Interview With Joe Boskovich Sr. Of Old West Investment Management

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First off, could you tell our readers a little about Old West and your investment strategy?

My partners and I started Old West in October 2008 at the depth of the financial crises. At the time, it seemed like a crazy period to start a money management firm given the turmoil in the markets, but that's also what conventional thinking would tell you. Like many value investors, we think a little differently. The last 8 years have been good for the overall market, but it has also been a difficult and frustrating time period for active managers. I believe that value investing will reward the active management community greatly over the next many years, and we are very excited about our future and many of the companies that we are invested in.

Our investment strategy largely focuses on the people in control of our capital. As a first principle, we believe that the surest way to protect and grow our capital is by aligning ourselves with management teams who have high stock ownership and smart pay. It is our contention that incentives matter deeply, and that there is no surer way to understand the character and motivation of a management team than to study stock ownership, and how management gets paid. In the time that it takes us to print out the proxy statement and study stock ownership, pay levels, and the business metrics that drive incentive pay, we are able to intelligently eliminate the vast majority of the potential companies that would otherwise absorb much of our time and resources. Simply, we seek to invest with management teams that have more to gain or lose through their equity ownership than they do through their compensation.

A second and equally important consideration is valuation. Not only do we seek companies that are led by talented owner operators, but we want to buy into those businesses at substantial discounts to our assessment of their intrinsic values. We spend a lot of time trying to understand what will make a company's stock price appreciate. It is unlikely that a company will appreciate just because it's undervalued, so we try to identify catalysts that the market will recognize.

How do you go about finding potential opportunities, where do you think the best ideas come from?

We find potential investment opportunities in a number of ways. We read a lot of industry periodicals, we look at special situations, we talk to our network of business leaders from varying industries and we talk to other like-minded and value oriented investors. However, I have found that our best ideas are sourced from Form 4 filings and 13-D filings. We monitor every purchase or sale of stock by insiders, every day. If a CEO and/or several directors purchase millions of dollars of their own stock in the public markets, we will print out the proxy statement to determine if we too think it might be an attractive investment. Once the proxy is printed, we will look at total stock ownership by management, study how that ownership was accumulated, and most critically, seek to understand total stock ownership as it relates to compensation.

What do you look for in a prospective investment, what makes you say, "yes we want that" or "no we don't"?

We look for undervalued and/or misunderstood investments that can ideally earn high returns on capital, and for investments where we can invest alongside great and proven owner/managers as silent partners. The process by which business value will grow is a direct function of management's approach to capital allocation, and we spend a lot of time trying to understand the various capital allocation levers at management's disposal. Because there is not a single and quantifiable data source to vet such issues, it requires a fluid and qualitative analysis that considers past actions as a way to understand how management will make future decisions. If we can't get comfortable with management, we simply move on no matter how compelling the valuation.

How much concentration are you prepared to take your portfolio?

We concentrate our capital in our most compelling ideas, and about 60% of our AUM is weighted in our top 10 names. We believe that our best idea is better than our 20th best idea, and that our clients will be better served by allocating incremental capital toward the former. Further, our knowledge about a business will inherently decline with the number of businesses we own, and we struggle to see how less knowledge translates into less risk. Average position sizes for a long position range between a 5-10% investment. A full sized 10% position is typically allocated to a company led by talented owner/managers at a great price, whereas a smaller 5% position might be made in a talented owner/operator run company at a fair price. For short positions, our average position size is significantly lower (2-3%) because of the inverted risk/return profile.

At the end of July, Old West Investment Partners had a short exposure of 40.4%. What's your strategy for finding shorts, what would be the perfect short situation for you?

On the short side, we selectively sell short companies with the goal of achieving attractive absolute returns on capital. Selling stocks short allows our clients to profit from the time that we already spend monitoring all insider transactions. Our focus is on shorting companies where senior executives and insiders are liquidating large portions of their personal stock holdings in both dollar terms and as a percentage of their total ownership. We then focus on those companies with poor and deteriorating quality of earnings, related party transactions that suggest a manipulative management team, and/or an excessive over-valuation to fundamentally support a short sale. Significant insider selling preceded the technology bubble in 2000, the sub-prime and housing collapse in 2008, and many of the biggest corporate failures of the past decades such as Enron, Tyco, Worldcom, Adelphia, and Countrywide Financial. Had you simply refused to own companies that displayed significant insider selling over the past 20 years, investors would have come out of the past two bubbles much better than the general investing public.

Would you mind sharing some of your current holdings, or perhaps your highest conviction idea?

Two of our core holdings are Fairfax Financial and Sears Holdings. Both companies are rarely discussed by the mainstream media, but fairly popular among Value Investing circles.

