

CENTAUR VALUE FUND

JULY 2010 REPORT

Dear Partners,

The Centaur Value Fund produced a return of +3.0% net to partners in July as compared to a +7.0% return for the S&P500 index and a +6.8% return for the NASDAQ Composite. For the year-to-date through July 31st, CVF returned +3.2% net to partners while the S&P500 returned -0.1% and the NASDAQ returned -0.6% for the same period. Our usual performance table is shown below:

	JULY	YTD 2010	SINCE INCEPTION
Centaur Value Fund	+ 3.5%	+ 3.8%	+291.9%
Centaur Value Fund – Net Returns**	+ 3.0%	+ 3.2%	+225.7%
S&P500	+ 7.0%	- 0.1%	+ 41.6%
NASDAQ Composite	+ 6.8%	- 0.6%	+ 69.7%

The table above shows the performance of the Centaur Value Fund for the month and year-to-date and since the inception of the Fund on August 1, 2002. All CVF figures include the reinvestment of dividends. Monthly and year-to-date figures are estimates and un-audited. Inception to date figures incorporate audited results from prior years and un-audited results from the current year.

***The Centaur Value Fund Net Returns reflects the experience of an investor who came into the Fund on August 1, 2002, and did not add to or withdraw from the Fund through the end of the most recently reported period. The reported net return figures will therefore include the impact of high water marks in the cumulative return. However, each investor's individual return will vary depending upon the timing of their investment, the effects of additions and withdrawals from their capital account, and each individual's high water mark figure, if any.*

July Update

The market returns in July were almost a photo-negative of the market performance of June, with a plus sign to the left of the return figure instead of a minus sign. We like the plus sign better! As second quarter earnings season began in mid-July, we believe that the focus on individual company earnings (which have generally been strong) managed to temporarily replace the focus on big picture macro worries.

At the CVF portfolio level, after the Fund captured only a small portion of the negative return of the markets in June, our portfolio managed to capture only about 50% of the market's positive performance in July. This was a bit of a disappointment, as we had made a material increase in the Fund's long exposure in late June and early July, moving from the 65% net exposure range to something more like 75%. However, several of our large positions did not perform well in July despite what we felt were strong financial reports. At the same time, some of our higher-volatility short positions ran against us a bit, which is to be expected in a strongly rising market. For the year-to-date, CVF continues to lead the major market indices, but it's been a tough year to make money. Overall, we are quite comfortable with the composition of our portfolio, and believe we are well positioned in what remains an uncertain market environment.

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Eight Year Milestone

The Centaur Value Fund reached its eight year milestone at the end of July. In looking over our performance history, we are generally pleased with the results to date. The table below summarizes the calendar year performance of the Centaur Value Fund since inception on August 1, 2002:

CENTAUR VALUE FUND CALENDAR YEAR RETURN SUMMARY 2002-2010

YEAR	CVF Gross	CVF Net	SP500 % Chg	Nasdaq % Chg
2002 (Aug - Dec)	+13.7%	+11.4%	-2.1%	-0.5%
2003	+33.5%	+28.3%	+28.2%	+51.7%
2004	+25.5%	+21.6%	+10.7%	+8.6%
2005	+18.6%	+16.3%	+4.8%	+1.4%
2006	+13.7%	+12.1%	+15.2%	+9.5%
2007	+20.0%	+17.2%	+5.1%	+9.8%
2008	- 6.9%	- 6.9%	-36.9%	-34.7%
2009	+31.4%	+27.8%	+26.5%	+43.9%
2010 (Jan - July)	+3.8%	+3.2%	-0.1%	-0.6%
CUMULATIVE	+291.9%	+225.7	+41.6%	+69.7%

To put our historical performance in a more usable context, an investor who put in \$100,000 at inception of the Centaur Value Fund on August 1, 2002 and never added to nor withdrew capital from the account would have an account balance on July 31, 2010 after all fees and expenses (but before taxes) of \$325,657. This is an annualized return of just a hair under 16%, versus the approximately 4.4% annualized return for the S&P500 (including dividends) over the same time span. Further, we believe we have accomplished these returns with a significantly lower risk profile than the major market indices.

