CHAPTER 1

Vagabond Value

Investor: Christopher Rees

Date of Birth: November 20, 1950

Hometown: Puerto Plata, Dominican Republic

Personal Web Site: www.tenstocks.com

Employment: Full-time investor, runs a subscription advisory

Passions/Pursuits: Workaholic, spends free time with wife and daughter

Investment Strategy: Deep value, special situations

Brokerage Accounts: TD Ameritrade

Key Strategy Metric: Tangible asset value

Online Haunts: www.marketocracy.com, www.valueinvestorsclub.com, www.10kwizard.com

Best Pick: Elan Corp., Up 143 percent

Worst Pick: Flag Telecom, Down 100 percent

Performance Since October 2000: Average annual return 25 percent versus 0.21 percent for the S&P 500[1]

Subsistence living is something that most of us never even consider. Living on the edge of poverty is, after all, the stuff of nightmares. It's the downside we try never to think about.

But for nearly 30 years of his life Christopher Rees thought about subsistence living or "just getting by" nearly every day. Understanding his downside was a way of life. From age 19 to 49, Christopher Rees was a vagabond, moving around the globe from city to city, working in low-paying jobs, earning just enough to keep him going until his next stop. He became masterful at understanding how to stretch a dollar.

In fact, figuring out the bare minimums of survival became a religion for Rees. It is a lifestyle that also set the foundation for Chris Rees's highly successful investment style.

Since October 2000 Chris Rees's Marketocracy.com portfolio (10STX) has logged an average annual return of 25 percent compared to less than 1 percent for the S&P 500 (see Figure 1.1). This impressive record incorporates a 40 percent loss during the financial meltdown of

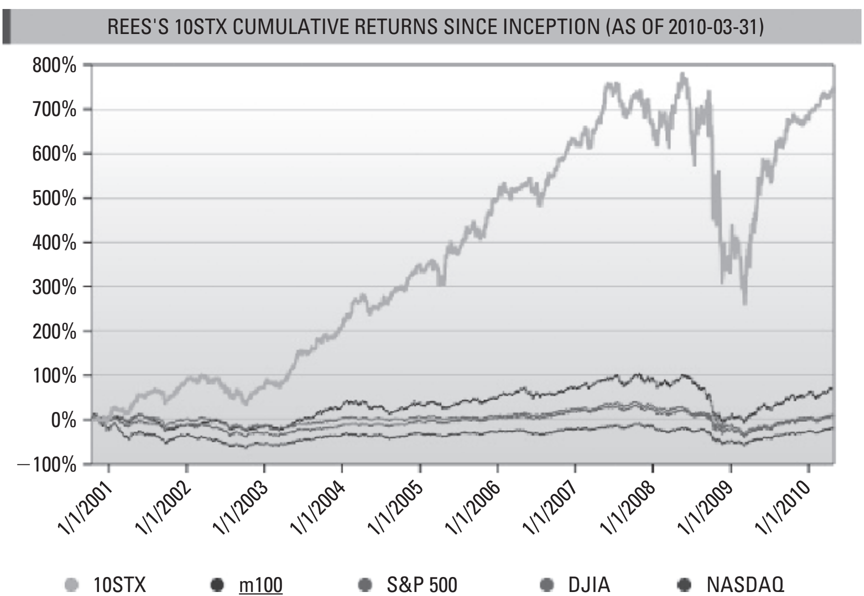

Figure 1.1 Chris Rees versus the Market

Note: Returns are after all implied fees including 5c/share transaction fees; SEC feeds; management and administration fees of 19.5 percent.

Source: Marketocracy.com; data as of March 31, 2010.

2008. It would be difficult to find a skilled hedge fund pro with Rees's stats. Among his closed stock positions, 89 percent have been winners.

Central to Rees's investment strategy is figuring out what a company's true net worth is. That means stripping out all of the fluff that is prevalent on CPA-certified corporate balance sheets.

