

Navigating Perilous Climes with Discovery Investing

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Michael A. Berry, Ph.D.

Info@DiscoveryInvesting.com

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Address for Rogoff Ferguson Video on Bloomberg, October 29 2009

- <http://www.bloomberg.com/avp/avp.htm?N=av&T=Rogoff%2C%20Ferguson%20Say%20Global%20Crisis%20Is%20Not%20Yet%20Over&clipSRC=mms://media2.bloomberg.com/cache/v3t.mGTZrnYU.asf>

Part I: The Perilous Climes

Diseconomies and The Current US Fiscal Crisis

Demise of the Reserve Dollar

Extraordinarily Large and ongoing external deficits,

The historical dominance of the US dollar, and

The large capital inflows that accompany deficits and
currency dominance

are

- NO LONGER IN THE NATIONAL INTEREST of the UNITED STATES.

Deterioration

- Administration and CBO projections suggest that over the next decade, as boomers age, the US budget deficit will exceed all previous records by considerable margins.
- The international economic position of the United States is likely to deteriorate enormously as a result.

As a Result of This Economic Misappropriation

The current account deficit will rise from a record of 6% of GDP to $> 15\%$, more than \$5 trillion annually by 2030.

Unsustainable Tipping Point

“The United States would then be transferring a full 7% (\$2.5 trillion) of its entire output to foreigners every year in order to service its external debt. This scenario highlights a grave triple threat for the United States.”

C. Fred Bergsten

The Dollar and the Deficits

Foreign Affairs

Nov Dec 2009

The Catch 22 Triple Threat

1. If the rest of the world finances the United States' external deficits the current crisis will be replicated and the calamity renewed.
2. Eventually increasing demands on foreign investors will be unsustainable and produce a severe drop in the dollar before 2030.
3. Even if the United States somehow avoids future crises while increasing deficits, the rising transfer of US income to service debt will seriously erode America's standard of living.

The 500 Year Event

(Niall Ferguson, Bloomberg Oct 29 2009)

- ***“Demise of Western Civilization as we have known it – the rise of Asia.”***
- Not your mother’s or father’s economic peril - no Great Depression likely in store.
- But what’s coming is certainly pain in the form of a lower quality of life for Americans.

Are we Living in the Period of the end of Western Ascendancy??

- “A plausible future at this point is that in our lifetime the US will cease to be the world’s largest economy.”
- **China is discovering itself and growth in Asia is the larger force.**
- “We’re close to a historical tipping point.”
- We Americans are not about to stop borrowing (while)... they give us money for nothing.

Professors Niall Ferguson and Kenneth Rogoff, Harvard,
Bloomberg Interview, October 29, 2009

Full Speed Ahead With China –

Kenneth Rogoff Harvard University

- ***“ We earthlings have found that when a country in fiscal distress tries to escape by printing more money, inflation rises uncontrollably.”***
- ***“It ends really suddenly when it ends. You think everything is fine. Americans are complacent.”***
- ***“The Chinese will decide some day soon....”***

China will Become Assertive

AND

There is a limit to what (Ed. ***reserves***) they can accumulate.

EXCESSES

Vastly beyond anything we have ever seen.

Already at a critical state. “When this thing changes it will be dramatic and non linear.” Ferguson

There will be an economic singularity when the international bond market finally blinks at \$9 trillion of debt issuance.

Not a gradual event - abrupt, unexpected – A Black Swan ...

Still, today, there is NO Congressional consensus on spending or taxes – benign ignorance and polarity in Washington.

China: Trading Dollars for Commodities – A Rational Response

- China is in the early phase of a massive buying spree to get the commodities she needs.
- ***“Load up on copper, load up on anything the Chinese want ... the safest one way trade you can make.”***
- Looking at Chimerica you need to place more money on China, related commodities and related economies.

The US Exit of the Fiscal Crisis

We need to do something imminently about the fiscal credibility of the United States.

Cannot run trillion dollar deficits every year for a decade.

Unfortunately Congress and the White House misunderstands or ignores the problem spending grandly and printing surreptitiously.

We need a credible plan to restore federal finances over a ten year timeframe. It's called leadership.

