Micro Cap Investing

“You’ve got to love to lose money, hate to make money”

The Dao of Capital, Mark Spitznagel

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Micro Cap Investing - Overview

- In previous presentations, we have discussed our philosophy to small and micro cap investing. (See attached link: Small Cap Investing Philosophy.)
- Instead of trying to find winning stocks, we try to find stocks with winning attributes:
  - Strong Balance Sheet
  - Good Earnings Quality
  - High Returning business with Large Potential Market Opportunity
  - Attractive Valuation
- Depending upon the investment strategy at play:
  - Deep Value
  - Cyclical
  - Growth
- We then aim to build positions in these stocks commensurate with the risk/reward proposition they offer.
- However, given we are often trading off near term momentum for valuation, the probability exists that we initially lose money on our early purchases.
- Given we use our purchases as signalling our views instead of formal Buy/Sell/Hold recommendations, we thought it is worth clarifying our trading position in more detail…
- … and particularly why we have come to love to lose money on these early investments.

Micro Cap Trading Strategy

- Our trading strategy can be identified as follows:

1. Identify winning attributes

2. Buy initial watching stake

3. Watch and observe:

   A. Company newsflow against key milestones:

      i. For growth stocks – if announcement demonstrates validation of growth strategy aim to buy more;

      ii. For deep value stocks – if announcement demonstrates improvement of momentum, buy more.

      iii. If announcement demonstrates delay to growth strategy, or poor earnings momentum – continue watching

      iv. If announcement demonstrates our previous understanding of the business model was flawed – sell. (Note contrast to 3 above – i.e. permanent flaw vs delay).

      v. If announcement demonstrates deterioration in balance sheet – sell.

   B. Share Price

      i. If share price falls significantly – add to position so long as balance sheet sound;

      ii. If share price rises significantly such that portfolio position no longer commensurate with risk – take part profits.

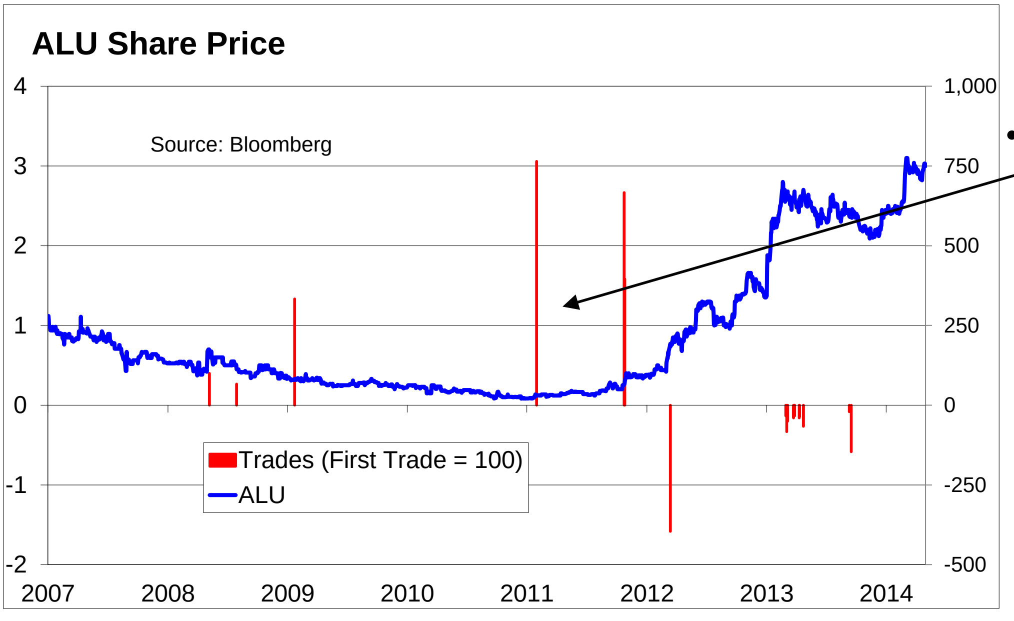
- As discussed, because many of these stocks are in start up stage, or poor momentum has provided the value opportunity – situations such as 3.A.(iii) are common. Hence, our initial purchases can often be under water in the early stages of our investment term.

