

Discovery Investing: Theory Versus Practice

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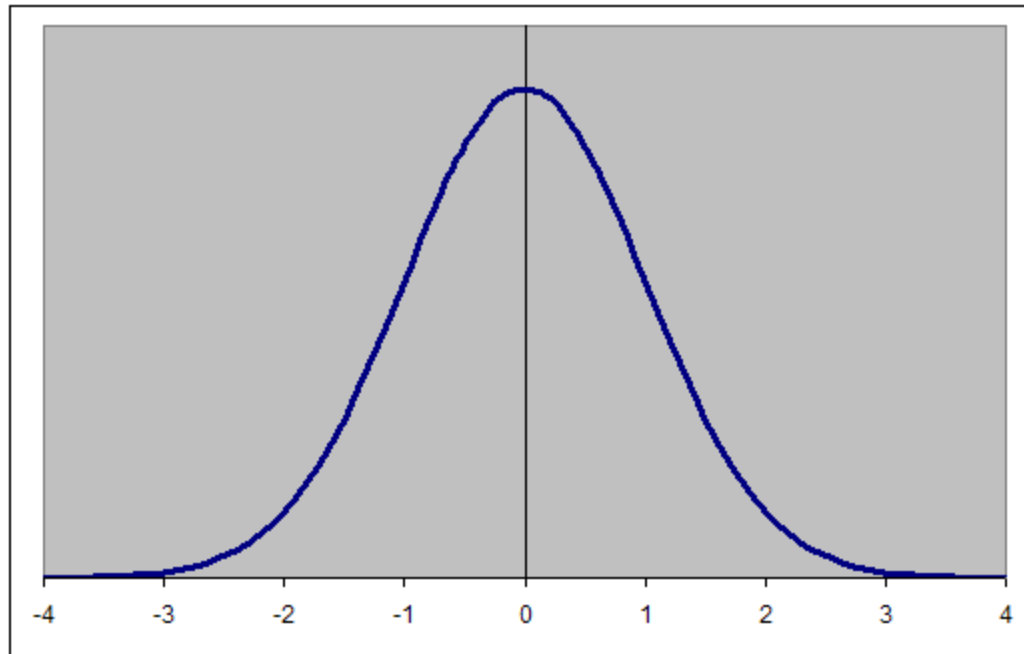
Traditional Investing Techniques

- Efficient Market Hypothesis (EMH)
- Modern Portfolio Theory (MPT)
- Risk and Reward Measures: Alpha and Beta
- Valuation Models: DCF, CAPM, APT, VaR
- *These techniques and theories have almost no application in Investing Today*