From Crisis to Crisis

- Major banking crisis 2007 / 2009 followed by major fiscal crisis 2010 / 2020.
- Two plausible exit scenarios from the fiscal crisis: Default or Currency Depreciation
- ***“A 10% decline in the real trade weighted value of the dollar looks like just the first stage.” Niall Ferguson***
- A much more significant dollar depreciation to follow, that’s the lesson of history.

China Continued

- China occupies the position of the United States in the 19th century. There is enormous potential from productivity gains and investment in infrastructure.
- Chinese momentum seems sustainable with intermittent and serious crises.

Part II –No Workable Investment Theory

Traditional Investing Techniques

- Efficient Market Hypothesis (EMH)
- Modern Portfolio Theory (MPT)
- Risk and Reward Measures: Alpha and Beta

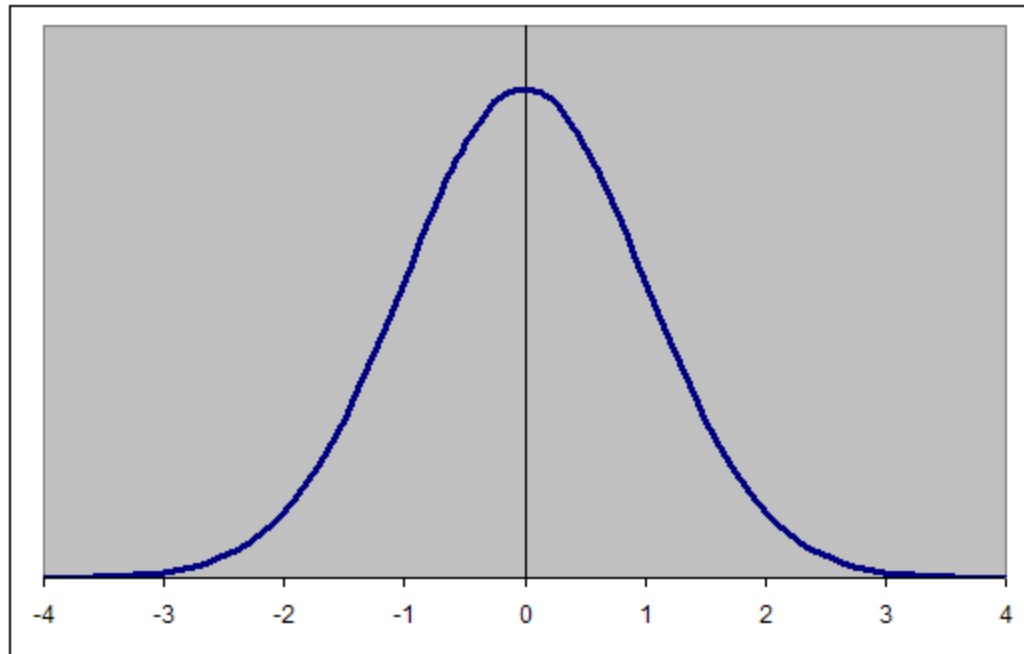
- Valuation Models:
 - » DCF, CAPM, OPM, APT, VaR

- *These techniques and theories have almost no application in Today's Eviscerated Capital markets*