- However, because we only invest in balance sheets that are good, we usually have the opportunity to purchase more at lower prices. (3.B.(i)).

- How has this strategy fared?

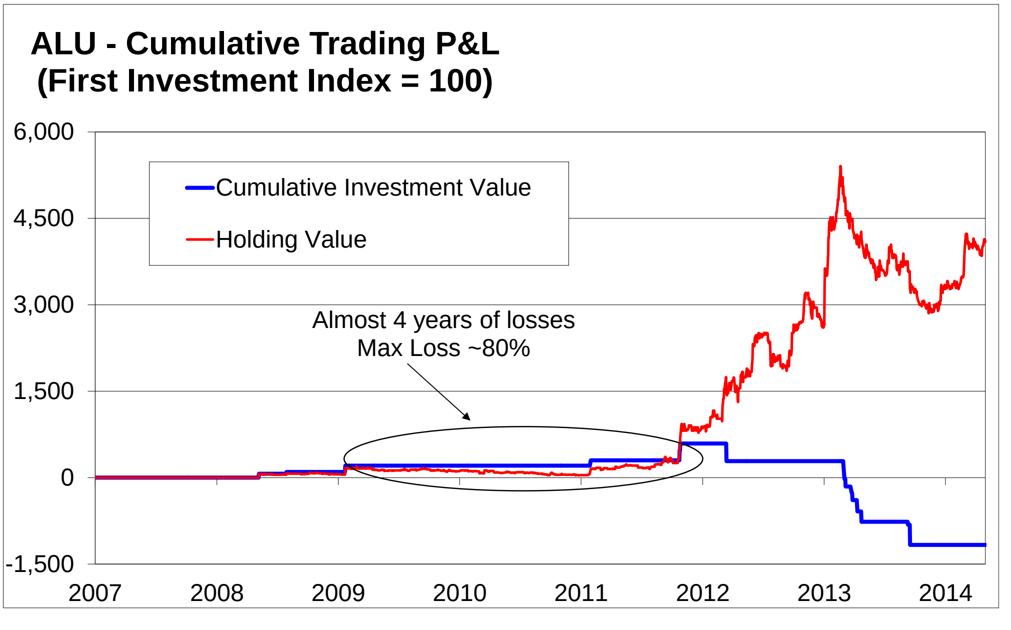
Trading Strategy Example - ALU

- We commenced buying ALU at $0.70 – the share price continued to fall for almost four years.



- Note lower share price = higher volumes for similar $ investment.

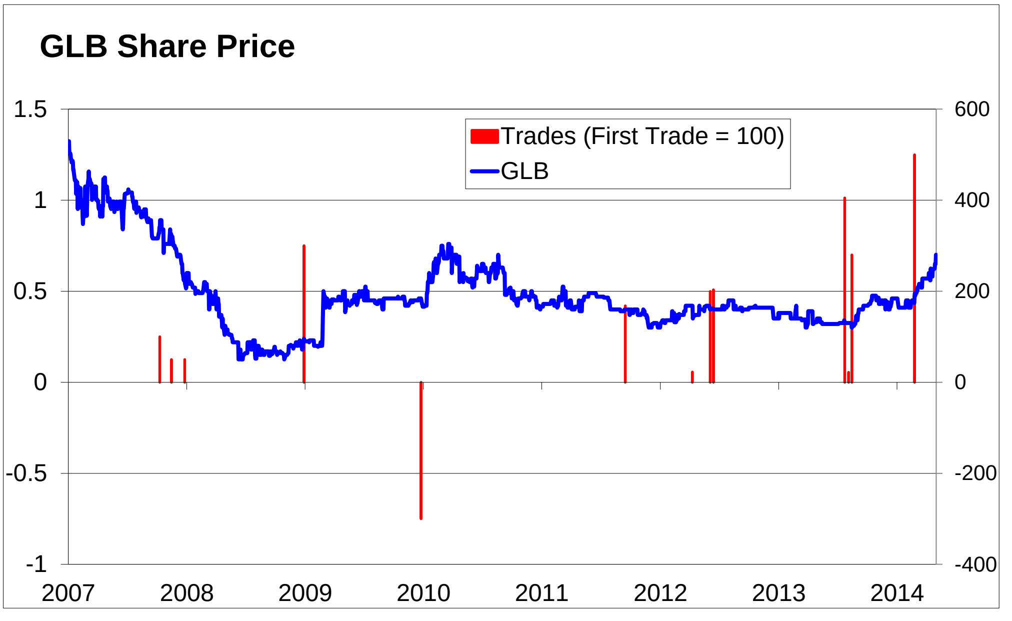
- We felt confident averaging down due to a net cash balance sheet, sales growth was solid and valuations highly attractive based on EV/Sales.