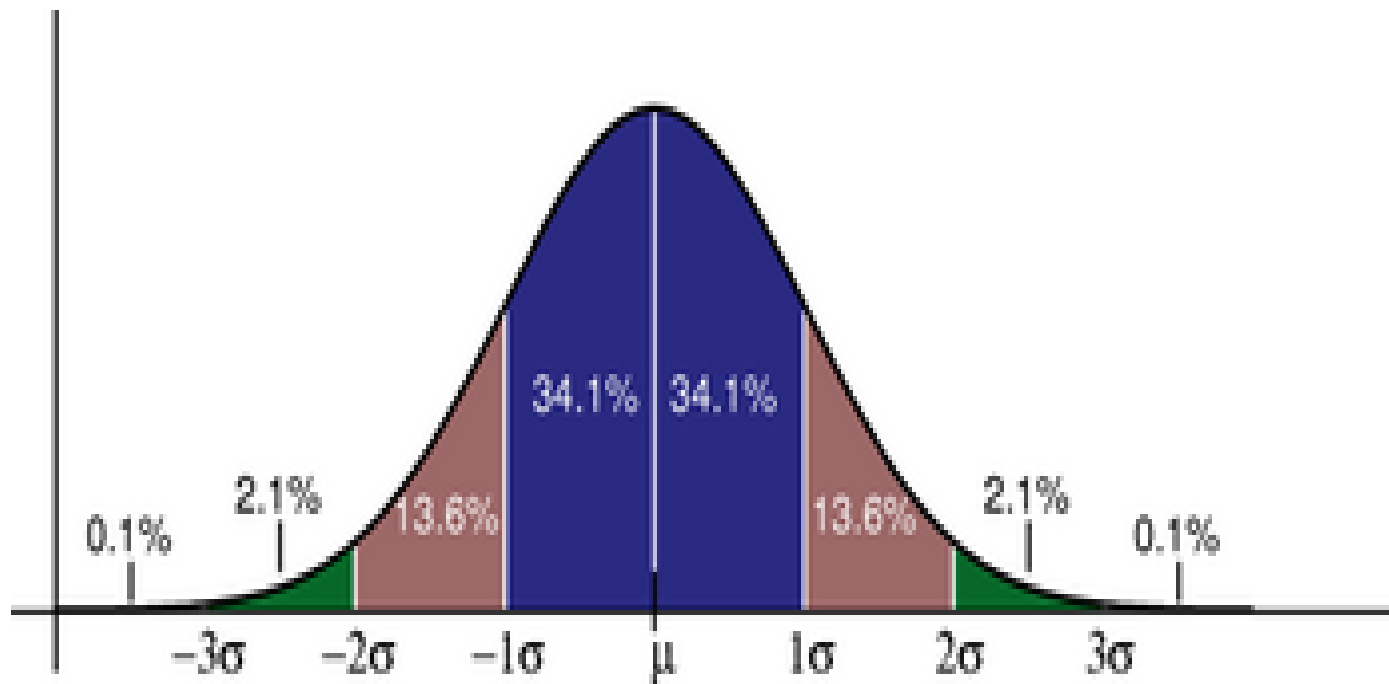
How to Characterize Risk Assessment

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

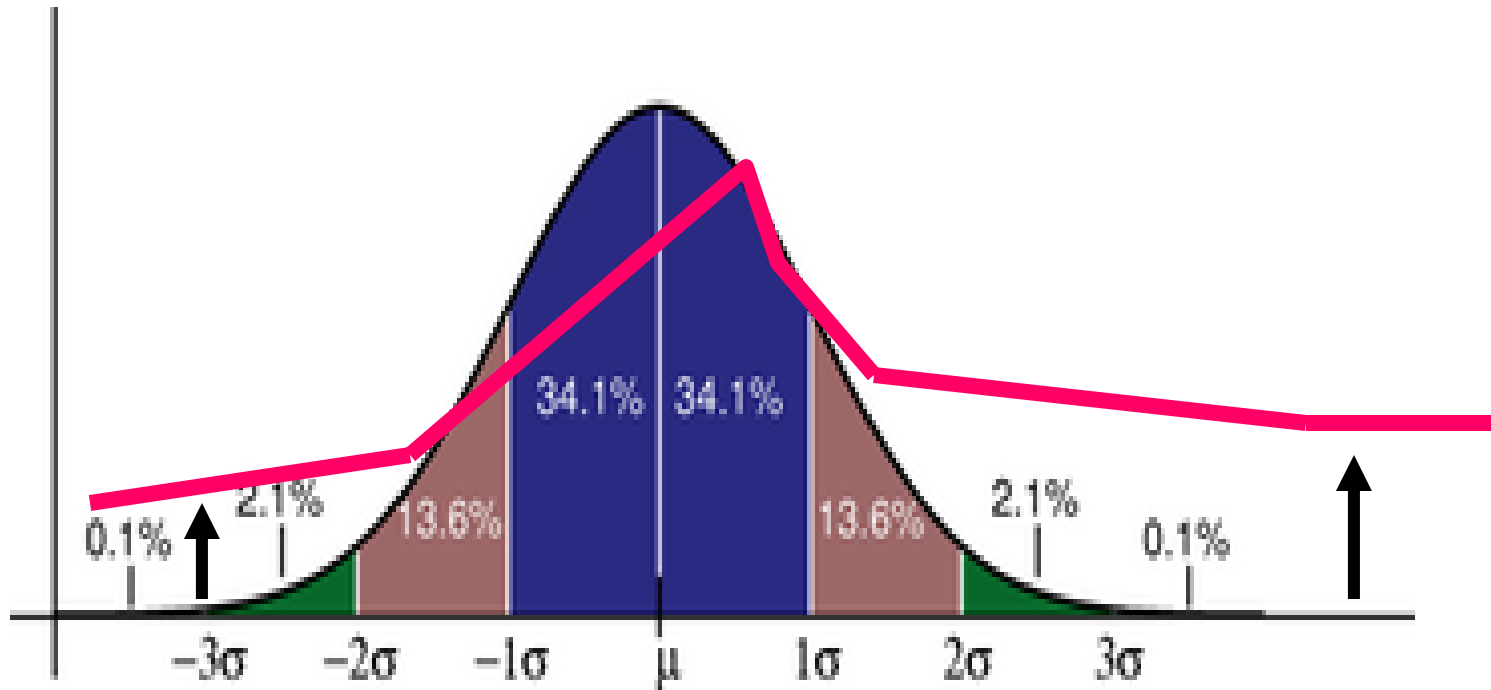
Risk / Reward



Traditional Risk: Normal Probabilities



Fat Tails and No Symmetry = No Theory



The world is 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".*
- *Ben Graham*
- *MOS in Discovery Investing is different – low share price, a reasonable probability of a world class discovery, diversification and significant upside provide a 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

- Styles Tend to Go “Out of Favor.”
- Risk Assessment is Difficult to Impossible.
- Valuation is in the “Eye of the Beholder.”
- Investor Behavior Changes.
- Catalyst Identification: what is a catalyst?
- Buy and Hold or Buy and Trade.
- Catching the Cycle.
- Rates of Return are Vary.