Tangible asset value, real earnings, and debt levels are what Rees obsesses about. Just as he did during his vagabond days, he wants to know the bare minimums for a company's survival so he can determine the risk he faces investing in a stock. Chris Rees wants to know the downside—the worst case. And if a stock is selling at 50 percent of what he reckons its value is, then he buys. Rees's motto is taken right from the pages of Warren Buffett's playbook. Simply, "Don't lose money."

Tangible Tactics

In a connected, always-on world where time is a precious resource and complexity and multitasking have become a way of life, Chris Rees is an unapologetic heretic.

He simply will not abide by this lifestyle, and this attitude infuses into his investment strategy. Life has a slower, simpler pace in the Dominican Republic where Rees resides. Temperatures rarely get below 70 degrees Fahrenheit, and the heat and humidity make siestas a way of life. It is a culture where patience is a prerequisite and "*mañana*" may be the most common refrain.

Simplicity is also a virtue for Rees, and when it comes to investing, Rees's objective is to have only 10 stocks in his portfolio at any one time. This is not unlike other famous "deep value" investors like Warren Buffett and hedge fund managers Seth Klarman of Baupost Group and David Einhorn of Greenlight Capital.

These legendary value managers run concentrated portfolios. The idea is to own stocks as though they are businesses and to have a deep knowledge of all aspects of the companies' operations, potential prospects, and pitfalls.

Strategy Tip

Though financial advisors lecture clients on the importance of diversification, many of the most successful investors like Chris Rees manage concentrated portfolios with relatively few holdings. Warren Buffett once said, "Diversification is protection against ignorance. It makes little sense for those who know what they are doing."

Says Rees, “I’m a one-man show. There’s only one brain in this office. I know investment managers, and I see them on the TV, they run a 200-stock portfolio. To me it’s simply nuts. I work a lot of hours because I love my work. But I don’t think you can follow more than 10 stocks well.”

Chris Rees says that he gets his ideas from a slew of sources and is reluctant to give specifics, but he clearly uses stock screening software and alert services from web sites like the old 10kwizard.com (now called Morningstar Document Research) and SecInfo.com to cull through official SEC filings for certain fundamental characteristics.

“I may be looking for one or two investments a year,” says Rees. “I’ve got a universe of 10,000-plus companies, so I’m throwing companies over my shoulder like a maniac. Anything that doesn’t sniff right is eliminated, until I finish up with one company.”

At the heart of Rees’s strategy is his extreme aversion to losing money, or protecting his downside. Says Rees, “My basic philosophy is that I don’t believe successful investing is about finding stuff that goes up. I think it’s about finding stuff that’s not going to go down.”

To this end Rees is obsessive about determining a company’s tangible asset value, also known as its tangible book value. In conversation he sometimes refers to it as liquidation value.

Tangible asset value is defined as a company’s assets minus its liabilities. However, deducted from those assets are the fuzzy things that tend to inflate the number such as “goodwill,” which might measure the value of brands acquired during an acquisition. Another intangible asset that Rees might deduct is his estimation for obsolete inventory. In general, Rees is looking for companies that are selling at a price that is significantly lower than his estimation of its tangible asset value per share.

Strategy Tip

Rees cautions investors not to confuse his tangible asset value with the book value figures that are commonly quoted on dozens of web sites, including Yahoo Finance. Book value can be inflated by intangibles like goodwill or obsolete inventory. “Book value is too dodgy, squishy,” says Rees.

The next thing Rees looks at when investigating a potential stock to buy is its balance sheet, or debt levels. "I don't like debt. I don't want anything to do with debt," he says. "Any business, any CEO who loads up on debt, I'm not interested." Rees mostly focuses on a company's debt-to-equity ratio, which he says shouldn't exceed 50 percent.

The last thing Rees looks at in his relatively simple strategy is earnings. "The company has got to be profitable or I have to see a pathway to profitability." Rees often looks for turnarounds and other special situations. Thus if Rees likes the long-term prospects of a company that will lose money for the next several quarters, before turning profitable, Rees will discount its tangible asset value by a multiple of its losses.