Further Reading

For some further reading, we have included a recent blog interview featuring Centaur Capital Partners that will hopefully provide some further insight into our investing approach. We are grateful for your investment in the Centaur Value Fund.

Respectfully yours,



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Fund Performance

The financial performance figures presented in this report are un-audited estimates based on the best information available at the time of the letter, and are subject to subsequent revision by the Fund's auditors. Past performance may not be indicative of future results.

Index Returns

S&P500 index returns are reported based on the information provided by Standard & Poor's and include the effect of re-invested dividends. The reported NASDAQ performance does not include dividends, which are generally immaterial to the total return of that index. Index returns are provided as a convenience to the reader only. The Fund's returns are likely to differ substantially from that of any index, and there can be no assurance that the Fund will achieve results that are superior to such indices.

Not an Offer – Confidential

This document is confidential and may not be distributed without the consent of the Investment Manager and does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product. Any such offer or solicitation may only be made by means of delivery of an approved confidential offering memorandum. Past results are no guarantee of future results and no representation is made that an investor will or is likely to achieve results similar to those shown. All investments involve risk including the loss of principal.

Forward Looking Statements

The information in this letter is not intended to provide specific investing advice or recommendations, and is provided solely for information purposes. This letter may include forward-looking statements, which are based upon expectations, estimates, opinions, and assumptions of the manager that are subject to uncertainty and should not be considered a promise or guaranty regarding future events or future Fund performance.

Offer to Provide Additional Information

Centaur Capital Partners LP is a registered investment advisor and is regulated by the United States Securities & Exchange Commission. We hereby offer to provide all investors in the Centaur Value Fund with the most recent version of our Form ADV describing our business activity upon written request.

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Street Capitalist: Event Driven Value Investments

Wisdom on such diverse topics as: spin-offs, merger arbitrage, post-bankruptcy equities, global macro commentary and short ideas.

My interview with Zeke Ashton of Centaur Capital and the Tilson Dividend Fund

I had a chance to interview Zeke Ashton of Centaur Capital and manager of the Tilson Dividend Fund. I think you'll enjoy the interview. Ashton is a generalist, he is willing to short stocks, and looks across all types of companies — from microcaps to large caps. Plus, he's based out of Texas. I've been hoping to showcase more Texas-based fund managers to prove that we're not all energy traders down here. You can find more about the Tilson Dividend Fund [here](#) or learn more about the fund's performance via [Morningstar](#).

My questions are in **bold**.

Can you give us a brief bio of yourself and how you came to run Centaur Capital?

I started my career in the financial software business as a consultant deploying complex treasury and risk management systems for large banks and conglomerates, mostly in Europe. At the time, I thought that my natural career progression might be to become a risk manager for a large bank or insurance company.

Somewhere along the way I developed an interest in the stock market and discovered Warren Buffett's Berkshire Hathaway letters and was immediately hooked. I also was a big fan of the [Motley Fool website](#), and when I decided that I wanted to change careers to investing, I was fortunate enough to land a job there. I moved back to the States and started working for TMF as an investment writer in early 2000 – just in time for the bear market. I spent two years writing articles and research on investing for TMF, which enabled me to learn and refine my own investing approach.

In 2002, I decided that I was ready to start investing professionally, and moved to the Dallas area and started Centaur Capital Partners. I set up a private limited partnership and opened for business with less than \$1 million under management, and it took several years to get to the point where Centaur Capital was a viable business. In 2005, we launched a mutual fund called the Tilson Dividend Fund ([TILDIX](#)) in partnership with our good friends Whitney Tilson and Glenn Tongue at T2 Partners, and that has done well. We've now been in business for eight years, and while it's not been without its challenges, overall I feel very fortunate to be where I am today.

A while back in 2007 at the [Value Investors Congress](#), you gave a presentation (PDF) about how you think about asset allocation at Centaur. Is it largely the same today? Or has the financial crisis influenced your take on capital allocation?

That VIC presentation was primarily a discussion about portfolio construction, and it was really in reaction to what I thought was a growing pressure amongst value investors to run excessively concentrated portfolios. Keep in mind that this was 2007, and the market had produced a long stretch of good returns from 2003 to early 2007. The book "[Fortune's Formula](#)" had become quite popular, and there were many discussions amongst investors about the potential for employing

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the Kelly Formula as some sort of secret sauce that would allow investors to increase returns by increasing concentration.

