Zeke Ashton
Centaur Capital Partners

NEGLECTED, HATED, & FEARED

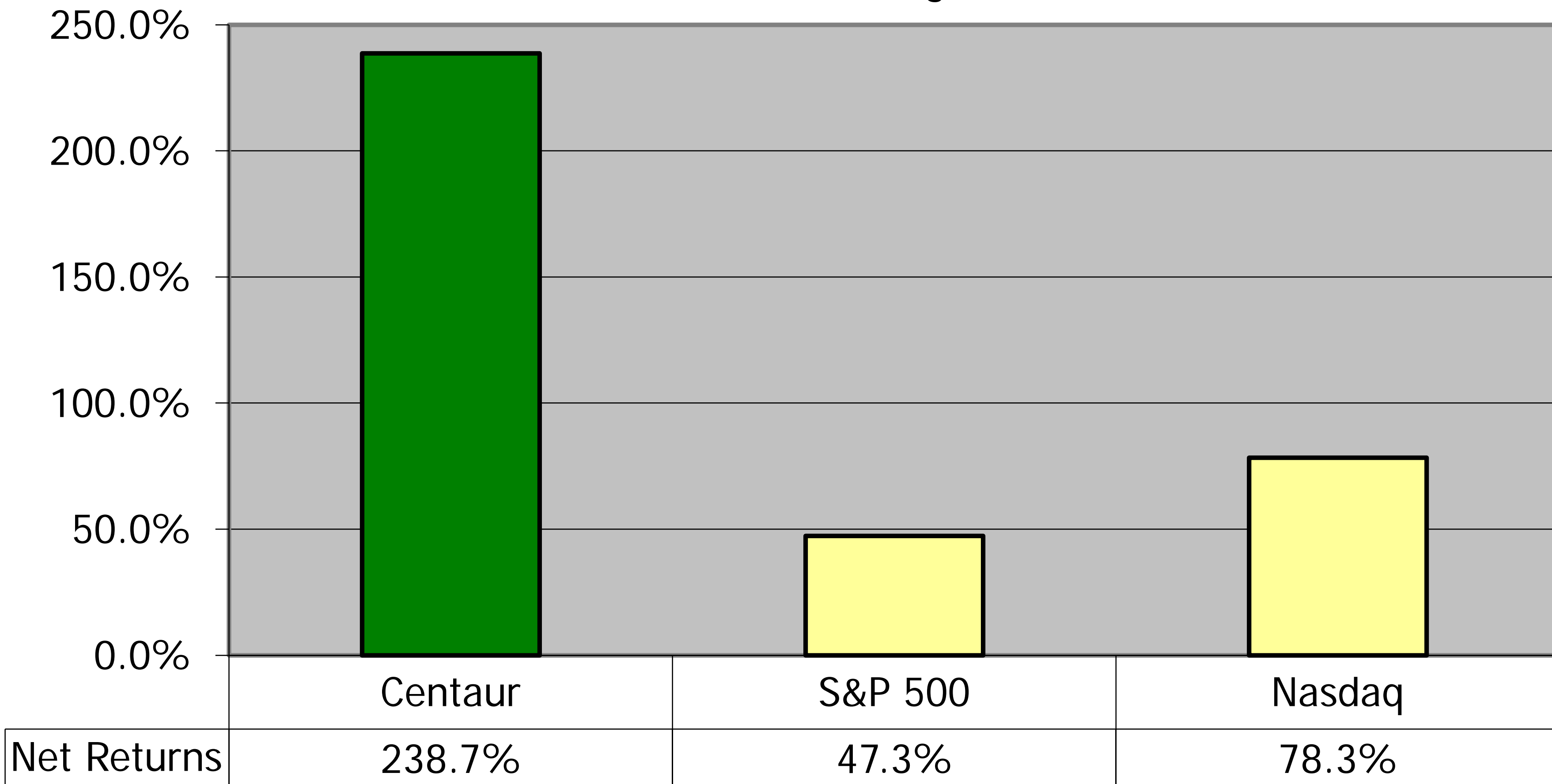
INVESTING IN OUT-OF-FAVOR INDUSTRIES

VALUE INVESTING CONGRESS – OCTOBER 2010

About Centaur Capital Partners

- Founded in 2002, Centaur Capital Partners (CCP) specializes in value-oriented investing strategies with an emphasis on achieving excellent risk-adjusted returns. Our approach is based on fundamental securities research and analysis. CCP is based in Southlake, Texas, just outside of Dallas.
- CCP serves as the investment advisor to the Centaur Value Fund. CVF is a long / short, long-biased private investment partnership that was launched in August 2002.
- Centaur Capital is also the sub-advisor to a retail mutual fund, the Tilson Dividend Fund (TILDX), launched in 2005 in partnership with Whitney Tilson and Glenn Tongue of T2 Partners.
- In managing TILDX, CCP utilizes a unique, value-based long-only equity income strategy that seeks to identify undervalued securities and emphasizes income through a combination of dividends and the selective use of written covered call options.
- Early seed investors in Centaur Capital include Whitney Tilson, John Schwartz, and West Coast Asset Management.
- As of September 30, 2010, Centaur Capital managed about $110 million.

Centaur Value Fund Cumulative Returns



	Centaur	S&P 500	Nasdaq
Net Returns	238.7%	47.3%	78.3%

*Returns shown through 9/30/10

Tilson Dividend Fund

- Centaur Capital Partners is the sole sub-advisor to TILDX.
- TILDX is an all-cap, long-only total return fund.
- 20-30 positions; the portfolio generates significant income with combination of dividends & covered call options.
- Deep fundamental research; value-based philosophy.
- Since 3/16/05 inception thru 9/30/10, TILDX has produced annualized returns of +8.9% versus -0.1% for benchmark Dow Jones Dividend Index (DVY) and +1.2% for S&P500.
- No loads; total management fee + expenses = 1.95%.
- Daily liquidity, minimum investment $1,500.
- Ticker: TILDX
- Website: www.tilsonmutualfunds.com

Morningstar Snapshot for TILDX

Morningstar Category
Mid-Cap Blend

Morningstar Rating
★★★★★

Total Return % (09/30/10)	YTD	1-Year	3-Year	5-Year
TILDX	11.07	14.97	6.05	8.73
S&P 500 TR	3.89	10.16	-7.16	0.64
Category (MB)	8.20	13.79	-4.73	1.66
+/- S&P 500 TR	7.18	4.81	13.21	8.09
+/- Category (MB)	2.87	1.18	10.78	7.07
Rank in Category	17	38	1	1

Neglected, Hated, & Feared

