

**Today's Notes:**

- 1. Discovery Investing: A Creative Future**
- 2. Mexico**

## **1. DISCOVERY INVESTING**

Almost a decade ago I realized that there was a big hole in current investing theory and practice. At the time I didn't realize that my ideas would morph into a new approach I called Discovery Investing (D.I.). This investing discipline is different and, more important; it is more powerful in many ways than traditional investing strategies we have from academics and practitioners.

First, though, we must define the technique. Discovery Investing is a discipline that seeks significant value creation through market recognition of a world class discovery. For example the discovery of a cure or effective treatment for cancer would be worth billions of dollars. The recent sale of Imclone and its cancer treatment Erbitux, a \$7 billion take-out, attests to this fact. In 2002, I recommended Western Silver as a micro cap (Incubator) Discovery company. After 4 years of silver exploration in Zacatecas, Mexico the company had discovered millions ounces of gold and hundreds of million ounces of silver. Goldcorp (GG) ended up owning Western's discovery for a premium of \$2 billion.

Practitioners of the discipline seek companies that offer these mega-wealth creating opportunities in many different fields. They may be found in the natural resource sector, bio tech sector, high tech sector or, today, in the infrastructure space here in the US. The reformation of the Utility sector (the development of the electrical grid) is a good example of how the Discovery Space tends to expand and change over time. A major discovery always pays a significant wealth dividend. The recent focus on health care and alternative energy discoveries has spawned dozens of new discovery opportunities.

D.I. is virtually an untouched investment space. At the beginning of their life cycle the discovery companies are usually small, illiquid micro caps. We categorize them as "Incubator" companies. Nobody cares about them. They fly "under the radar screen." I developed a ranking model to identify the best of these opportunities. It is called the Discovery Investing Factor Model. Consisting of just 10 rules, it is easy to use. A quick examination of the grid's analytical framework below provides a useful description of the discipline. For each company, each discovery factor is rated by its potential between 1 and 10 (10 points being the optimal rating).

- 1. Discovery Potential is real. Does this discovery have "world class" value-creation potential?**
- 2. Ownership share: does the company own control of the asset 100%?**
- 3. Is the potential discovery a game changer? Is it revolutionary, useful today and progressing towards realization?**
- 4. Is there diversification of discovery risk, multiple opportunities? Are there opportunities for serendipity?**
- 5. Management and the Board: track record, ownership and insider transactions, option strategy.**
- 6. Identify a Dominant Cycle (e.g. the Global Quality of Life Cycle) and Catalyst (e.g. the discovery).**
- 7. Is this a Contrarian discovery play? Are you buying into this for pennies?**
- 8. Financial strength: balance sheet & income statement management; sustainability of operations, dilution strategy.**
- 9. Does management communicate well with employees, shareholders and customers - Stakeholder relations?**
- 10. Can you exhibit self control, patience, courage, sustain loss, and continue to invest?**

## The Practice of Discovery Investing

Factor number 10 is critical. You must always realize that the discovery process is long term, costly and risky. Is this an investment that **you** believe will sustain itself and create value in strong and weak economies? One most important question is this: Are you willing to stay the course?

In order to become a Discovery Investor you must practice the discipline. Analyzing any of the companies mentioned in this short note is your opportunity. A score above 70 (when you add the ten factors) is a very good score that usually puts a company in the top quartile of its universe.

Is Discovery Investing a more creative approach? It is certainly different from traditional equity investment disciplines. Perhaps the appropriate answer is that it is a more powerful way of looking at an old problem – how to invest in your equity portfolio to create wealth. What we do know is this. While D.I. is risky, the risk-reward ratio for a given discovery opportunity is usually very appealing. Since we base this investing discipline on the proposition that great discoveries will create great wealth, D.I. should work in all economic seasons including recessions. In our experiences over the past 7 years, we have found this to be true. Since investors in this discipline tend to focus initially more on the discovery itself, the core of the investment issue, there is less immediate focus on the company itself. That's an excellent starting point for analysis. We think this is an advantage for investors. In the end analysis Discovery Investing is an adjunct to the investing tools that have developed over the course of the past few decades.

A few recent examples of Incubator, Mature or Legacy discovery companies:

- 1) Quaterra Resources (Mature, QMM NYSE AMEX),
- 2) MegaWest Energy (Mature, MGWSF),
- 3) Avalon Rare Metals Inc. (Incubator, AVL TSXV AVARF),
- 4) Houston Lake Mining (Incubator, HLM TSXV) and,
- 5) Senesco Technologies (Incubator, SNT NYSE AMEX).
- 6) Goldcorp (Legacy GG NYSE)

These are companies of interest to me that you might follow in the 2010 timeframe. You might even evaluate them using the Discovery Factor Model outlined above.

**Quaterra** is a diversified metals company with top management and silver, copper and molybdenum properties in North America. QMM has developed an extensive pipeline of highly prospective properties. Freeport McMoran and Goldcorp, two industry giants, have recently made significant investments in the QMM business model. **MegaWest Energy** is producing ~200 barrels each day of heavy oil in the US (Missouri) on 5% of its U.S. land position of 130,000 acres. MGWSF expects production of 1,000 bpd by June 2010. MegaWest is classified as a Mature Discovery company with production and cash flow. **Senesco** is an Incubator bio tech company with a promising genetic cancer technology. Senesco management expects to enter human cancer 1A/2B trials in 2010 at the Mayo Clinic. Their chances for positive multiple myeloma results are excellent. **Avalon** has developed a large rare earth ore body near Yellowknife in Canada's Northwest Territories. AVL is an example of a rapidly maturing discovery investment. Its deposit contains both light and heavy rare earth elements. **Houston Lake Mining** continues to make excellent progress on their gold property near Kenora in Northern Ontario.

As always, a word of caution is in order. Discovery Investing, especially in the Incubator space, is risky. To counter the high risk, the risk / reward ratio must be favorable. Not all of discoveries will come to fruition. In this investing discipline if you bat 300 you will be richly rewarded. That is why we developed and utilize the Discovery Factor Model, revise our factor values and weightings frequently, diversify thoroughly and follow a rigorous sell discipline.

*Dr. Michael Berry is the former Wheat First Professor of Investments at James Madison University and an Assistant Professor of Business Administration at The University of Virginia. He is also a former Wall Street money manager. He has spent the last decade developing the discipline of Discovery Investing. Dr. Berry believes that the coming resource constraints in the world, stimulated by a rising Quality of Life Cycle in the emerging world, will require significant discovery efforts in many different areas including natural resources, bio tech, high tech and infrastructure development. He publishes Morning Notes by Michael Berry and owns shares in Quaterra Resources, Senesco Technologies and MegaWest Energy.*

## 2. MEXICO: THE GAME IS ON (REDUX)

Just a quick follow up to yesterday's Morning Note on the Newmont/ Fresnillo bid for Canplats. Obviously Canplats was much higher yesterday (a stock I own in my retirement account). We think Goldcorp will respond within the 5 day window with a bid for Canplats. Canplats must be worth a lot more to GG than the Newmont / Fresnillo JV.

If you are interested in viewing a very recent interview I conducted with Tom Patton of Quaterra please click on the following web address.

<http://www.quaterraresources.com/index.php?page=interview&subpage=1>

The interview is contained on the Quaterra website. In Section 5 Dr. Patton speaks of the company's position in central Mexico. This is a most enlightening interview from the perspective of yesterday's events. The market seems very interested in all the players in this opera. Goldcorp, Canplats and Quaterra were all up significantly yesterday.





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