My own view is that most investors are better off running portfolios of 15-25 stocks because such a portfolio would ultimately be a truer reflection over time of an investor's skill. In other words, a 15-25 stock portfolio has enough concentration to allow a skilled investor to really stand apart from the market, but is not so concentrated that bad luck, bad timing, or one or two mistakes can sink an otherwise competent investor. One of the points of emphasis in that presentation was that concentration shouldn't be a constant, but rather should be idea and environment dependent. It has always seemed to me that each idea in the portfolio should be sized based on a careful assessment of the body of evidence available for that idea, with particular emphasis on risk factors. This would include factors such as how deeply the security appears to be under-valued, how predictable and reliable the business is, how it is capitalized, the quality and track record of the management team, and even how familiar the investor is with the idea. Also, it should be influenced by the presence of clearly correlated ideas in the portfolio.

I believed then and I believe now that using the flexible 20-stock model portfolio position sizing exercise that I described in the presentation is a very solid framework to start with. In looking back over that presentation today, I wouldn't change a thing regarding the content of that discussion. But I'd sure like to have the stock picks back – I presented four ideas at that conference and three of the four performed very poorly in the bear market that followed.

How long do you study a potential investment before you decide to buy? After initiating the position, do you continue your research process on the name?

We generally produce a research document that covers all the important components of the investment, both qualitatively and quantitatively, prior to investing. For a simple idea, the document may well be five pages long. For a very complex idea, the report will be longer. But regardless of the complexity of the idea, writing a research document using a fairly standard template serves as both a form of checklist for us and ensures that we both understand the idea and can articulate why the idea meets our criteria for both value and safety. It also allows for a "quality check" in that it can be reviewed by a second analyst internally and even potentially by contacts outside of our shop that may be able to review our work and provide some insight back to us.

You have mentioned in the past that you are increasingly looking at macro data when making an investment. What kinds of macro indicators do you look at? Has there ever been a situation where a stock looked cheap but you did not invest because of the macro?

I wouldn't say necessarily that we look at macro "data" when making an investment. It is more the recognition that an otherwise compelling idea can get overwhelmed if the larger forces surrounding that idea are negative enough. Going forward, we will probably be a little more cognizant of looking for the larger risks that could really hurt us as investors. As for an example, we basically decided in mid-2008 that we weren't going to invest in any bank or other leveraged financial business given our concerns about the credit environment, and we sold the one stock we held at that time that qualified, which was **American Express** (NYSE:[AXP](#)). Granted, this was an extreme case, but it did help protect us from the worst of the permanent capital losses that many of our value investing peers suffered in banks and other leveraged financial stocks.

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I suspect that our approach going forward when assessing ideas where we have identified a major industry or macro risk would be to use smaller position sizes, demand more compelling prices, or actively look for a way to hedge out any obvious macro risk that we identify if it can be done in a cost-effective way.

When you use valuation methods like DCFs, what kinds of factors do you look at when forecasting? Is it mostly things in the current-year, the past, or your own predictions? How far out do you model?

We use DCFs more as a sanity-check and to reverse engineer current market expectations than to try to produce any kind of precise valuation. When basing our views as far as what the future might look like, we try to look at a longer view of the company's operating history (normally five to ten years) to see how the business has done over time. As an example, one of our larger current positions is **Lab Corporation of America** (NYSE:[LH](#)). Qualitatively, this is an outstanding business with tremendous barriers to entry. There is something of a Coke / Pepsi dynamic in the laboratory services industry, with competitor **Quest Diagnostics** (NYSE:[DGX](#)) the slightly larger company in the industry and LH being a strong number two in terms of revenues. LH has been a consistent but moderate grower over many years, with revenue growth in the high single digits and free cash flow growth at around 10% for the last five years. In looking at the recent stock price of around \$72, when we plug the numbers into a DCF spreadsheet, we find that the market basically assumes that LH will never be able to grow its free cash flow at more than 2% annually going forward forever. Our view of the company's growth prospects is significantly more optimistic than that.

