FORUM

European Smallcaps GmbH

Memorandum

To : Forum Staff

From : BW, RK

Copy to :

Date : January 20th, 2009

Subject : FORUM European Smallcaps Q IV 2008 Results

Q IV put an especially negative cap on an already tough year. Our operations had the worst quarter, and year, in its 7-year history. While part of the losses can be attributed to the prick of the credit bubble and the havoc it wrecked on global asset prices **they also point towards weaknesses in our investment policy and the need for changes as described below.**

In addressing the results, we would like to **separate our analysis and comments into two separate communications:**

a) **In this memo** we would like to address **Q IV specifically**, and stick to our standard format which comments on the outcome of our investment process and our scoreboard within the period.

b) **In a separate memo** we will address the **year as a whole**, and reflect on the current crisis as well as on mistakes made in our investment process in a more reflective way.

The following addresses the results in Q IV 2008.

1. Results and Benchmarking

We would like to refer to **Table 1** for an overview over results. The key observations are:

a) **In Q IV we lost 28,9%** making it the worst quarter in the history of the operation. This loss matched the loss of the HSBC Small-cap index in € which we use for benchmarking.

The European Smallcap Fund of Ennismore in € which has a long/short strategy with only ca. 12% net long exposure at the end of the year reported a smaller loss of 17% in the quarter.

b) This brings the **full year return to -52% -** in line with the performance of the HSBC index and clearly worse than Ennismore (-28%). Ennismore was able to generate significant outperformance over the benchmark index and over us due to its long/short strategy.

Considering the significant cash balance we held and the fact that we were **not invested in any financial services company** (other than a squeeze-out situation with downside protection) we should have clearly outperformed both in the quarter and in the year. As we will explain below we suffered from some special effects which require a change in our investment policy.

c) Due to these losses our performance since inception **dropped to 14% p.a.** – the first time it dropped below the low-end of our targeted range of 15 – 20%. p.a.

2. Sources of Results

Please refer to **Table 2** for an overview over the sources of the loss of 28,9% in Q IV 2008 as well as the loss of 51,7% in the full year 2008. As you can see **adjustments to the Intrinsic Value of our holdings due to earnings power adjustments** were the biggest negative contributor with a negative effect of ca. -23%. It was followed by **multiple contraction** with a negative effect of 8,6% and **currency devaluation** with a negative effect of 3,5%.

Conversely Portfolio Management – buying below Intrinsic Value and selling above – reduced the loss by ca. 6%.

2.1 Changes in Intrinsic Value

In Q IV 2008 the Intrinsic Value of our portfolio – before currency movements - **decreased by 17%.** This decline is the net effect of

- a negative ca. 23% contribution due to the **reduction in earnings estimates**
- a positive ca 6% contribution from **portfolio management.**

2.1.1 Contribution from lower Earnings Estimates to Intrinsic Value

The reduction in earnings estimates in existing holdings by 23% in our holdings is worrying as **the concept of Intrinsic Value implies a long-term stability independent of short-term changes in the economy or the state of companies**. It is even more worrying as these downgrades have a history:

a) **In Q I and Q II 2008** we had moderate downgrades of Intrinsic Values by ca. 3% and ca. 2%. Most of them related to growth assumptions which were too aggressive – not taking into account the Execution risk which is inherent in the small and mid-cap companies which are the vast majority of our portfolio. **The underlying biases are**

overconfidence and greed – **in connection with growth assumptions summarized under the term "rosy glasses".**

We identified "rosy glasses" as a central bias in our Q II 2008 newsletter and stated that we would try to eliminate it from our modeling.

b) **In Q III we sincerely tried to eliminate all "rosy glasses" from our calculations of Intrinsic Value** – producing a major downgrade by ca. 19%.

c) So having to report another downgrade by ca. 23% needs an additional explanation. The reasons for this downgrade are different from the over-ambitious growth assumptions which we corrected in Q III 2008:

- C**a. 72% of the total downgrade are due to massive mismanagement in two holdings we own.** Management of our largest holding Pulsion – a medtech business with a razor/razor blade business model and a patent-protected product dominating a growing market niche – **managed to reduce EBIT from 2007 to 2008 by more than 70%.** In another holding the **negative earnings surprise was even steeper**. In both cases the CEO was fired in Q IV. None of these decreases was due to the deterioration in the economy.

