THE GLOBE AND MAIL

A rocket scientist’s formula for beating the market

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If you grew up in the early days of manned space exploration, you might have dreamed of becoming an astronaut. Unfortunately, only a few people actually made it into space. But many others, like James East, helped to get them there.

Mr. East spent more than a decade designing the engine parts that lifted NASA’s space shuttles into orbit, before deciding it was time for a change of career.

These days, he can be found running the successful ACI Partnership Fund LP out of Charlotte, N.C. His shift of occupations was prompted by friends and colleagues who knew about his investment record and wanted him to manage their money.

Mr. East developed his interest in stocks when he was a boy. As a preteen he was a devoted follower of the Cincinnati Reds and became intrigued by the stock section in the newspaper, which appeared near the statistics on his favourite ballplayers.

However, it wasn’t until he was nearly 20 that he developed a keener interest in the market. It was then that he read *The Intelligent Investor* after hearing the book publicly recommended by famed investor Warren Buffett.

Benjamin Graham’s classic treatise on the art of stock selection was a revelation for Mr. East and persuaded him to become a value investor. Nearly three decades later, he still characterizes his approach as being more than 90 per cent old-school Graham.

Practically speaking, that means Mr. East tries to buy companies that trade at sharp discounts to book value. Ideally, he would like to buy a stock at a 50-per-cent discount to book value – “the ol’ 50-cent dollar,” as he puts it. But he often starts nibbling at 60 to 65 cents on the dollar and may go a little higher depending on the quality of the company.

He started his fund in the waning days of 2007 and it has performed very well since then. From the start of 2008 to the end of 2012, it gained an average of 13.3 per cent annually before fees and 11.5 per cent annually after fees. By way of comparison, the S&P 500 advanced by an average of only 1.7 per cent a year over the same period.

Even more remarkably, the fund hasn’t had a down year since it started and that includes 2008, which was downright awful for most investors.

The fund’s portfolio gained 10 per cent in 2008 thanks, in part, to a large cash position and an investment in Fairfax Financial Holdings Ltd. The Toronto-based insurance company run by noted value investor Prem Watsa fared well during the market crisis because of a series of savvy hedges that allowed it to profit from the U.S. housing debacle.

Mr. East still has about 24 per cent of his fund’s assets in Fairfax, which he views as being very defensive due to the company’s extensive hedging program, designed to cushion it in the event of a stock market decline.

Unfortunately, like many value investors, Mr. East isn’t finding many bargains in the market at the moment. As a result, his fund’s cash levels are back up to about 28 per cent of assets.

But he did recently buy a few shares of Telcom Italia SpA. The telecommunications company operates out of Milan and offers telephone, mobile and broadband services to customers in Italy. It also has a large mobile phone business in Brazil and other South American countries, which makes it an interesting combination.

The company isn’t for the squeamish because it lost money over the last two years. But the poor results have led to low prices on its shares. These days the stock trades for only 73 per cent of Mr. East’s estimate of book value. With a bit of luck, it will help his portfolio climb skyward.