"While there are some Warren Buffett in the world, identifying one is like finding a needle in the haystack", Burton Malkiel, Economist, Princeton University.

ACI Partnership Fund: A Needle in the Haystack

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Mr. Malkiel was probably not too far from reality, as very few individuals have been able to outperform the market over time. However, he probably didn't know about GuruFocus.com, which follows the best investors, those with proven track records and who usually outperform the market in the long term.

ACI Partnership fund is one of the few needles found in the haystack, a real compounding machine delivering an outstanding performance since its inception in 2008 with, according to my calculation, a 257.8% return compared to 163.4% for the S&P 500 index (including dividends) over this same period*. The following interview will probably convince you, just as I was, that James East, who manages the ACI Partnership fund portfolio, is an exceptional investor with an astute mind that few other investors possess.

History of ACI Partnership and James East

James East is the founder and capital allocator at ACI Partnership. Mr. East is a former engineer who became a full-time investor. It was at the young age of 11 that he bought his first stock "Uniroyal", known as a tire company, but also for its tennis shoes which he liked when he was a kid. He then read Benjamin Franklin's autobiography and was introduced to the power of compounding. He was good in math and went on to study aerospace engineering at Georgia Tech while maintaining a real passion for investing as a part-time hobby. As an engineer, he had a successful career and worked for 10 years on the development of rocket engines for the space shuttle at NASA.

During his studies, he learned about Phil Fisher, which led him to learn about Warren Buffett, then Benjamin Graham. At the onset, his investment style was 85% Fisher; now it is 85% Benjamin Graham and 15% Phil Fisher, in order to focus more on the downside. He identified seven different approaches used by Benjamin Graham: two associated with price and five with quality. While the net-net approach covers but a small portion of Benjamin Graham's written works and is something ACI Partnership fund never did, its main aspect is to focus on the risk of losing permanent capital, and for the ACI Partnership fund it's really a quality assessment rather than a quantitative issue.

The Interview

When we look at the performance of your portfolio, you registered positive returns during the financial crisis. Can you explain to us how this was accomplished?

It had a lot to do with the process of looking to protect the downside and being very selective on the price; this imposed a limit on buying just anything. At the time the market was becoming inflated. In this 2006-07 period, I had my radar list of investment prospects, but not one even came close to my targeted purchase price. Since I couldn't buy anything, our cash level in the fund kept growing, and we got close to a 40% cash position, and we also had a large position in Fairfax. Fairfax delivered good returns during the crisis because they profited from the CDS purchase to protect them and also it allowed them to profit from the crisis.

It all boils down to psychology; I had the personality to be patient. As Charlie Munger said, you need to sit and wait, it's not easy. You see your friends with Facebook and Netflix going up every day, so you have to fight this little envy or jealousy and wait for your fat pitch, and fat pitches come rarely. To make an analogy with baseball, I hit lots of singles, some doubles and occasionally some triples.

Do you take the macro-economy into account?

I'm very micro, focusing on specific companies, but at the same time you need to keep an eye on the macro. You can't completely ignore it, but if you are like Warren Buffett you don't have to worry about the macro. Should you be running under a billion dollars, I think you need to at least be aware of what's happening in the macro level.

As an average investor, you should at least be aware of what's happening in your country. For Canada, a question to ask would concern the real estate. Is there an issue there? We will see how it evolves with time.

Where and how do you find investment ideas?

As an example, let's take a look at Greece. The headlines say there's a carnage underway in Greece and everybody's leaving; that's a place to just start looking. So you start, and my technique is to draw up a list of between 30 and 100 stocks to keep under my radar, for different periods of time. They are potential investment ideas that may eventually reach the right price. The companies on the list are all companies I have already researched in order to understand their competitive advantage. If they prove to have some and go on to reach a certain level, I go into a deeper research mode, and evaluate potential problems. There might be management issues, and you estimate their probabilities. Some ideas may be under the radar for a long period, and most of them have been for 3 to 5 years, some for 10 years. That reminds me a story of Warren Buffett, who sometimes read some annual reports for decades before finally buying some shares in a company.

Can you give us an example of a company that was on your radar for 10 years?

Old Republic Insurance. During late '99, early '00 dot-com crisis all the stocks were going down. Those were incredible times, all the value stocks were going down every single day. I then had a 10-year history on this particular company, not necessarily the best company I ever came across but at the then price of 40 % of book value, it was making money, had an interesting yield, was stable and it was not going bankrupt.

There was a good variety of that type of opportunity available during the crash. This is really my strategy: I have my radar list of companies on which I do some research and when the price becomes attractive, I do more research to dig even deeper.

Are you always waiting to do deeper analyses?

You have to be quicker these days, more than 5 or 10 years ago. I have usually done enough research to know my comfort zone, and when the price gets closer to it, I start diving deeper, always looking for competitive advantage. I ask myself: How much lower can it go before the market starts to turn around again? Then I try to assess the causality that created the low valuation, for example is it a sector or a management issue? You assess the probabilities for each situation and then revaluate your buy price. It may also happen that I decide to discard it from the radar because the new research reveals that it's not a good investment.

Do you have another example for us?

Yes, a recent example happened a few months ago with Dreamworks. For some reason, one day the market told me that I didn't want Dreamworks anymore. It sold off 15-20% over a couple of days for no reason, no nothing; it was a great opportunity so I pulled the trigger on it. I had Dreamworks on my radar for three years, and at one point it was really close to my buy price, then came a buyout rumor and the stock went up. This is the problem with value investors, we wait for the price to be cheap and it never gets there.

