In a world where investment horizons are short and month-to-month performance is scrutinized, we think it more important than ever that our investors understand the process by which we make decisions – how we select candidates for investment in the fund, how we size them, how we monitor them, and ultimately how we determine when it is time to sell them.

The Idea Funnel

We visualize our idea generation process as a funnel – we drop a bunch of interesting potential ideas into the funnel, filter them further by selecting the most compelling for further research, reject those that don't meet our standards, and ultimately at the end of the process we hope to emerge with enough actionable ideas with which to build a fully invested portfolio.

Our goal is generally to produce an average of two compelling new ideas per month, though we've discovered that ideas seem to come in bursts – we get dry spells for a few months followed by stretches where good opportunities seem relatively abundant. Of course, much more than the quantity of the decisions, it is the quality of each idea that will ultimately determine our results. We have to be careful to avoid mistakes and ensure that each new idea meets our criteria for value and safety. Our standards never change – we are looking for ideas that can produce 15-20% average annual returns within acceptable risk parameters.

The Research Process

The real work starts once one of us selects from our "Top 10" list a single idea that we believe to have the most merit for further research. We then print off or order annual reports for the past several years, comb through the latest filings with the SEC (or foreign equivalent, if a non-U.S. listed company). We search the Internet for any relevant supporting material (magazine articles, management bios or profiles, competitors, etc.) Once the stack of research material looks sufficiently daunting, we stop printing things and start reading.

We first need to fully understand the business – what industry it competes in, how it has performed historically, who its competitors are, what competitive advantages it may or may not possess, etc. We also review the management's record of decisions over the years. Essentially, we try to capture all the information we'd want to have if we were buying the whole business lock, stock, and barrel – is this a business we'd want to own for twenty years? If not, is it cheap enough that we could sell the assets of the business to a rational buyer and get a reasonable return? Are there hidden assets to which the market is assigning little or no value? Then finally, what are the risk factors? We've learned that every business has risks, and the key is to ensure that they are properly factored into the price we pay for the shares – though there are some risks that we simply do not take regardless of price. Once we believe that we have captured all the relevant inputs from the examination of the evidence available to us, we try to calculate a conservative value for the business.

Estimating a fair value for a business is more art than science, and our value estimates are generally expressed as a range of values using what we consider to be the most likely results for the business over time. We also must consider what the value might be in the poorest environment that we can practically envision for the company we're looking at. If we were trying to value General Motors, for example, we would have to take into account the very real possibility that GM could go bankrupt within the next three years. If we were trying to value Exxon Mobil, we have to consider the possibility that oil prices may drop from the current $60 per barrel to $35 a barrel within the next three years. We have to consider how probable such a scenario is, as well as its likely effect on Exxon Mobil's profits, cash flows, and the future value of the company's oil and gas reserves.

We then condense the critical information into a research document, which can be as short as a couple of pages for a simple idea or as long as 20 pages for a more complex idea. These documents capture our assessment of the business, any relevant risk factors, our estimate of the fair value, and a recommendation for action. If Matthew was the lead analyst on the idea, he will present his report and recommendation to Zeke. If Zeke did the initial research, he will give his work to Matthew for review. The reviewing analyst then conducts an independent "quality check" of the idea – carefully reviewing the research document, looking for holes in the thesis, bringing to the idea any past experiences or industry knowledge, watchful for risk factors not mentioned or glossed over. When the idea has been completely reviewed, we get together to make the critical decisions – is the idea worthy of investment, and if so, what position size should we take? In many cases, a very fast consensus is reached. In other cases, further discussion and incremental research is needed to clarify one or more aspects of the report. At some point, a consensus is reached based on the logical merits of the idea, and an action is decided. The final conclusion is then documented to our report, and we place the trade order.

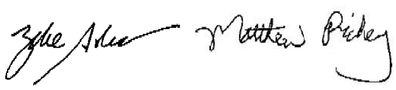
In Search of Crystallization

The requirement to fully document our ideas before investing forces us to achieve a level of clarity that we refer to as "crystallization." We find that by carefully documenting the idea at the outset, we are able to improve our decision-making on that idea down the road – the better we understand our investments, the easier it is to make the right decision in response to new information as it becomes available. This can be a critical factor in exploiting opportunities when new value is identified, and can ensure that we exit positions when the investing case is no longer compelling.

The downside of our process is that it takes a lot of time, and the temptation to cut corners in order to get capital to work is sometimes great. There is also very real opportunity cost, in that sometimes the time it takes for us to reach crystallization about an idea causes us to miss a fleeting opportunity. However, we believe that our process dramatically reduces the number of mistakes we might otherwise make – and in this business, mistakes are costly both in time and money.

In next month's letter, we'll cover the risk factors we look for, what risk factors we try to avoid altogether, and how we size each position in the fund. As always, we thank you for your continued confidence in us and the Fund.

Respectfully yours,



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**The S&P500 Index inception to date return is reported using the S&P500 Depository Receipt Trust (SPDR) which trades under the ticker symbol SPY. Reinvested dividends are included in these figures. The returns reported for SPDR may not exactly match the reported returns for the index. A spreadsheet showing the SPY performance vs. the Centaur Value Fund since inception is available upon request. NASDAQ performance does not include dividends, which are generally immaterial to the total return of that index.*