- Today I will present some ideas from three industries that appear to be particularly out of favor with investors at the present time.

- The three industries I will cover are 1) property & casualty insurance; 2) equity asset managers; and 3) retailers.

- Each of these sectors is out of favor for a variety of reasons today, but are likely to benefit from a change of investor perception at some time in the future.

- For each industry, I'll highlight a couple of stock ideas that I find especially interesting.

- In addition, I'll offer some thoughts on how we think about each industry in terms of portfolio construction and risk management.

Insurance: Neglected and Misunderstood

How do I know that the insurance sector is out of favor?

- As of October 1, 2010, a screen containing 82 U.S. listed property and casualty insurers showed that 56 of the 82 (or more than two-thirds of the stocks) were trading at less than most recently reported book value.

- Liberty Mutual, the fifth largest P&C insurer in the U.S., announced on September 29th that it would delay its IPO, saying that it was "unable to receive appropriate value" for shares.

Why might the insurance sector be out of favor with investors?

- We are four years into a "soft market" with premiums generally becoming less attractive for insurers. At the same time, bond yields are falling which makes it difficult for insurers to invest the float at reasonable returns. Insurers are therefore being squeezed from both sides of the book.

- Nobody wants "tail risk", either natural (Katrina) or man-made (AIG).

Insurance: Catastrophe “Tail” Risk

TOP TEN MOST COSTLY INSURANCE LOSSES 1970-2008

#	DATE	COUNTRY	EVENT	COST ($M)
1	Aug ’05	U.S.	Hurricane Katrina	$71,300
2	Aug ’92	U.S.	Hurricane Andrew	$24,552
3	Sept ’01	U.S.	Terrorist attacks	$22,835
4	Jan ’94	U.S.	California earthquake	$20,337
5	Sept ’08	U.S.	Hurricane Ike	$20,000
6	Sept ’04	U.S.	Hurricane Ivan	$14,680
7	Oct ’05	U.S.	Hurricane Wilma	$13,847
8	Sept ’05	U.S.	Hurricane Rita	$11,122
9	Aug ’04	U.S.	Hurricane Charley	$ 9,176
10	Sept ’91	Japan	Typhoon Mireille	$ 8,926

Source: Swiss Re 2008   All $ figures in 2008 dollars

Insurance: Now the Good News

- Soft markets don't last forever. Eventually capacity is removed from the industry and the smarter players take share. Since 1979, there have been four "soft markets" and three "hard markets" for P&C insurance:

SOFT MARKETS	HARD MARKETS
1979-1985	1986-1988
1989-1992	1993-1995
1996-2001	2002-2005
2006 - ?	