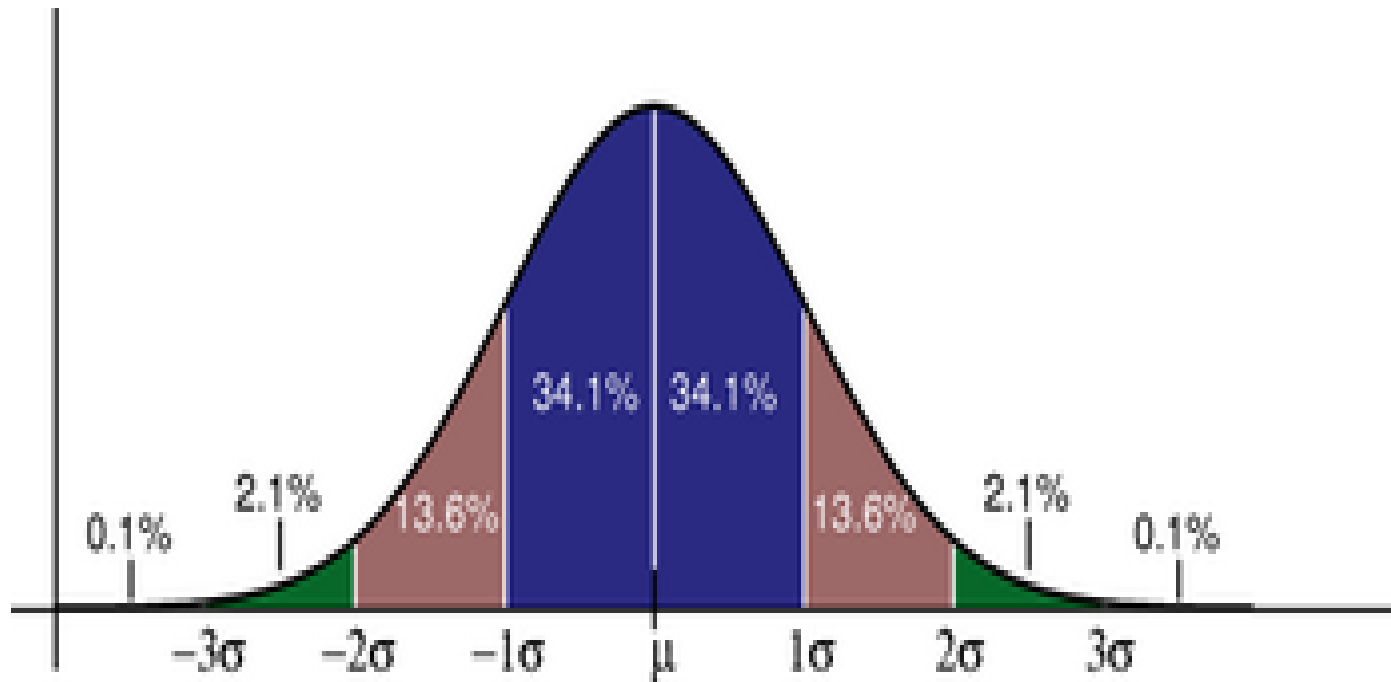
How to Characterize Risk Assessment

- What is Risk?
- How should I measure risk?
- Is risk systematic or unsystematic?