So that's our first sign that LH is a potential opportunity for us.

If I drop in even 5% average FCF growth for LH going out for ten years before dropping down to a terminal growth rate of 2% after that, my spreadsheet tells me the stock is worth \$96. Because I've owned LH in the past and am extremely familiar with the business, I am very comfortable taking the view that the company will be able to grow its FCF much faster than the current market price is discounting. I don't have to be super precise. When the stock gets to \$85-90, it will be a closer call and I will probably respond by reducing our position size somewhat. So we try to use the full body of evidence we have available about a company, but in general we just don't buy stocks that require heroic growth assumptions to justify the current price.

You operate largely as a generalist. Sometimes that entails investing in unfamiliar industries. Can you give an example of a case where this happened? What were some of the things you specifically did to learn the ins and outs of the business?

Yes, being a generalist means that one needs to have a framework for getting up to speed quickly when looking at a company or industry that is new for us. So we have learned to quickly identify the business model, which gives us a huge head start in terms of how to approach the research. There really probably aren't more than a dozen or so basic business models in existence and most companies employ a variation of one of them. Then we start our study of the targeted business and some competitors, and we start reading annual reports, industry publications, and whatever we think we need until we feel we have a good handle on the business. One of the good things about this business is that knowledge is cumulative and the longer I've been investing, the more businesses and industries I've become familiar with and the faster I am able to get up to speed.

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What is one company that you think you would be comfortable with buying and holding for 15 years? Why?

That's an interesting question, and I'm going to have to answer it by changing your question a bit. We've come to believe that if your goal as an investor is to compound at high rates (our goal is 15-20%), that a "buy and hold" philosophy for 15 years simply isn't likely to work except perhaps in very rare cases. To get that kind of return, you have to buy stocks when they are undervalued and sell them when they are fully valued. Therefore, to give you a stock that I'd be comfortable buying and holding for 15 years simply doesn't reflect our philosophy, since over a 15-year period we'd expect to have the opportunity to buy a stock at discounted prices and sell it back at full prices multiple times. Of course we are prepared to wait a long time if necessary to get fair value for our holdings, and there are other cases where the performance of the company results in ever-increasing estimates of fair value such that we can hold on to the position for a long time. But we are usually hoping that we will be able to get full value for our stocks within 2-3 years of purchasing them.

So let me give you a list of companies that we admire and that we very much like to own when the stocks are cheap: **Fairfax Financial** (TSE:[FFH](#)), because we admire Prem Watsa. **Berkshire Hathaway** (NYSE:[BRK.A](#) / [BRK.B](#)) of course. In our current portfolio, I like **Lab Corp** (NYSE:[LH](#)), **Dreamworks** (NASDAQ:[DWA](#)), and a small Canadian company called **Ag Growth International** (TSE:[AFN](#)). In all of these, I either have a great deal of comfort and admiration for the management team, or else the business is extremely unique and enjoys a strong competitive advantage.

One of the things that value investors often talk about with shorting is how it gives you potentially unlimited losses. How do you manage risk with shorts?

Shorting is a very tough business, and we continue to learn new lessons every year. I have come to the belief from talking to several guys who are more experienced than myself on the short side that the best way to manage risk is to keep position sizes small and have a slightly more diversified short book. We also limit the size of our overall short exposure. Unlike the long side, where we have no individual position loss limits, we have historically used a position loss limit on short positions, though over time it has probably hurt us as much as it has helped us.

Can you give an example of a past investment mistake? What do you think happened? What did you learn?

Sure. Rather than give you a specific mistake, I'll give you a category mistake that we've made more than once and that I therefore think is one that investors are extremely vulnerable to. The mistake is one of commitment bias, where for example we will decide that a given idea is very compelling but due to its potential risk is justifiable only as a small position. For example, every once in a while we find ideas where there is a very wide range of possible outcomes, but where either the potential magnitude of the return in the good case scenario is very high or we think the probabilities are favorably skewed in our favor. On balance, we've done OK with this kind of idea. The problems have come when we've initiated the position at an appropriate position size (say, 1% of the fund, or 2% or whatever) but then the stock declines either because of some new development or for another reason. We've often added to the stock and built them to inappropriately large position sizes simply due to the lower price, rather than sticking to our initial game plan of limiting our bet. Because of this, we've occasionally made what would have been a small loser into a bigger loser.