- Soft markets aren't the end of the world – 22 of the last 31 years in the industry have been in the softer part of the cycle, or about 70% of the time.

- The best players in the industry produce good ROE and book value growth during the soft parts of the cycle, and hyper-growth during hard markets. Industry valuations do not support new entrants as was true in '01 and '05.

Fairfax Financial: A Double Threat

- Fairfax Financial (Toronto: FFH) has been the biggest winner in the insurance industry over the past three years. Take a look at the growth in book value per share: +53% in 2007, +21% in 2008, and +33% in 2009.
- Fairfax features one of the best long-term investing track records of any insurance company in the world, both on the equity side and the fixed income side.
- Over the 10 years ending December 31, 2009, Fairfax has produced a compounded return of 19.9% (with equity hedging) versus a negative return for the S&P500.
- On the bond side, Fairfax returned 12.1% annualized over the same time period, versus 6.4% for a corporate bond index.
- The return figures above do not include the credit default swaps, which produced a cumulative gain of over $2 billion from 2007-2009.
- Prem Watsa may not be Warren Buffett, but he's as close as we're likely to find. And he did way better in the credit crisis.
- At a very modest premium to stated book value, I believe that FFH offers an outstanding value given the quality of management and assets in place.

Aspen Insurance: Deep Discount to Book

- Aspen is a Bermuda-based diversified insurance company with annual premiums of about $2 billion and a roughly 50 / 50 mix of specialty insurance and re-insurance.
- The company was founded by a group of executives from a successful Lloyd's syndicate in 2002 to take advantage of the hard market after 9-11 and went public in 2003.
- Aspen has grown primarily by recruiting underwriters and teams with successful track records. The company has expanded in this way over the years and now writes business in 25 different insurance categories.
- Aspen has compounded book value at 12.7% per year (including dividends) from 2003 through 2009. The company suffered one loss year (2005 from Katrina / Rita / Wilma) but has since reduced it natural catastrophe exposure to about half of what it was in 2005.
- Diluted book value per share is about $37. At recent price of $30, the stock would have to rise by over 20% just to get back to book value. We think Aspen should trade at a modest premium to BV and peg fair value at $40.
- Aspen is buying back stock aggressively as a low risk way to grow BVPS.

Portfolio Management – Insurance

- There are three big risks to owning P&C insurance companies. The first is natural catastrophe exposure. The second is underwriting transparency (i.e., AIG or MBIA). The last is investing risk, esp. interest rate risk.
- Interest rate risk is the easiest to gauge and hedge, if desired. The portfolios of most P&C insurers are pretty basic, heavily weighted to bonds, and generally short to medium in duration. We usually purchase long-dated puts on the iShares 20 year Treasury ETF, ticker symbol TLT.
- Underwriting transparency is the most difficult to discern. It's hard to know in advance whether the company is correctly pricing risk. AIG and MBIA each had great long-term track records prior to their spectacular implosions during 2007-2008.
- We do the best we can in terms of gauging the risk culture of the companies we consider for investment, but at the end of the day we rely on position size limits to save us from nasty surprises.
- Call options are another good way to limit downside risk. Insurance stocks generally exhibit low volatility and the option premiums are reasonable.
- We use a portfolio sector limit (cost and market) to limit cat exposure. We also like to own companies that are widely diversified.

Equity Asset Managers: Feared

How do I know that the asset management sector is out of favor?

- AUM flows have shown that equities are becoming increasingly out of favor. Through August 31, U.S. equity mutual funds showed outflows of $42.1 billion for the year-to-date, of which $48.9 billion occurred after the "Flash Crash" in May. U.S. equity funds had outflows of $25 B in '09. (Source: Morningstar)

- A review of publicly traded asset managers shows that most now are valued at less than 3% of AUM on an EV basis, and many at less than 2.5%. Historically, well-run asset managers rarely traded at this level.