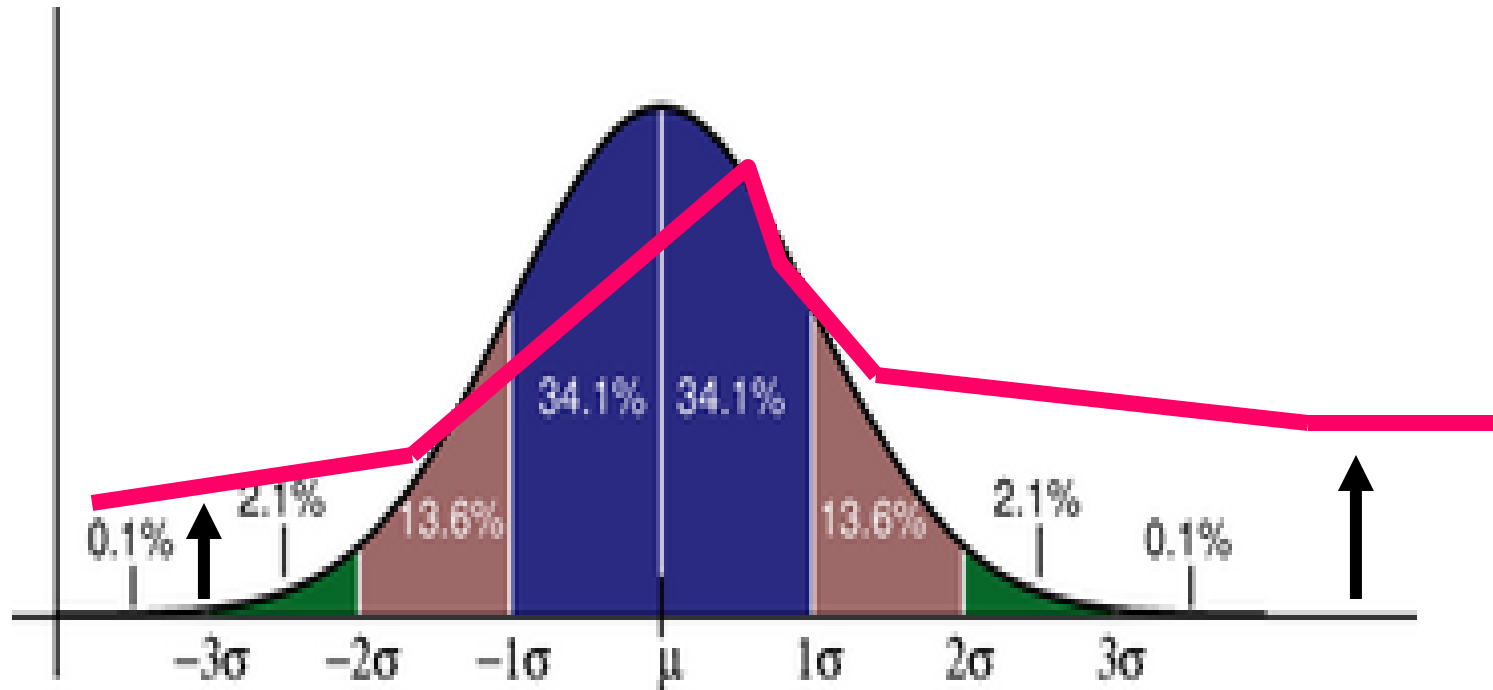
Risk / Reward



Traditional Risk: Normal Probabilities



Fat Tails and No Symmetry = No Theory



The world is often decidedly not normal

**Cannot be described with ordinary
mathematics**

Behavioral winds blow strongly

A New Approach to Risk Analysis

- Use “Fuzzy Logic” to map the relevant factors.
- Solicit consensus expert view on each factor.

Margin of Safety (MOS)

- *"[To] have a true investment, there must be a true margin of safety. And a true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience".*

Benjamin Graham

- *The MOS in Discovery Investing is slightly different – very low share price at acquisition, a reasonable probability of a world class discovery, or immediate sustainable cash flows and significant upside → MOS.*

Valuation of Discovery

- Comparative Relevance.
- Net Asset Value (often rule of thumb in early days).
- Discounted Cash Flows.
- Real Options.

Traditional Investment Practice

- Styles: Growth Versus Value
 - Technique: Active versus Passive
 - Size: Market Capitalization
 - Locale: Developing, Domestic, International
 - Vehicle: Hedge Fund, Mutual Fund, Individual
 - Fees: How Do Money Managers Get Paid?
-
- What's A Good Expected Return?
 - Discovery Investing offers a superior alternative

Problems with Traditional Investing Strategies

- Styles Go “Out of Favor.”
- Risk Assessment is Difficult.
- Valuation is in the “Eye of the Beholder.”
- Investor Behavior Changes Quickly.
- Catalyst Identification: what is a catalyst?
- Should you Buy and Hold or Buy and Trade.
- Catching the Cycle.
- Equilibrium Rates of Return in each asset class vary over time.

BUT

A WORLD CLASS DISCOVERY IS VALUABLE and IMMEDIATELY ACCRETIVE

A Few Secrets of Discovery

- Control the Asset or Intellectual Property.
- Seek Discovery Where Others Won't.
- Seek High Potentiality
- Seek Near Term Cash flows.
- Seek High Potential Risk Reward Ratios (gold / silver ratio) – Relative Valuation.
- Try To Pay A Low Price.
- Always Align with Superior Management.

Discovery Yields Both Success and Failure

- By its very nature Discovery Investing even when executed correctly yields both success and failure. You cannot be afraid to FAIL!
- Rule of Thumb: Target at least a 30% success rate (3 out of 10 investments) to create significant portfolio wealth.