A Few Secrets of Discovery

- Own Control.
- Look Where Others Won't.
- Seek High Potentiality.
- Seek Very High Risk Reward Ratios (gold / silver ratio).
- Pay A Low Price.
- Align with Superior Management.

Discovery Yields Both success and failure

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

Reversion to the Mean

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

Practice In Discovery Investing



Antioquia Gold

AGD.V (Antioquia Gold Inc.) CDNX
2-Nov-2009

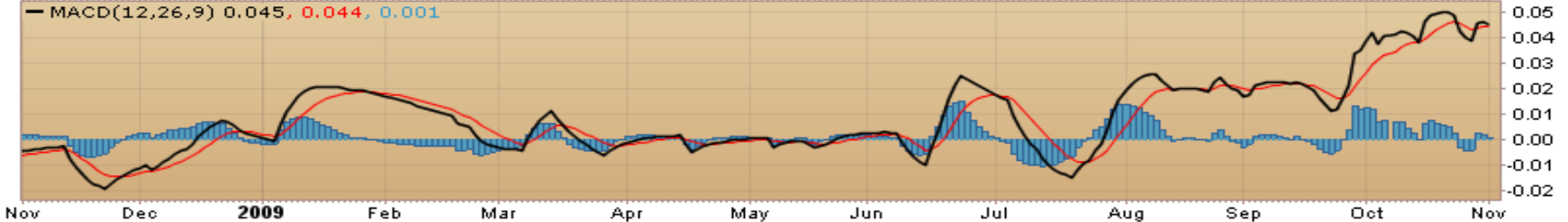
© StockCharts.com

Open 0.450 High 0.530 Low 0.450 Close 0.520 Volume 29.3K Chg -0.010 (-1.89%)

▲ RSI(14) 58.33



MACD(12,26,9) 0.045, 0.044, 0.001



Golden Rules of Discovery Investing

- Must be used in an asset allocation framework.
- Requires diversification in your chosen discovery field due to much higher risk.
- A 5% to 20% weighting in Discovery is usual.

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

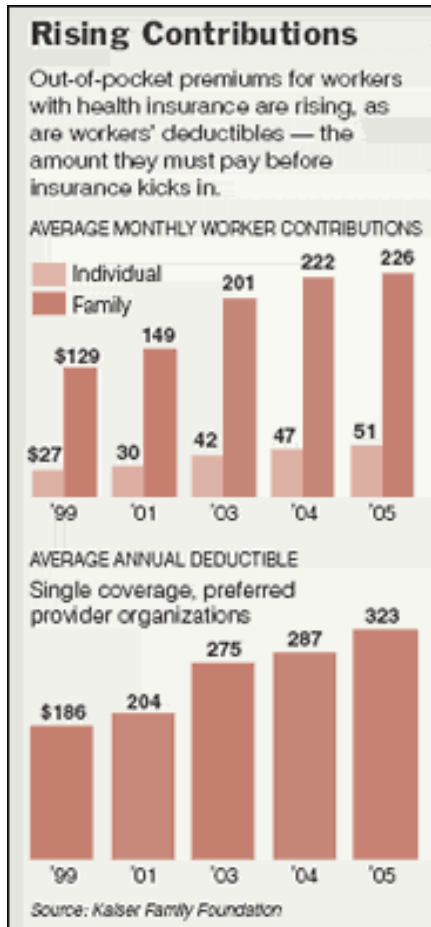
More households* now have a **computer** than have a **dishwasher**.

	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.

Harvard Profs Ken Rogoff and Niall Ferguson

- Chimerica is dead. It will occur soon and be painful for the US.
- Buy hard assets.

• Source: Bloomberg October 26, 2009

Current Catalysts

- Higher Taxes – half the population pays 4% of tax.
- The threat of Inflation / Deflation.
- Mandatory Contributions.
- Unsustainable deficits – dollar decline.
- Government intrusion. WHO / IMF reserve currency?

Ten Point Discovery Grid

- **Seek Assets** in “elephant” territory.
- **Obtain Control**: Percent asset ownership.
- **Judge** Asset potential.
- **Align with a Management** track record.
- **Diversify**: A portfolio across discovery categories.
- **Cycle** identification and **Catalyst** identification.
- **Purchase** Assets that are down and out.
- Search for Financial **Soundness / Sustainability**.
- **Build good Stakeholder** relations.
- Investor **Behavior**: Patience and Courage.

Look For Unloved, Unwanted Discovery Opportunities

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

Morning Notes

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