  The tentative conclusion we draw from this is that **we are not capable to assess management in a publicly-quoted company based on its talk and a rather short time series of financial numbers and actions**. (Is anybody able to make that call?) We think that we have already drawn the right conclusions from this in H1: **we will not invest in any new company unless the acting management team has at least a 5-year track record. Unfortunately these events happened in existing holdings.**

- Another **19% of the revisions are due to the sudden deterioration of the worldwide economy**. These downgrades affected several holdings. We are fairly confident that **most of these revisions will be temporary** as 2009 results will most likely be below Average Future Conditions – which define Intrinsic Value.

- This leaves **the remaining ca. 9% of the downgrade due to "rosy glasses"** which we had not eliminated in Q III 2008. It related to a UK-based software company

2.1.2 Contribution from Portfolio Management to Intrinsic Value

In Q IV 2008 **portfolio management, the second source of increasing Intrinsic Value, contributed a ca. 6% positive result to the Intrinsic Value of our portfolio**.

We were able to **exit three positions completely**. The most significant was a negotiated exit from a business which had de-listed in Q III 2008 at a price which we consider clearly above Intrinsic Value.

The most significant **addition to our portfolio** was our participation in a capital increase in UK based medical diagnostics company with a discount from Intrinsic Value.

We did **not take on any new names in Q IV 200**8.

2.2 Currency Losses

In Q IV 2008 currency losses amounted to ca. 3,5% of total assets. This bringing the full year currency loss to -6,0%. All of these losses are due to the steep devaluation of the British Pound.

Our policies on currency management as outlined in the Q I 2008 newsletter are still unchanged.

2.3 Multiple Contraction/Expansion

The remaining portion of the quarterly loss – i.e. – 8,6% - is attributable to Multiple Contraction. Specifically the **EV/EBITA multiple** of our holdings (after applying the earnings downgrades mentioned above) **decreased from 7,0x at the beginning of the quarter to 6,2x at the end.**

The multiple of 6,3x compares with 8,3x at the beginning of the year.

Using our standard multiples to determine Fair Value yields **a Fair Multiple of 8,6x for the companies in our portfolio**. Our multiples reflect the Franchise strength of our companies, their growth and the market cap. Thus the present market valuation of 6,3x implies **a discount of ca. 27% below what we consider Fair Values**. This discount reflects the **Margin of Safety** of our operations.

3. Special Aspects of Q IV 2008

3.1 Total Number of Holdings

In Q IV 2008 the **total number of positions dropped to 11**.

Our **Investment Policy defines 10 positions as a target upper limit** – thus we are getting in line with this policy again.

We would like to maintain this upper limit as we felt that we were stretched monitoring the 15 holdings (and their competitors as well as the business system around them) we had in Q II 2008. Also, the allocation of assets to our holdings is very skewed producing a long tail of companies making very little difference to our portfolio.

3.2 Liquidity of Holdings

Please refer to **Table 3** for a structure of our portfolio by market cap. **In terms of market cap 74% of the invested part of our portfolio is in companies with a market cap < € 100m**. As a result at the end of Q IV 2008 liquidation period of our holdings – defined as the period required to liquidate 50% of our stake – was at **92 bank days** – only down slightly from the 104 days at the beginning of the year. To manage this number down we have established two modifications to our Investment Policy:

a) **For the existing portfolio we will have to seek negotiated deals to exit.** This may imply joining the Boards of selected companies.

b) **For new investments our Investment Policy requires an average daily trading volume ("ADTV") of € 500.000,- -** unless we have control or have the opportunity to get control. This translates into a market cap of > € 100m, depending on the Free Float in many cases > € 200m. We made some exemptions to this principle in 2008 because the opportunity was so tempting – but will not do so any more in 2009.