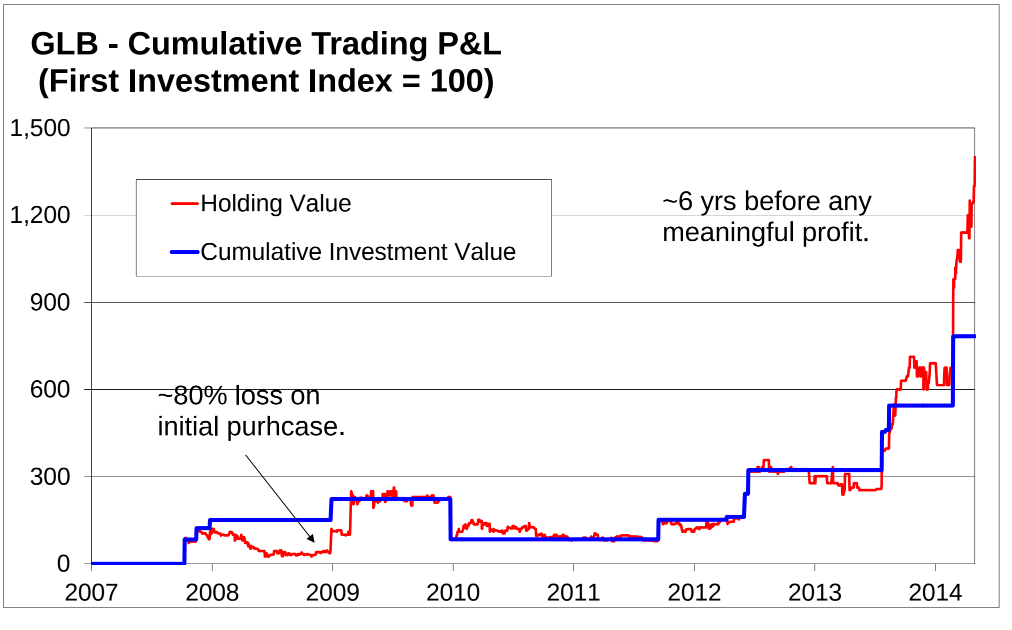
- In this situation, the falling share price over time provided the opportunity for much greater profits (through higher ownership)

Trading Strategy Example - GLB

- GLB share price still below level when first small stake acquired.



- Has taken ~6 yrs before any meaningful profit on position (and whilst we are increasingly confident there is more upside in this stock – it has not yet fully turned the corner).