Over the last 3 years they had done some reorganization in the corporation which increased the intrinsic quality of the business. Their production costs, overhead and expenses were too high. The management realized that, and reduced the quantity of movies instead of diluting talent. They reduced their production costs. They also started to become more of a content provider than a movie producer, signing some content contracts with Netflix and Verizon, for example.

In this example the opportunity lasted only 4 or 5 days, so you had to be quick. And this is the market we have these days, so we have to be quicker. I was able to buy it because I revaluated the business and it was a better business than 3 years before. I evaluated it from a balance sheet point of view: they had redeployed some of the capital. There was a very limited downside in my opinion with a really positive upside.

Do you first look for the downside?

Yes, my first assessment is the downside, always. Using George Soros' terminology of reflexivity, these phenomena always overshoot. They overshoot on the top and they overshoot on the bottom. If I can figure out what the floor is, although it's potentially going through the floor. As value investors, we always buy too early and we sell too early. When you have a 10-15-year history and you look back at your own result, you realize that you always buy too early and sell too early, obviously those are your winners. For your losers, obviously, you bought too early and didn't sell early enough.

How has the idea of Reflexivity as it applies to financial markets promoted by George Soros, influenced your thinking?

I'm an engineer by training, so I was very familiar with reflexivity in the first place because of feedback loops that make complete sense to me because I see them in nature, I saw them in dynamics, and with an engineering background you see those patterns all the time. Feedback loops always overshoot; it's the same thing with the market, they always overshoot, they overshoot on the top, and they overshoot on the bottom.

Right now we have a record of buy backs, but in 2008-09 you couldn't find a company that was doing buy backs as most of them were scared. In 2010-11 the level of buy backs wasn't that high, so I asked myself, why don't you buy back your stock? You should be buying your stock! Now every company out there wants to buy back its stock, it went up 2x or 3x since 2008-09 and now they are buying it back!

Can you give us an example of reflexivity for a particular case?

Fairfax would be a good example in 1997-98. At that time its stock was traded at more than 4 times its book value, it was over the price I would have paid. They issued shares at those prices to make their acquisition of the undervalued insurance business, which had the effect of making a high price go higher; that's reflexivity on the upside. It was trading close to $550 (Canadian dollar) per share, they made two acquisitions that didn't meet their expectations and the company got into trouble, driving the price on a reflexive process on the way down to $70 per share in 2003.

Fairfax has been one of your larger holdings for 15 years, can you comment on this?

Fortunately and unfortunately, we were in Fairfax during their hard times and rocky roads. Many lessons have been learned through the Fairfax story. I think that finally the story is widely known and in a good way in the investment community, because they had some really bad breaks, some self-inflicted wounds, but underneath all of that cacophony, there is really a fantastic underlying business. For example Fairfax Asia is unbelievable, Odyssey RE is probably the gold standard in Reinsurance.

So there are many qualities in Fairfax that don't reap the appreciation that they should because of the overhanging issue that the investment community has with Fairfax. For example the community is asking: "Why you are hedging?'' The answer is that they are trying to protect their capital because of the past experience they had, as they never want to be in the same situation again.

Another example is they just bought BRIT insurance, fantastic, unbelievable, that's what Fairfax wants to do and it's also what their Shareholders want them to do. They bought 100% of Brit but turned around and announced they will sell 29%. They had just bought the shares, so the shareholders were wondering what was happening. At the shareholders meeting they gave a good reason: In 4 years, they will own it 100%. So it's something that came out in the press release, it doesn't always. You need to know the historical reference and the character and principles on which decisions are made. Even though I trust them, I don't always agree with what they do, but as I said, it's my biggest holding and I have been with them for a very long time.

Going forward, I think Fairfax is in a sweet spot because of the global footprint and platform they have in insurance operations and to be honest, the insurance industry hasn't been that great over the last 10 years, except for Odyssey Re and Fairfax Asia, but they have been overshadowed. It took them literally 10 years to recover from the Crum & Foster problems which they had bought, along with TIG. The due diligence they now perform is quite superior, they learned a lesson and I know Fairfax will not repeat those same mistakes again.

I had my opportunity because of their mistakes. Historically they are value investors, they are a team, and they are truly honest, they just make mistakes. Regarding the story that came out in the media on Fairfax from 2001 to 2006, 99% of it was false, and much of it has been proven to be false. There's an ongoing legal

case out there trying to prove that 100% of it consisted of false accusations, but from an investor point of view it's been resolved fairly.

Going back to the 7 Graham approach template, 2 about cheap prices and 5 about qualities, do you look more for qualities?

It took me a while, I was stuck in the growth camp. From 25 to 35 years old I advocated the Fisher compound stock growth and better business. But after reading more Graham I really changed to be more concerned with protecting the downside.

I think that a successful investor can be a trader in private equity, commercial real estate and many other fields, but the really successful are those who match up their investments with their personality. My personality is more laid back, patient, if I were not patient I would not have lasted so long with the Fairfax investment given their volatility. It did hurt, but differently from owning a growth stock, the difference being a deep value situation that becomes extremely undervalued because of bear attacks that I hold onto because of my personality and the research I did. Matching your personality to your investment style is really important. For example, there are successful venture capitalists that probably don't have the personality to be a successful value investor. For my part, I need to see the business history that allows me to see the value, and I mean value in the tangible and intangible more on the quality side, be it brand, better costumer contact, and length of time in business.

So there are all kinds of adjustments I make on the assets but also and more so on the liabilities, most of the time increasing them. Regarding the assets usually I cut them and most of the time there's little advantage left when compared with the market of that day. Also, the balance sheet will correct itself if the right management is in place and if you are correct on your analysis.