3.3 Cash

At the end of Q IV 2008 **cash and cash equivalents accounted for 35,8% of AUM**, significantly up on the 22,0% at the end of Q III 2008. While the nominal value of "dry powder" did increase 18% in the period, unfortunately this increase is mostly attributable to falling share prices within the invested portion of the portfolio.

We used to view cash as a residual from the opportunities we would find (or not find) in equities. We have **changed our Investment Policy** to define a target range of cash as a function of

a) the **current valuation** of the markets relative to historical averages

b) the **valuation at the preceding peak or trough** – as an indicator for the probability of an overshooting in the corrections process.

Both of these aspects are documented and discussed in the Macro Dashboard which we have started to do in Q II 2008. At present this model suggests **a target cash level of 25 – 30%, mostly to take advantage of an overshooting of the market into negative territory which could be expected based on historical market behaviour.** Thus actual cash is slightly higher than we would like to have it.

We hold cash in € only.

3.4 Shorting

We use the signals from the Macro Dashboard also to define a target range of short positions we would like to have in order to manage the maximum long-only exposure. This is another learning experience from 2008: **we do not want to be 80 – 100% long if the market is grossly overvalued by historical standards – even if our model does not produce "sell" signals for our holdings.**

As the market has already come down from a massive overvaluation to about Fair Value our model suggests a moderate shorting of 0 – 10% of AUM.

As shorting is new territory for us and history shows that many long-only managers have lost money entering this field. We are carefully assessing an investment in two individual shorting candidates.

The key impact of this revised Investment Policy will be **a significantly higher share of shorts should we get back to another period of significant overvaluation in the future**. In such a case we would try individual company shorts first, but compromise on shorting indexes if we do not find candidates which we feel comfortable with. We discussed these issues at the beginning of the year, but unfortunately never defined a "hard policy" – if we had our results would very likely have resembled more those of Ennismore.

3.5 Circle of Competence

2008 generated proof that our Investment Policy to limit ourselves to our "Circle of Competence" is an important first-line defense against risk **as it kept us from investing in any financial institution** (other than a squeeze out situation). We always felt that nobody could understand the Balance Sheet of most financial institution and that proved right.

Conversely, as it turns out some of the biggest losses we took in 2008 were in the IT sector – which we had only added to our investment universe in 2007. It looks now that we did not fully understand the complex nature of competition in this sector.

As a consequence in 2009 we will **focus on the ca. 5 sectors which have historically defined the core of our Circle of Competence**, i.e. Medtech, branded consumer goods/retailing, media, B-to-B service companies with a strong user value proposition and engineering companies with strong after-sales.

3.6 Calculation of Intrinsic Values in our Investment Process

2008 was the year in which we learned painfully that our calculation of Intrinsic Values – which are at the heart of any value investing approach – was flawed by mental biases ("rosy glasses") and the – by now questionable or even untenable - assumption that we can assess management in a publicly-quoted company without a multi-year track record. We introduced some changes to our Investment Policy to protect us against a repeat of these mistakes, mainly calculation of IV based on CTM earnings and requirement of a 5-year track record for the acting management team.

We may have to re-think our calculation of the Intrinsic Value even more as outlined in the last newsletter. **The general idea will be to base any valuation more strongly on past data as opposed to forecasts. We will discuss this issue internally and comment on the outcome in our Annual Report.**

4. Discussion of Risk Management

4.1 Margin of Safety at Investment Portfolio Level

At the end of 2008 the Margin of Safety – the discount of market prices from our estimates of the Intrinsic Values of our investments – stood at 27%. This is up from 18% at the end of Q III 2008.

Normally this should instill strong confident that we should expect healthy returns going forward as valuations have historically reverted to means. **The key question is how firm these Intrinsic Values are**. We have now experienced two rounds of downward adjustments:

a) In Q III 2008 in the process of eliminating the **"rosy glasses bias**" – **overconfidence and greed producing over-optimistic assumptions on growth**

b) In Q IV 2008 being hit by **massive mismanagement** not detected by us and beyond what we thought would be conceivable.

So we are still cautious as to what other biases and risks are still out there which have not hit us yet.