Fairfax Financial is an insurance holding company based in Toronto, Ontario, and is led by the tremendously talented Chairman and CEO, Prem Watsa. Like Buffett, Watsa has made his shareholders a fortune by taking the premiums that Fairfax receives from its various insurance agencies worldwide, and investing those premiums in stocks, bonds, and other assets. Since 1985, Prem Watsa has compounded book value per share at 21.15% annually, and the common stock price has compounded at 19.8% annually.

Prem Watsa has amazingly navigated his company through and profited off of some of the most volatile investing landscapes. He sold half of his stocks and bought S&P put options ahead of the stock market crash of 1987, he bet big on Japanese puts- or rights to sell stocks at guaranteed prices – ahead of the Tokyo stock market collapse in 1990, and he made a fortune for his clients during the 2008 subprime mortgage crisis and the United States housing bubble. Today, we believe that Fairfax Financial is uniquely positioned to profit during the next bear market. Watsa sees global stock markets as overvalued, and he has instituted major hedges against a market drop. At the end of 2015, about 90% of the Fairfax's equity and equity-related holdings were subject to defensive equity hedges and deflation protection. In short, if the market drops, Fairfax gains!!

Despite Prem Watsa's bearish views on the global stock market, Fairfax continues to identify many exciting investment opportunities for its long book, and our stake in Fairfax gives us exposure to those long term investments. For example, in 2011, Fairfax purchased a 9% stake in the Bank of Ireland, and last year cashed in those shares for almost four times what they were worth at the time of purchase. In November 2014, Prem Watsa formed Fairfax India, a new $1 Billion investment holding company that is 30% owned by Fairfax Financial. This entity is aimed at acquiring control or significant influence positions in Indian companies based on Prem Watsa's confidence in the "business-friendly government" of Indian Prime Minister Narendra Modi. Fairfax also has a large position in IBM, which we believe is in the midst of a formative transformation. The company continues to shed low margin business in favor of higher margin enterprises such as IT Infrastructure in the Cloud and Data Analytics such as its Watson subsidiary which is becoming an integral part of our healthcare system. The stock is trading at a ridiculously low price of $158 per share (10x earnings), down from $215 per share. Berkshire Hathaway is the largest holder, and they continue to add to their position. We see very limited downside with huge upside potential.

Bank of Ireland, Fairfax India and IBM are just a few examples of long term investments that Fairfax has been purchasing despite an overall negative macroeconomic view.

Sears Holdings is a company that we have owned for several years, and although it has been a large drag on our track record, we believe that it will be a big boost to our track record in the near future. Our thesis on Sears has always been the sum of the parts asset value, not Sears the retailer. One year, ago, management (Eddie Lampert) spun off 266 of their 1,727 properties into a REIT called Seritage Growth Properties. A widespread belief is that the best properties were spun into the REIT, robbing Sears Holdings of its last remaining value. This is far from the case. The 266 spun properties only represented 15% of their total property count, 20% of their square footage, and 1/3 of their owned properties. The quality of the properties still retained by Sears Holdings closely mirrors the quality of the real estate spun off. In exchange for these 266 properties, Sears received $3 billion, a fair value, in cash. Not only did this monetize an asset not earning anything, but it provided the company, and Eddie Lampert, options for capital allocation, a talent for which he is much better suited than as a retailer.

Besides the remaining 160 million square feet of retail real estate, other valuable assets include three iconic brands (Kenmore, Craftsman, Die Hard), 800 auto centers, a re-insurance company, a product protection and warranty business, net inventory, and the largest home repair and installation operation in America. This past year, the two largest shareholders, Eddie Lampert and Bruce Berkowitz, continued to accumulate more shares. Together they now own 77% of the shares outstanding. We believe the sum of the parts valuation is in excess of $100 per share (today's price is $17). There are many possibilities for how this all plays out, but we are confident in Sears and it's transformation. For example, Sears recently announced that they would explore strategic alternatives for their Kenmore, Craftsman and Die Hard brands. Another example is the newly branded Innovel Solutions, a 1,100 truck delivery service that has signed up the likes of Costco and the U.S Military and is making money.

One of the stocks on the long side you like is Cheniere Energy. Could you walk us through your investment thesis here?

Cheniere, whose stock symbol is aptly L.N.G., (Liquified Natural Gas) is one of our newest investments, and one that I am hugely optimistic over. LNG is in the business of sourcing natural gas here in the U.S. and shipping it all over the world. LNG first came to our attention several years ago when we noticed legendary investor Seth Klarman of the Baupost Group accumulating shares. Another legendary investor, Carl Icahn, is the largest shareholder and two of his lieutenants have board seats. Today, Baupost owns 30 million shares (12.7% of the company) and Icahn owns 32 million shares (14% of the company). Both of them have an average cost in excess of $55 per share, far above today's price of $44.