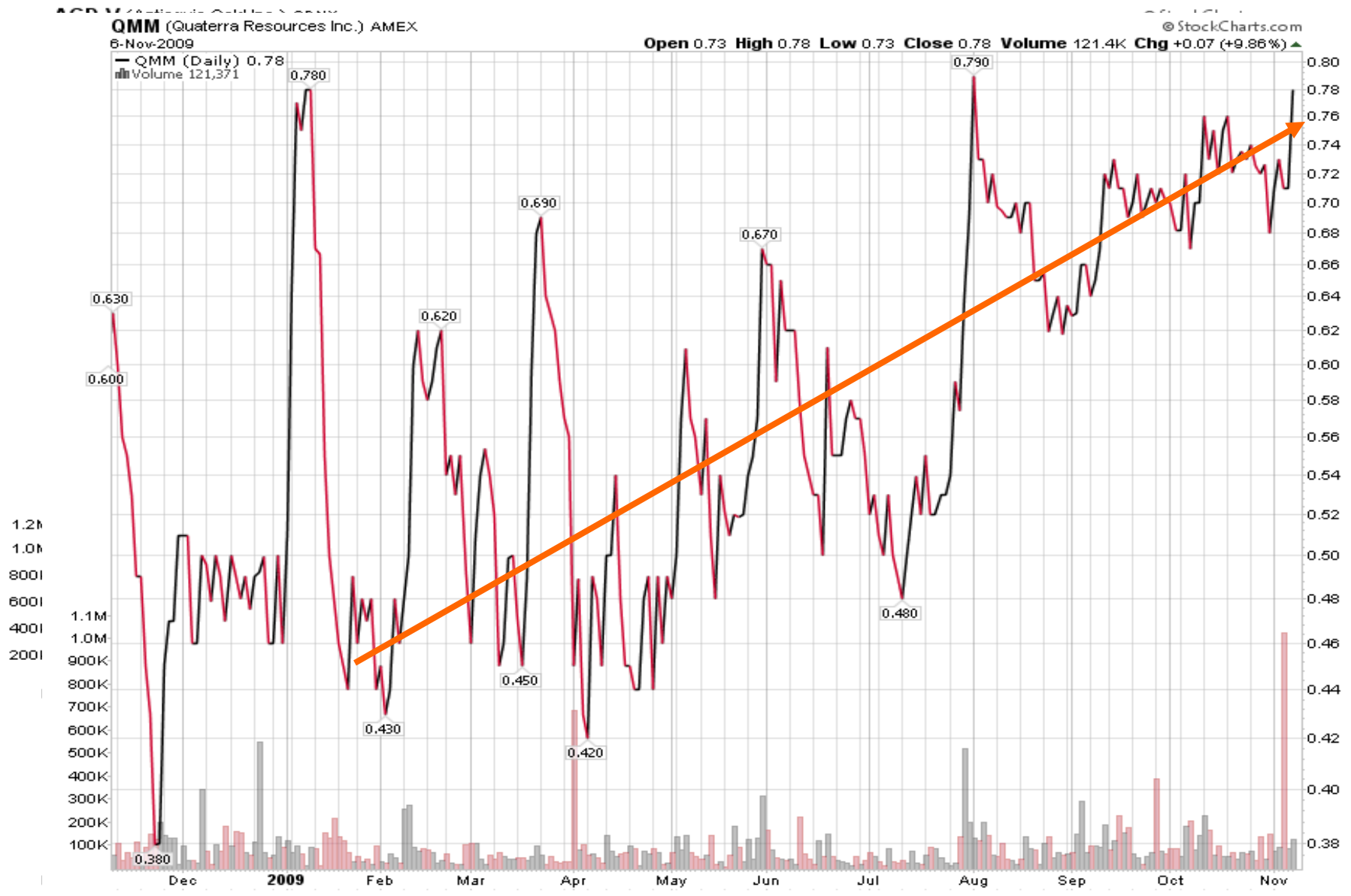
Reversion to the Mean

- The Only exception to this Universal Behavioral Rule occurs in Discovery.
- In Discovery Initial Overreactions Tends to be Magnified.

Practice In Discovery Investing Top Quartile Names



Quaterra Resources QMM



Avalon Rare Fish Inc.



Avalon Rare Metals Inc. (AVL.TO)



Houston Lake (HLM.V)

HLM.V (Houston Lake Mining, Inc.) CDNX
6-Nov-2009

© StockCharts.com

Open 0.24 High 0.24 Low 0.23 Close 0.23 Volume 142.0K Chg -0.01 (-4.08%)



Sandspring: SSP

(NB: Sandspring will begin trading within a few weeks)

- Guyanese Gold play with decent infrastructure.
- Mined for over 100 years by alluvial miners/
- Gold and copper resource.
- \$335.000 cash flow per month from gold mining
- Self funding except for drilling expenses.
- 3.3 million ounces gold in resource with copper credit.

- Ongoing drilling results expected.
- Guyana's next big gold mine?