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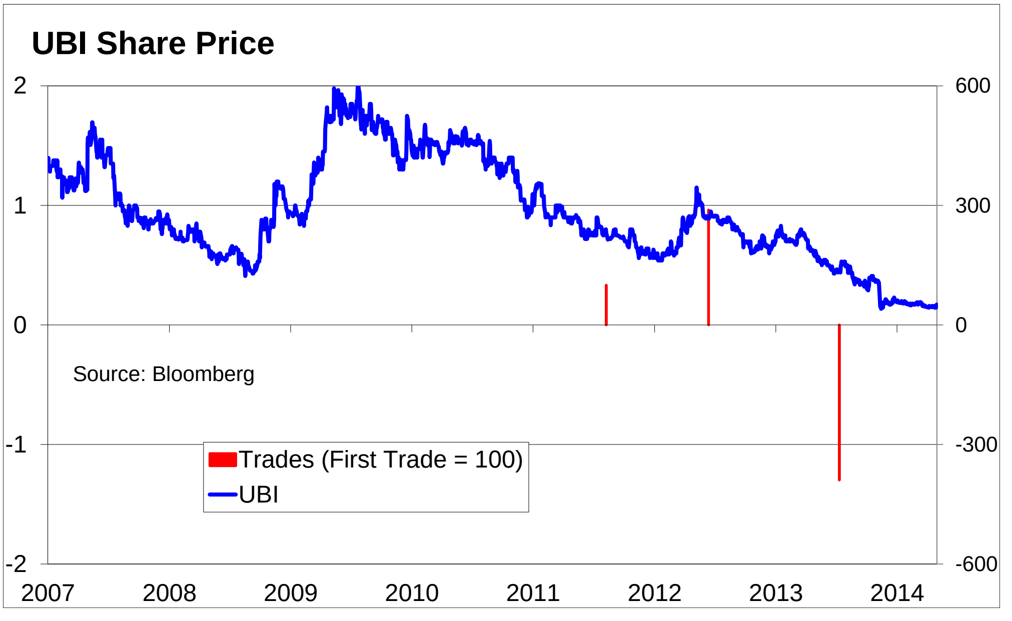
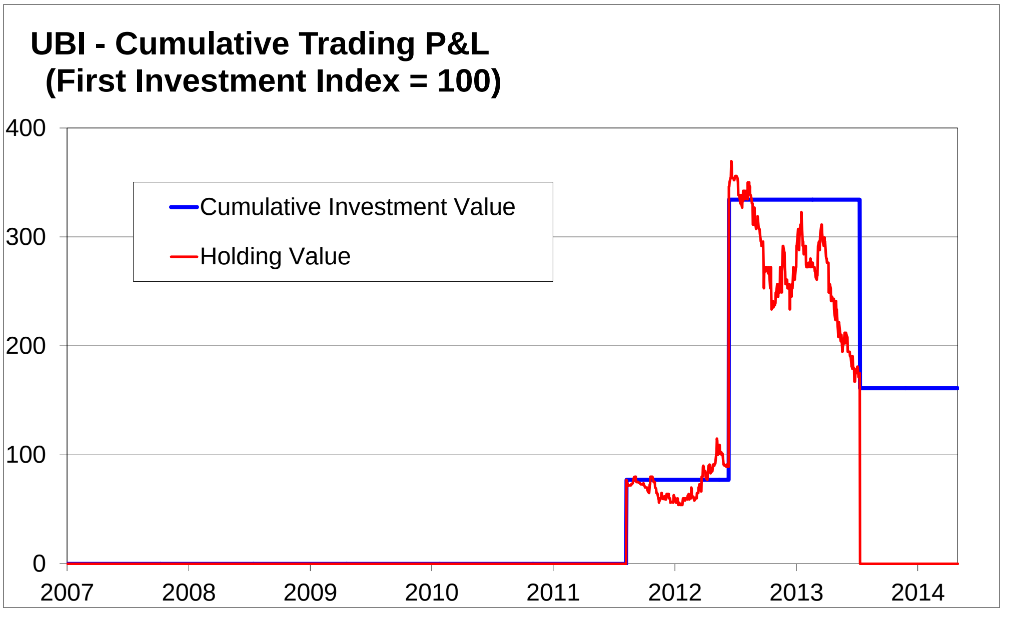
Trading Strategy Example - UBI

- An alternative example was our investment in UBI. We acquired a small stake, averaged up when it appeared progress was good…



- … but ended up liquidating our position when it become clear our assessment of the business had been wrong and the company entered into a US$25m loan facility.



- Cutting our position was a painful loss of ~50%.
- But following our process not to own poor balance sheets has at least saved us the further 65% fall in the share price.

Conclusion

- Obviously these are a few examples out of many. We have had many situations where:

    - We invested and closed positions at a large percentage loss.

    - We invested and shares went up straight away (thus leaving us with an opportunity loss of not having acquired a full unit size to begin with).

- However, what these examples highlight are:

    - Don’t take our initial purchase as a recommendation that we expect the stock to go up near term. In many situations we are just buying a small stake to get interested.

    - The worst short term outcomes are often the best long term, as they enable time to observer and acquire a much larger position. (Note that at any time the total exposure to these loss making stocks remains modest due to the falling share price)!

    - Buying good balance sheets provides some measure of protection to enable averaging down – thus keeping alive the potential for longer term gains.

- For us the real lesson is to keep following process and to invest in micro caps as a diversified portfolio, where we maximise our chances of gaining exposure to the next ALU.

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