I generally don't think much of CEOs who appear on CNBC's Jim Cramer show. I would hope they are too busy running their company to participate in such a circus. I watched interviews with LNG CEO Charif Souki, and I was totally turned off. He appeared to be a jet setting, fast talker who spent a fair part of the year in Aspen. I decided not to touch the stock with him as CEO. When I heard he was fired, I was excited and anxious to see who they would hire. Jack Fusco, CEO of electric power plant operator Calpine, left a very good job to take over as LNG CEO. Fusco has spent his entire career in the utility/ power plant/ natural gas business and seemed perfect for the role. I was also thrilled to learn that Fusco agreed to buy $10 million of LNG stock, and he was given another $10 million of restricted stock as part of his package.

To ship natural gas overseas by vessel, it needs to be converted to liquefied natural gas (LNG). The natural gas is delivered to the terminal where it's chilled to -240°F, a temperature that transforms vapor to a liquid, compressing its volume 600 times. Once it arrives at a foreign destination, it is deliquified for use. Thanks to technology in oil and gas production, the United States has become the leading natural gas producer in the world, and natural gas usage continues to grow dramatically. Much of the world is dealing with air pollution, and some of the biggest contributors are coal fired power plants. Wind and solar plants are still in their infancy, and are very expensive, and nuclear powered plants are problematic to say the least. Natural gas fired plants aren't pollution free, but are much, much cleaner than coal plants. Natural gas is also used heavily in manufacturing plants, production of chemicals, and on highway and off highway trucks.

LNG has two locations where they operate what they call "trains". Each train is a terminal where the gas is liquefied and transferred on to a vessel. LNG will have six trains at Sabine Pass, Louisiana, and three trains at Corpus Christi, Texas, both locations situated on the Gulf of Mexico. All trains at both locations should be completed by 2019. After years and years of planning and construction, Train One at Sabine is completed and they shipped the first vessel two months ago. Construction giant Bechtel Corp. is building the projects, and total project cost is estimated to be $30 billion. There are competing LNG projects being developed around the world, including Chevron's huge Gorgon project in Australia. The fact that Cheniere began the process several years ago gives them an advantage as they have supply contracts with users all over the world. LNG has supply contracts with British Gas, Gas Natural Fenosa of Spain, Korea Gas, Gail Limited (India), Total of France, Centrica (U.K.), PT Pertamina (Indonesia) and more. With these supply contracts, LNG is paid a fixed fee to liquefy and load the LNG on to the vessel. They are not taking market risk with the price of natural gas. There is talk of oversupply of L.N.G. in the future, but Cheniere is in a great position having all these customers signed to long term supply contracts.

The LNG investment is not without risk. A major concern of ours is the amount of debt the company has. As I stated earlier, the total project cost is estimated to be $30 billion, and LNG has $16 billion of long term debt, and this number could increase. However, the company estimates they will have in excess of $1.0 billion of free cash flow within five years. The company is confident they'll have no problem servicing and repaying their debt. The bottom line is, we in the U.S. have enormous reserves of natural gas, and the world is using more of it every day.

You also like gold and owned several gold miners earlier in the year. Is this a theme you still like and are you still buying gold miners after recent gains?

Yes, we still do own several gold miners, and I am very excited about the outlook for these companies. Much of what I see going on in the world today favors the ownership of gold in one's portfolio. I believe there are several dynamics that will push the price much higher in the near future.
Consider the following factors:

- Interest rates at a 500 year low. Today's low rates could cause another financial crisis, bankrupting pension plans, putting retirees at risk, and hurting stocks. Gold, which has no yield, now has as good of a yield as holding cash!!!

- Every central bank in the world is implementing monetary easing, which results in the steady debasement of fiat currency. I believe gold is a form of currency, yet it is the only currency in the world that is limited in supply.

- The constant threat of terrorism

- An explosion of debt in China, with thousands of bad loans being rolled over into new loans. China's banking system is now $35 trillion, which is larger than that of the U.S., with a much smaller economy.