Golden Rules of Discovery Investing

- Must be used in an asset allocation framework.
- Requires a focus on adequate diversification in your discovery space due to high risk.
- A 5% to 10% weighting in Discovery is prudent.

The Global Quality of Life Cycle

Material well-being on the rise

	1992	2002
Refrigerator	98.7%	99.2%
Stove	98.0	98.3
Color TV	94.7	98.2
Auto, truck, van	85.1	85.7
Microwave	76.8	93.2
VCR	68.1	86.9
Washer	75.0	80.0
Dryer	68.5	77.1
Sound components	57.3	72.5
Computer	18.6	59.3
Dishwasher	48.7	58.1
Garbage disposal	37.3	47.0
Freezer	32.8	30.8

By almost all measures, American households* had more consumer goods in 2002 than a decade earlier, a recent Census Bureau report found. Computer and VCR ownership jumped dramatically.

*Households where members are related or share expenses

COMPUTERS BY A NOSE

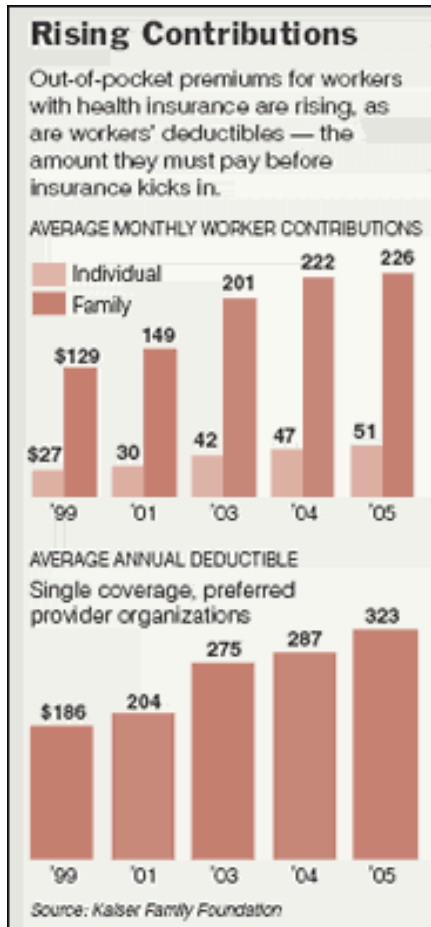
More households* now have a **computer** than have a **dishwasher**.

	1992	2002
Computer	18.6%	59.3%
Dishwasher	48.7	58.1

*Households where members are related or share expenses

By July 2009 there were 400 million computers worldwide all sucking up electricity And providing an upward bridge in lifestyle for the rest of the world's billions.

Catalysts at Home: Are You Ready?



- Defined benefit pensions are being replaced by 401Ks.
- Labor contracts are being re-negotiated by Corporations
- Safety nets are being stripped away.
- Baby boomers are coming.
- Taxes

Current Legislative Catalysts For Discovery Investing

Higher Taxes – 50% the population pays 96% of inc. tax.

The threat of serious Inflation / Deflation.

Mandatory Contributions: Health Care.

Stealth Contributions: Cost of Cap and Trade - +20% to 40%.

Unsustainable, continuing internal and external deficits ---> dollar decline.

Government intrusion. WHO / IMF reserve currency?

Ten Point Discovery Investing Grid

(Used to Rank Order Your Discovery Investing Universe)

1. **Seek Assets and Intellectual Property** that have World Class Potential. (1 to 10)
2. **Obtain Control:** Percent asset ownership.
3. **Judge** Asset Strategic Potential.
4. **Align with an Proven Management** track record.
5. **Diversify:** A portfolio across discovery categories.
6. **Identify the Cycle, Timing and Catalysts** for value recognition.
7. **Purchase** Assets that are out of favor (2009: Natural Gas?).
8. Seek Financial **Soundness / Sustainability and Relative Strength.**
9. **Find management that Builds Positive Stakeholder** relations.
10. Investor **Behavior:** Patience and Courage. DI is Long Term.

Look For Unloved, Unwanted Discovery Opportunities

- Uranium (2003)
- Gold
- Silver
- Oil (1999)
- Vaccines
- Rare earth minerals
- Utilities

Morning Notes By Michael Berry

- Michael A. Berry, PhD.
- www.DiscoveryInvesting.com
- info@DiscoveryInvesting.com