appear to be cheap from a statistical basis and occasionally we find a good one.

One of our major idea sources these days is from the inventory of the many ideas we've owned or researched at some point in the past — many times, after we've sold those stocks, the price will come back down to a level that

makes them very interesting again. Since we generally already know the company, it is just a matter of getting quickly up to speed with the latest developments to determine if it is actionable. We also find occasional ideas by doing industry overviews to get to know a number of players in a specific sector or niche that we think may be out of favor or neglected for some reason. Often we will find a gem or two. Finally, we get some ideas through our network of value investing contacts, and through a number of specialized research publications that we have found are compatible with our approach, of which your own publication would be one example. But no matter the source, the ideas are merely candidates until we've actually produced a piece of internal research that covers the bases and gives us confidence that we understand the business, can reasonably value it and also gauge the risks factors involved. And of course, the stock has to be cheap.

MOI: What is the single biggest mistake that keeps investors from reaching their goals?

Zeke Ashton: That's a tough question. There are a probably an infinite number of ways one can screw things up. But I think one can capture a very large percentage of the possible mistakes under one broad roof by saying that a lack of a coherent investment strategy that makes sense and can be followed with discipline and perseverance is the biggest mistake investors make. Without an intelligent framework for making decisions, it's awfully hard to succeed.

MOI: What books have you read in recent years that have stood out as valuable additions to your investment library?

Zeke Ashton: In my opinion, the most important investing book to come along in many years has been [Fooling Some of the People All of the Time](#) by David Einhorn. In writing a story about a "garden variety fraud" at a company called Allied Capital and his efforts to expose it, this book sheds a lot of light on the ugly realities of our financial regulatory system and how that system has become so terribly dysfunctional. The system is particularly unjust to short sellers who do the difficult and thankless work of uncovering fraud or excess risk at publicly traded companies. To those who wonder how a fraud on the scale of that perpetuated by Bernie Madoff could have gone undetected for so long, this book provides some answers. As an aside, it took a lot of courage for Mr. Einhorn to continue his struggle against Allied Capital and to publish this book, as the personal risks to his business and reputation were very real. For that, he has my respect and admiration.

The investing book I read most recently was [More Mortgage Meltdown](#) by Whitney Tilson and Glenn Tongue of T2 Partners. The book is a very readable and accessible discussion of how the mortgage crisis happened, and more importantly, offers some very good perspective on how the credit crisis may develop from here. In addition, there are a number of timely investment ideas presented in the form of detailed case studies that will be valuable for both beginner and advanced investors. I should disclose that Whitney and Glenn are friends of mine and that my firm manages the Tilson Dividend Fund through a joint venture with T2 Partners. So while I am no doubt a bit biased, I enjoyed the book and found it very stimulating food for thought.

MOI: Zeke, thank you very much for taking the time to interview with us.

About Zeke Ashton

Zeke Ashton is the managing partner of Centaur Capital Partners and manages the investments for the Centaur Value Fund. From November 1999 to July 2002, Mr. Ashton served as the general partner and portfolio manager of Centaur Investments LP, a private investment partnership and the predecessor entity to the Fund. From 1999 to 2001, Mr. Ashton was an investment analyst and writer for The Motley Fool, a media company that specializes in investing and personal finance. Mr. Ashton continues to write for The Motley Fool as a guest columnist.

About Centaur Capital

Centaur Capital Partners, LP is an asset management company and investment advisor based in Dallas, Texas. Centaur Capital Partners follows an investment philosophy based upon value principles, and selects stock investments based upon true business value as reflected by asset value, cash flow generation, management quality, and the competitive advantages of the underlying businesses when such stocks are available at compelling prices. Centaur Capital Partners is the General Partner and investment advisor to the Centaur Value Fund. The Centaur Value Fund is a long-biased, value-oriented private investment partnership open to accredited investors. The fund is limited to 99 partners. The Centaur Value Fund was launched on August 1, 2002. For more information, visit www.centaurcapital.com.

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