Keep in mind we are not investing in gold bars or the GLD ETF. We are investing in companies that produce a product with ready and growing demand. How did we choose the mining companies in our portfolios? First, following our investment process, we own companies run by owner/managers. Management teams that are heavily invested in their company, combined with modest compensation packages that are respectful to us shareholders. Second, when a company's revenue is dictated by the price of a commodity, a strong balance sheet is imperative. The price of gold can be at or below breakeven for long stretches, and too much debt can be crippling. Third, reserves must be in business friendly and stable countries. Many mining companies have reserves in countries like the South Africa and the Congo, and if the price of gold was high enough, nationalization would be a real possibility. Our miners have reserves in Canada, Chile, Mexico and the good old U.S.A. Our two biggest gold mining positions are New Gold and Novagold.

NEW GOLD, INC (NGD)

New Gold is a Vancouver based mining company with properties in Mexico, Canada, the U.S., Australia and Chile. If the price of gold goes as high as I might speculate, I take comfort in the fact that NGD's mines are in countries that are politically stable.

Randy Oliphant is the long time CEO of NGD, and he has done a wonderful job of positioning NGD as one of the low cost producers in the industry with an all in cost of just over $800 per ounce. With today's price of $1,340 per ounce, the company is operating well in the black. Oliphant owns $20 million of stock in the company, so our interests are truly aligned. The company has $500 million of liquidity with $219 million in cash. Although NGD has not been profitable the past two years due to the low gold price, they could become extremely profitable in the future as the gold price recovers and new production comes on board. Pierre Lassonde, known as the godfather of mining, has been a long time director, and he owns 6 million shares of stock. Better known companies like Newmont and Barrick are mostly mentioned in the media, but I much prefer New Gold as a long term investment.

NOVAGOLD (NG)

Novagold has no income and doesn't even generate revenue, but they are sitting on one of the largest known reserves of gold in the world. The Donlin project is located in Alaska. The proven reserves of Donlin are 40 million ounces of gold, plus huge amounts of copper and silver. Dr. Thomas Kaplan is Chairman of the Board, and owns 80 million shares of NG, or 25% of the company. Dr. Kaplan has a long history of successfully investing in precious metals and energy. The second and fifth largest investors in NG are legendary investors John Paulson and Baupost Group's Seth Klarman.

The Donlin project is a 50/50 joint venture with Barrick Gold Corp., and production is still a few years off. I love the fact that they haven't been burning fuel, tearing up equipment and depleting resources the past few years at low prices. Hopefully once production begins the gold price will be much higher.

NG has $117 million of cash and short term investments, and they are burning $20 million per year as they continue through the permit process. They have plenty of liquidity to bring this project to be construction ready, at which time I predict they will sell their interest to a major miner and possibly Barrick.

The market seems to be reaching new highs almost every day valuations continue to rise. What's your playbook for the rest of the year, are you preparing for a downturn?

I do not know what the markets will do for the rest of this year and next. I think there are a lot more negatives than positives, and investing in the broader market today would really scare me. I think index funds might be in for a rude awakening over the next few years. I believe holding cash or having a large short position needs to be a function of a research process rather than making some sort of macro prediction, which is unknowable. On that note, our short book is abnormally high. The ratio of insider selling to buying in companies is extraordinarily high.

What I do know is we own a collection of high quality companies run by great management teams, whose interests are aligned with ours, and that are selling at attractive prices. We are excited about our portfolio companies and think that they have bright futures.

And lastly, what experiences have shaped you personally as an investor?

Before entering the investment business almost twenty years ago, I spent the first part of my career running a family farming and food processing business. At the time, our company farmed 25,000 acres of crops in California, Arizona and Mexico, and we employed 1,000 workers. My experience running a large business has been very important in how we approach investing at Old West. Business is more than just numbers, and it's very easy to lose sight of this when you are staring at financial statements all day long. Being able to approach investing as not only an investor, but also as a business operator, has been very beneficial to me in my investing career.

One particular experience that I constantly think about, was when I was asked to serve on the Board of a small regional bank in my early 30's. The bank was called Santa Clarita National Bank, and our family farming operation was the bank's largest customer at the time. This was in the 1980's before the computer era, so information wasn't as easily attainable as it is today. Every quarter at the board meeting, we would receive a bound booklet with all the relevant information for the past 3 months. One section of the materials listed each of the stock transactions that had occurred over the past quarter, and for several quarters running, I had noticed that many stock purchases had been made by the bank's Chairman. After watching this for several quarters, I approached the bank Chairman and asked that I be able to purchase stock alongside him. The following day, the bank secretary contacted me, and I purchased what was a meaningful amount of stock for someone in his early 30's. Several years later, Santa Clarita National Bank sold to Security Pacific Bank, which is now part of Bank of America, and I made roughly 10x on my original investment. The lesson learned is that it is quite possible that nobody knows the future plans and direction of a company more than the people in charge of allocating its capital. This doesn't mean that we should always follow management's lead, but it does make us think long and hard about their possible motives.

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