Here's a basic explanation of how Rees determines value. Say Rees finds a company with low debt and figures out that its tangible asset value is $5 per share. If his estimate for forward earnings per share was $0.10 he might apply a price-earnings multiple of 10 to that. That would amount to $1 of future earnings value, so Chris would simply add the two to get a $6 estimated fair value for the stock. He would then seek to purchase it at a 50 percent discount to that value, or $3. If the stock price was too high, he would simply move on to the next candidate.

As part of Rees's "go anywhere" deep value strategy, he often seeks special situations where he believes the stock's true potential is misunderstood. One such special situation he's made a killing on is Elan Corp. (NYSE: ELN). Rees first became interested in the biotech company in 2005 after its multiple sclerosis drug Tysabri was abruptly pulled from the market. Apparently, one of the patients taking Tysabri died of a rare brain infection. Elan's stock plummeted to $3 from $30.

Rees did some digging to find out that the medical records revealed that part of the problem revolved around the patient taking the drug in conjunction with other medications and that the problem patient had a compromised immune system.

"Shares were trading on emotion and misinformation. I was a buyer into the fear and panic, which wasn't easy at the time," says Rees. "I thought Tysabri would come back, perhaps with a stiffer label, but the risk/reward benefit to the patient was significant." Rees bought Elan's distressed shares starting in 2005 as it was recovering. Elan's been a volatile stock ever since, and Rees has skillfully traded in and out of it.

According to Marketocracy, Elan has accounted for $2.7 million of the gains on Rees's million dollar virtual portfolio, which had a total value of $8.3 million as of the beginning of 2010.

Of course not all of Rees's picks have been homeruns like Elan. In late 2000 Rees bought into the distressed shares of Flag Telecom,[2] an Indian company that was laying fiber-optic cable under the sea for countries in the Middle East, Europe, and Asia. "I thought this was a valuable asset and it would stay out of bankruptcy. Even if it filed I thought there were enough tangible assets and cash for the common stock to be worth something."

However, in 2001 Flag filed for Chapter 11 bankruptcy, and common stockholders were wiped out. Rees learned a valuable lesson about distressed asset investing.

"I saw first hand how bankruptcy law is used and abused using the wonder of 'fresh start' accounting. So, my interest now is more in who is in bankruptcy currently and who is likely to emerge with 'fresh start' value. Bankruptcy investing is fascinating." Indeed, Rees cites Wilbur Ross, the well-known billionaire bankruptcy investor, among his investing role models.

In late 2009, Rees bought the post-bankruptcy shares of commercial finance and leasing company CIT Group (NYSE: CIT) for about $25. As of April 2010 its stock had risen to $40.

Who Is Chris Rees?

Chris Rees was born in 1950 in Stony Stratford, England, a small picturesque town about 90 minutes northeast of London. Stony Stratford dates back to Roman times, but it's best known for being the birthplace of the proverbial "cock and bull story." In the eighteenth century, two of Stony's pubs, the Cock and the Bull, were known to host travelers going between London and Liverpool who would gossip and tell outlandish tales. To this day Stony still hosts storytelling and humor festivals celebrating Cock and Bull's legacy.

The "Saga of Chris Rees" certainly deserves a place in Stony's colorful history. Rees's start in life was tortured because as a young child he suffered from severe allergies and eczema. As he recalls it, he spent from ages 5 to 10 confined to a hospital. "I was basically getting eaten alive with eczema," he says. "The strategy in those days was to take a five-year-old kid and spread-eagle him out on a bed, tying him to the four corners and basically leave him there," quips

Rees. “I made a decision that if I ever got out of that place, I was never going back. So I thought the best way of making sure of this was to get the hell out of Dodge, be an independent person.”

So upon being released from the hospital at age 10, Rees began dreaming of his departure from Stony Stratford. His teachers didn’t think much of him, and as he puts it he was pegged for a career in “shoveling horse manure onto loganberry plants.” The only subject he seemed to excel at was geography.