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Another and similar mistake is reacting immediately to a sharp decline in an existing holding on negative news without taking adequate time to fully review the new information to ensure that making the additional deployment is justified by the new development. We try now to be rigorous in ensuring that each incremental add to an existing position is truly justified by the existence of a widening discount to our expected range of fair value and not due to some embedded commitment to the name.

What are some of your favorite books? Investing or non-investing related.

I kind of like to follow good writers around. For financial-related books, I always like to read anything by Roger Lowenstein, with particular nods to his [biography of Warren Buffett](#) as well as his book [Origins of the Crash](#) that described the causes of the tech and large cap bull market of the late 1990's. I think Michael Lewis does fantastic work – his latest of course is [The Big Short](#), but I also loved [Liar's Poker](#) as well as his non-financial books [The Blind Side](#) and [Moneyball](#).

How do you look at the market cap of a company? Are you less willing to invest in large caps? Do you see more opportunities in one than the other?

No, we don't care what the market cap is. We are looking to get the best combination of value and safety out of our investment dollars as we possibly can. I do think that large cap, high quality stocks are as cheap now relative to the rest of the market as I've ever seen them, and that being the case our portfolio is more heavily weighted to large company stocks than it has been for most of our history.

Can you give us a company that you think is undervalued/attractive right now? What is your thesis there?

Sure. **Lab Corp** is our biggest position, and I've already explained our thinking there. Let me give you an esoteric one. This one is a small position for us, because the stock trades on the pink sheets and isn't very liquid. Therefore, I'm not making a recommendation, only naming a stock that I personally think is undervalued and attractive. The company is **Mass Financial Corp** (PINK:[MFCAF](#)), and it trades in the U.S. on the pink sheets under the ticker MFCAF. MFC is a merchant bank specializing in a combination of traditional financing services and proprietary investing, primarily involving commodities and natural resources. The business is run by Michael Smith, who is also the chairman of the company formerly known as KHD Humboldt Wedag and is now called **Terra Nova Royalty Corporation** (NYSE:[TTT](#)).

MFC was spun out of KHD in January 2006, and had negligible book value at the time of its spin-off. The stock trades for \$9 and change, and has a market cap of approximately \$200 million. In the last four years, MFC has averaged over \$40 million in net income and over \$50 million in free cash flow. Here's the book value per-share at the year-end each of the last four years, starting basically from zero at January 2006 (note that the book value per share figures are adjusted for a 9% stock dividend issued in late December 2009):

December 31, 2006 \$2.43
December 31, 2007 \$4.39
December 31, 2008 \$5.71
December 31, 2009 \$9.72

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Going back further, prior to folding MFC into KHD, Michael Smith ran the company (then called MFC Bancorp) from 1984 to 1995, and during that stretch he grew book value from \$1.49 per share to \$17.09 per share, which is a pretty impressive performance. Overall, we think that MFC is a very intriguing investment at a discount to book value given the impressive track record.

The downside to an investment in MFC is that there is never really any way to know what Michael Smith is up to. Smith's policy is to report financial results every six months, and only issues press releases when a material development occurs. In addition, the company's disclosures are not as highly detailed as one might like regarding its merchant banking and direct investment activities. Nevertheless, the performance of the company speaks for itself, and MFC has an extremely strong and liquid balance sheet and uses very little leverage in its activities, making the historical performance that much more impressive. A couple months ago, MFC took over a majority interest in a micro-cap Canadian listed company called **Canoro Resources** (CVE:[CNS](#)), which has some very interesting oil and gas assets in India. As I mentioned, MFC is a small position for us, but I like having it in the portfolio.

Zeke, thank you for taking the time to interview with Street Capitalist

About the Street Capitalist Author

My name is Tariq Ali, I run Street Capitalist. I recently graduated from the University of Texas at Austin. There, I stumbled onto value investing via the school library. I read everything I could and now I'm here, writing out my thoughts and investment ideas.