- For an example, Calamos Asset Management (CLMS) went public at $20 in 2004 with $32B in AUM and $100 million of net debt. Today, CLMS has about $32B in AUM and $250M in net cash, and the stock trades for $12.50.

Why might asset managers be out of favor with investors?

- Ten years of negative stock market returns will do that for you. Stocks are feared.

Asset Managers By the Numbers

- We use EV/AUM and EV/FCF as first look valuation metrics for equity asset managers. Historically, high quality managers have often traded at 4-5% of AUM on an EV basis. Today, only two equity managers (T. Rowe Price and Franklin Resources) trade meaningfully above 3%.
- We use the EV/FCF because many managers have cash invested in their own funds that does not produce investment income but is marked to market on the balance sheet.
- Using EV/AUM is a good way to get a sense of how the manager is valued given the most recent level of managed assets, since trailing FCF figures can be misleading if there have been significant asset flows over the past twelve months.
- Most decent equity managers produce FCF equal to about 25% of revenue, such that if an investor pays 3% of AUM or less on an EV basis, the effective P/FCF ratio should be something like 9-12 times (assuming an 80-100 basis point average management fee) on a look-forward basis.
- Asset managers should theoretically be skilled at value creating capital allocation at the parent company level. Given the capital-light business model and significant free cash flow, managers should be able to return capital to shareholders by dividends & buybacks or grow via acquisitions.

Asset Managers by the Numbers

- We think the mid-sized and specialty asset managers listed below are the most interesting in the sector at the current time. All are trading at very reasonable equity valuations relative to AUM.
- Each of these companies would likely show dramatic margin expansion in a scenario of rising AUM and therefore offer leverage to a rising market.
- We have taken a basket approach in order to reduce exposure to any particular specialty and benefit from rising popularity in any one.

COMPANY	SPECIALTY	EV ($M)	AUM(B)	EV/AUM
Affltd Mgrs (AMG)	Diversified	$ 4,400	$250	1.8%
Janus Capital (JNS)	Large Cap Growth	$ 2,320	$150	1.6%
Artio Global (ART)	International Stocks	$ 900	$ 50	1.8%
Calamos (CLMS)	Converts / Growth	$ 850	$ 32	2.7%
Gamco (GBL)	Whatever You Want	$ 680	$ 26	2.6%
Epoch (EPHC)	Free Cash Flow	$ 255	$ 13	2.0%
Diamond Hill (DHIL)	S/M Cap & Long/Short	$ 175	$ 7	2.5%

Note: EV and AUM are 9/30 Centaur estimates

Another Way to Play – Equity BDCs

- Equity-oriented business development companies are also trading at deep discounts to stated NAV, while debt-oriented BDCs are generally back to trading at slight premiums to book value.
- We look for BDCs trading at less than 75% of stated NAV and that we believe have a good record of capital allocation, fair compensation structures, and appear to be shareholder oriented. We currently own and like two equity-oriented BDCs (note that both are low liquidity stocks).
- MVC Capital (MVC) was one of my ideas from last year. Since then, the company has announced two significant portfolio exits at very nice valuations. MVC has also paid down all of its debt and announced a new credit facility. I expect MVC to move from its current heavy equity emphasis to more of a 50/50 hybrid between debt and equity investments. The stock trades at around $13 with an NAV of $17.43 as of 9/30.
- Capital Southwest (CSWC) is a high quality BDC with a long history of intelligent capital allocation and good stewardship. The portfolio is a mixture of solid wholly-owned businesses, restricted publicly traded securities, and a basket of venture capital investments. The stock currently trades at about $92 per share while the NAV of the portfolio is > $130. CSWC has significant cash that can be deployed in new investments.

Asset Managers and Portfolio Management

- Large and well-diversified asset managers are relatively safe compared to smaller specialty firms, as outflows from one asset class often find its way to another asset class in the same firm. We feel comfortable sizing a large and diversified asset manager using typical position allocations.
- Smaller, more specialized asset managers tend to be much more volatile (and tend to offer much more leverage) to overall performance and flows into their chosen strategy. We tend to size smaller managers at about half the typical position size given the embedded leverage and magnified exposure to one or two strategies. This also reflects that trading liquidity in the smaller managers can be limited.
- We generally use our typical sector limit of 20% for asset managers (which would include BDCs and other similar companies).
- The biggest risk factor is overall market direction. One can obviously hedge this by purchasing puts on an index that seems to best represent the asset mix at the owned company. Of course, we generally don't buy asset managers unless they appear very cheap or when our outlook for broad market prices in their specialty is generally positive.
- We watch the inflow / outflow data to get a sense of which direction AUM is going. Good managers tend to outperform broad category flow data.