In the middle to late 1960s, when Rees was finishing up high school, British authorities decided that they would create a new planned city called Milton Keynes just a few miles from Stony that would house hundreds of thousands of city dwellers being overcrowded in London. Rees saw this as an opportunity to earn money for the “escape” he was planning. So Rees took up selling household appliances to builders and contractors developing the vast suburban housing tracts of Milton Keynes. He also worked in odd jobs like furniture and carpet sales, saving for his departure.

Rees finally accumulated enough money for his travels by wagering his boss on a Chelsea versus Leeds United FA Cup final soccer match in 1970. Rees told his boss that he would leave if his team, Chelsea, won. After tying initially, Chelsea beat Leeds in a heated replay match 2 to 1. Rees collected his winnings and left for Spain.

“My mum thought I would make it about 10 miles down the road and get homesick and come back,” say Rees. However, this was the beginning of a nearly three-decades-long journey in which Rees wandered through some 30 countries around the globe. Hippie culture was in full bloom, and being a flower child and living a nomadic lifestyle had great appeal to Rees. “The idea was to live as frugally and cheaply as I could and to make the trip last as long as I could. I had to spend close to zero money and pick up odd jobs that would keep me going,” says Rees.

So Rees washed dishes, waited tables, and worked on construction sites while traveling throughout Europe. Every few years he would return to England to work factory jobs for a few months and save money for his next adventure. However, eventually Rees figured out that Switzerland was a better place to sojourn and earn money. “I knew the Swiss franc was very strong and I could do carpentry there, sleep on a friend’s couch, save money and then go to places like India, or Yugoslavia, or Central America, and it was like having three times the amount of cash in your pocket.”

In Switzerland, Rees installed saunas in homes. In Amritsar, Punjab, India, Rees was a cook in a restaurant, sleeping on a mat on the kitchen floor at night. In Kandahar, Afghanistan, Rees worked as a tailor wearing a traditional turban and *salwar kameez* helping to make three-piece men's polyester business suits, mostly for export to Iran. In Belize, he was an eco-tour operator and charter boat captain.

Finally Rees made his way to the United States, traveling around in a secondhand Volkswagen bus. By the time Rees made it to California, his VW engine was shot. Without any money for repairs, Rees ended up sleeping in his bus in a trailer park on a Native American Reservation just across the Colorado River in Yuma, Arizona, wondering what to do next.

One night Rees ended up at a saloon down the road where they were playing poker in a backroom. Rees was intrigued and eventually he learned to play Lowball Poker, a game in which the worst hand wins. Chris Rees had a good understanding of odds—back in England his father had been a bookmaker and Rees remembered watching him at the chalkboard change odds based on the "book" or betting interest in the horses as the race time drew near. Chris Rees became so good at this variation of poker that the tavern owner employed him to play for the house.

One evening, while playing with the money that he had earned, one of the players at his table threw the keys to his 1965 Cadillac Sedan DeVille into the pot as the stakes got higher. Rees had the worst and winning hand—five cards with six high. Rees had what he needed to continue on his journeys, so he packed up his new Caddy and started to make his way to Florida.

By the time he arrived in Tampa, Rees had run out of money again. So he slept in his car on the beach at night and was about to give up and figure out a way back to England when he was offered a job in the kitchen of a restaurant. He took it and rose from dishwasher to cook to kitchen manager and was making enough money to share a rented apartment.

By the middle of the 1980s, Rees's yearning for adventure led him to buy a 33-foot sailboat with the idea that he would teach himself to sail and explore the Caribbean by boat. Rees figured it was the best way to travel that part of the world, given that you didn't have to pay for airline travel or hotels. After work each day, Rees headed to the local library and read dozens of sailing books until he felt ready to set sail.

Rees spent the next 14 years traveling in the Florida Keys, Central America, and the Caribbean Islands in his sloop, the *Trilogy*, supporting himself mostly by giving "eco-tours" and sailing excursions. "In sailing you learn to stay safe. Screwing up or putting yourself in a bad place at a bad time can cost you your life," says Rees reflecting on his years at sea. "Risk analysis becomes second nature."