In a Recession, Retailers Are Hated

How do I know that the retail sector is out of favor?

- We use a series of screens designed to produce a list of decent quality retailers that trade at low valuations to search for investment candidates in the sector. Our most discerning screen usually produces 20 or so candidates. As of early October the screen produced more than 45 different retail stocks meeting the criteria.

- A similar screen that we use to identify potential shorting opportunities in the retail sector produced only 5 candidates.

Why might the retail sector be out of favor with investors?

- Major macro worries: unemployment, reduction in consumer credit, and general uncertainty makes for a very uncertain retail environment.

- Retailers really got hurt in 2007 and 2008 and investors may be anchoring on the low prices available during that time period.

Recent Drama Creates Opportunity at BH

- Biglari Holdings (BH) is a restaurant holding company that owns burger chain Steak 'N Shake and diner chain Western Sizzlin.
- The company is now run by 32-year old hedge fund manager Sardar Biglari, a Warren Buffett disciple who took over as CEO after a proxy fight in August 2008.
- Biglari has led an dramatic turn-around at Steak 'N Shake over the past two years with a successful "traffic for check" trade-off strategy involving reducing growth cap-ex, simplifying the menu, investing in product quality, and reducing prices to bring more traffic to the restaurants.
- BH recently purchased the assets of Western Sizzlin, which Biglari had previously turned around with a similar strategy to Steak N Shake.
- Biglari has made it clear that his strategy will be to turn BH into a holding company that deploys capital in a number of areas, including asset management, insurance, real estate, and other areas.
- Biglari angered many shareholders by re-naming the parent company after himself in early 2010, and then in April 2010 the company announced the purchase of Biglari's hedge fund business. In return, Biglari would get a hedge-fund type carry of 25% of BV growth at BH above a 5% hurdle. This proposal kicked off a firestorm of controversy and criticism.

Recent Favorable Developments at BH

- On September 29th BH issued a revised proxy with modifications to the Biglari compensation package. The two major changes are an increase in the annual hurdle rate to 6% and an annual compensation cap of $10 million. A new shareholder vote is scheduled for November 5th.
- Biglari will be required to use at least 30% of his pre-tax compensation to purchase BH stock on the open market and hold them for at least 3 years.
- A rational approach is to assess the value of BH assets and then to apply an adjustment for the effects of the proposed compensation scheme. At $340, BH is valued at approximately $485 million market cap. We estimate that enterprise value is approximately $440 million.
- The company produces approximately $55 million in free cash flow per annum, or about $13.75 million per quarter. On an EV/ FCF basis, the stock trades at right around 8X. Every quarter the company adds about $10 per share to the value from the accumulated cash flow.
- Investors are getting a free call option on the hedge fund business. From 2000 to 2010 Biglari produced high teen IRRs for investors in his fund.
- Using a 6% annual FCF growth rate, a DCF pegs BH value at $460.
- Anything beyond 6% (which triggers compensation to Biglari) is gravy.

General Thoughts on Retailers

- We use a 20% overall portfolio exposure limit for retailers. We also keep in mind that many other categories of securities have exposure to consumer spending and we factor this in to our portfolio construction.
- We like to have our retail exposure be spread across a number of different types of concepts. Mass market retailers, restaurants, fashion retailers, warehouse clubs, and specialty retailers tend to behave in different ways and offer some additional diversity to our portfolio.
- We generally prefer to own retailers that we can buy at low multiples to operating and free cash flow or that have significant owned real estate or other assets to provide a margin of safety.
- We demand a bigger discount to our estimate of fair value for retailers that carry fashion risk or are specialty retailers versus the high quality mass market retailers such as Wal-Mart, Target, or Costco.
- We almost invariably have at least one or two short positions in the retail sector at any given time, which offers a natural hedge.
- We often buy retailers after they've missed quarterly earnings estimates or reported disappointing same store sales data. In our mutual fund, we will often exploit such moments of volatility to buy the stock and sell calls.

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Questions & Answers