While Chris Rees was sailing around the Florida Keys he developed a toothache that would change his life.

Sitting in the dental office in excruciating pain, Rees became fed up with waiting and went looking for the dentist whom he found hunched over a computer screen in his office tending to his stock portfolio. Rees was fascinated by what he was doing and made it his point to learn more about investing.

Rees became a regular at the Marathon public library in the Florida Keys, reading everything he could on investing and eventually learning how to navigate web sites like Yahoo Finance with the library's computer. He managed to invest small sums of his savings through a Schwab brokerage account and became addicted to publications like *Barron's*.

During one of his stints giving eco-tours on the Rio Dulce in Guatemala, Rees paid a series of local merchants and couriers to bring him a *Barron's* each week from a hotel in Guatemala City to his sailboat far down the river via dug-out canoe. "It was like waiting for God to arrive," recalls Rees.

Ultimately, as Rees was approaching 50, he began to tire of his adventures. "I had been doing this my whole life; save $5,000, go traveling for a year then become penniless and start all over again," he says. "It's wonderful when you're young, but you've got to get a bit practical."

So Rees decided that if he could save up $50,000 in capital, he could probably live modestly in one of his favorite destinations, the Dominican Republic. His plan was to manage an investment portfolio and produce an average annual return of 15 percent. "I knew if I started and I had a bad first year, it might never work, but I thought if I'm really, really careful and really disciplined and treat it like a business, then I could get my 15 percent."

Rees worked two jobs to save $30,000 over the course of a few years, all the while learning about investing and using the Internet at the library in Marathon. In October 2000 Rees joined the Web stock picking community Marketocracy.com and created a million-dollar virtual portfolio to test his skills and see how he measured up against others. A few months later, Rees sold his 33-foot sloop for $20,000 and bought a ticket for the Dominican Republic, $50,000 cash in hand.

"The Dominican Republic fits me like an old tee shirt. It's a nutty place. It's almost the country that Monty Python would have invented," says Rees. With his $50,000 nest egg ready for investing, Rees rented a three-bedroom house with a two-car garage, electricity and cable TV, in the countryside outside of Puerto Plata for $84 per month. His 26kbps Internet access cost an additional $30 per month.

Nearly a decade later, Rees lives comfortably as a full-time investor. His real-life personal portfolio is similar to his virtual one on Marketocracy except for the fact that he occasionally uses leverage. Rees and his Dominican wife Isabel and six-year-old daughter Tina live in a spacious apartment on the North coast of the Dominican Republic, about 200 yards from the beach with views of the Caribbean Sea. The Rees family has four computers, and a satellite dish keeps Rees connected to the Internet at a speed of 1.5 megabytes per second. Rees runs a small subscription alert service and owns investment properties in the Puerta Plata area that he intends to develop.

Rees admits he is singularly devoted to his investing portfolio except for the time he spends with his wife and daughter going to the beach or eating out. Rees drives his daughter to school every day in a 1988 Jeep Cherokee, which he bought second hand. With age, and maturity, Rees's wanderlust seems to have fizzled. He is staying put. He no longer owns a boat or yearns for exotic foreign adventure.

Rees's Rules of Investing

Buy Rules

- Find companies with low debt, less than 50 percent of equity.
- Focus on tangible asset value (also known as tangible book value) and be mindful of intangibles that can inflate asset values.
- Look at realistic forward earnings potential.

Sell Rules

- Take profits if the stockholding approaches your estimated fair value.
- Sell if market-, sector-, or company-specific risk increases.
- Sell if the stock becomes overweighted in the portfolio.
- Sell if you find a better, lower-risk investment.
- Take profits if you can lower your overall portfolio risk by reallocating capital.

Case Study: Abatix Corp (OTC: ABIX)

Figure 1.2 Abatix Corp, September 2006–September 2007

Source: © TickerTech.com, 2010.

Though Elan has been Chris Rees's best single pick to date, he claims that his success is mostly based on "hitting singles," buying low-risk/high-probability value stocks where he might book 30 percent plus gains. A good portion of Rees's investments are in the micro-cap arena, either because the companies are small or because they are distressed.

Abatix is an example of this (see Figure 1.2). Back in 2006 Rees had an investment in an oil exploration company operating in the Gulf of Mexico, but he wanted to somehow hedge against hurricanes, which are a real risk to these companies. So Rees discovered Abatix either through screens or an article he read online.

The firm, based in Mesquite, Texas, is a supplier of environmental products, and safety equipment firms prosper during disasters. Hurricanes, wildfires, pandemics, and terror attacks are good for its business because it sells things like fire retardant jumpsuits, high-visibility safety vests, dehumidifiers, and water and air filtration systems.

Rees downloaded Abatix's SEC filings and after doing some calculating, he figured that its tangible asset value per share was $6.75, mostly in the form of inventory and receivables.

In 2005, the year of Hurricane Katrina, Abatix had banner earnings of $1.22 a share. Rees calculated that normalized earnings for Abatix would be around $0.35 a share. He estimated this amount by using its last five years of reported earnings as a benchmark.

Says Rees, "I generally assign an estimated fair value on a company based on the value of net tangible assets plus a ten multiple on estimated forward run rate earnings." Thus Abatix was worth $10.25 on a no-disaster, no-chaos basis, according to Rees:

$$\$6.75 + \$3.50 = \$10.25$$

However, Rees also figured that if there was a bioterrorism attack or another big hurricane or earthquake, earnings could climb to a $1 or more per share, which when added to his tangible book value would give Abatix an upper end share price of $16. (*Indeed in late 2005 Abatix shares reached a high of $18.50.*) So Rees settled on a fair value for Abatix between $10 and $16. He purchased shares in November 2006 for an average cost of $6.25 and sold the stock seven months later for $11.10, a 78 percent gain.

Rees In His Own Words

Reflecting on the Financial Meltdown of 2008

I have just finished the worst year in my history.

My model fund at Marketocracy ended the year down 42 percent. It is remarkable that I was still positive (up 8 percent) as late as September 22nd. But to lose over half a portfolio in two months really takes some doing, but I managed it.

While getting my head handed to me in 2008, I was not alone. I had some very good company. Warren Buffett's Berkshire Hathaway (NYSE: BRK-A) (a holding in my model fund until late 2007) fell around 45 percent from its 2007 high. Martin Whitman's Third Avenue Value Fund (TAVFX) was down 46 percent for the year. Bill Miller, of Legg Mason Value Trust (LMVTX), and famous for outperforming the S&P 500 for 15 years straight, finished the year down 55 percent. There were so many violent twists and turns in 2008 that very few people got it right and of those who did, a lot of them STILL lost a lot of money.

Buffett has said, "Predicting rain doesn't count; building arks does." I clearly didn't build an ark, and I can be faulted for that. But I did have anchors to windward. But when the Category 7 hurricane of October/November came, nothing held.

We have had a jarring and painful 2008. I have received many e-mails, especially in Q4, expressing understandable concern. Overall, you have been truly wonderful. I thank you for your support and continued trust in me.

Also, I am a strong believer in keeping my mouth shut and letting the results do the talking. Over the long term, the results have generally spoken favorably. I spend a lot of time reading opinions, articles, and reports. I listen to talking heads on Bloomberg. Ninety percent of everything I read, see, and hear is total garbage and an utter waste of time. Not too long ago I told someone that "increasingly investors will need to produce more return on their capital and with conventional mutual funds wallowing in mediocrity it becomes a smart proposition to at least consider alternative methods and vehicles where the emphasis is less on the talk and more on the walk." In 2007 and now in 2008, there hasn't been much *walk*. But I still don't like talking. When I have a reasonable year, I don't usually do a year-end letter. For 2008, it's all I've got.

—*January 3, 2009, Marketocracy.com*