4.2 Company-Specific Risks

During Q IV 2008 the most significant impact on the portfolio in terms of Intrinsic Value reduction was a major downgrade in the Intrinsic Value of our holding in Pulsion due to rapidly declining fundamentals. The resulting downgrade in **reduced the Intrinsic Value of our AUM by ca. 8% – well above the 3% limit which we have set ourselves for the maximum exposure to any risk**.

In this case **two safeguards in our risk management system failed:**

a) BW was the **Non-Executive Chairman** of the company - giving him better access to information in most cases where we are just outside shareholders. We have to state that the whole Board did not detect this evolution early enough. At the source was a CEO who was brought in from the outside in May 2006. He produced a flurry of management decisions that diverted the company away from its core – but they were masked by the strong positive momentum and the financial resilience of the wonderful med-tech business he had inherited. One might also debate whether revenues were supported by **selling into channels rather than increasing end use – which is unwinding now.**

Eventually the Board became suspicious, but at that time the two-year record or poor actions started to take its toll in a precipitous manner. The conclusion is that **even a Non-Executive Board may not detect early warning signals on mismanagement from a new external CEO in a strong business.**

b) Because of a) **we had not defined a risk scenario for massive mismanagement in our quantitative risk management system**. Therefore our internal systems did not produce a quantitative warning signal that the possible loss on massive mismanagement would exceed the **3% maximum we are willing to tolerate.**

As a conclusion we have further hardened our requirement for a track record of at least 5 years as a requirement for any new investment: this requirement has now been defined as mandatory and we have added that we would prefer a 10-year history of the company. The new policy matches the philosophy followed by Warren Buffett who has long stated that he will only invest in management with a proven track record as he feels incapable of assessing management.

Requiring a track record of 5 or even 10 years is a logical conclusion for anybody who wants to take concentrated bets. The only protection against the limitations to assessing management would be a limitation to each position – and that is something we clearly reject.

Keeping in mind the systemic limitations of our risk management system discusses above – mainly the short track record of companies and their management - **we see no individual risk which could reduce the Intrinsic Value of our portfolio by more than 3% of AUM.**

5. Outlook

5.1 Macro Outlook

We summarized our position on the outlook on the economy and financial markets in our Q IV 2008 Macro Dashboard:

"We should prepare ourselves for a major correction in both the real economy and in equity markets. This recession and the accompanying bear market is very likely not at all comparable with the 2000 – 2003, most likely it will be as deep as the two worst recessions after the war

a) 1974 – 1978

b) 1982 – 1984.

There is also a clear risk case – in particular driven by the unwinding of the Debt Super-Cycle as a cumulating effect which would suggest that we may see the economy and valuations test the lows which were seen in the 4 -5 worst troughs since the start of the last century."

5.2 Specific Plans

At the beginning of the year our pipeline of new investment candidates which are within 10% of our buy limits is rather short. This appears surprising after one of the steepest market drops in history.

The main reason is that even after this market correction the market is only valued fairly by historical standards when using valuation metrics like Schiller's CAPE or Tobin's Q.

Secondly, we have made several changes to our investment policy in 2008 which raised the hurdles for a new investment:

a) We have **withdrawn from the micro-cap segment** where we had spent most of our research since inception. Also, **in the mid-cap segment which we focus on now** we compete against more analysts in the mid-cap sector, reducing the likelihood of significant market inefficiencies.

b) We have **tightened our investment requirements**: we now demand a 5-year track record of management, specifically no fault in capital allocation or integrity, our management assessment still has to produce minimum scores, valuation has to meet our hurdles based on CTM earnings (before: FTM) and we do not tolerate a risk of losing more than 3% of AUM in case the most significant identified risk materializes.

The stronger pipeline of investment candidates which we wrote about in previous letters was nearly all in the micro-cap segment – applying very aggressive assumptions on growth and being willing to pay for the growth as we used FTM earnings as the relevant benchmark. Thus it appears plausible that we have dried out the supply of interesting candidates.

Thirdly, in the present market conditions strong Franchise Businesses are in the focus of all investors. So our traditional strong areas of medtech and subscription-based businesses are **sought as a "safe haven" by many institutional investors**. As a result they have not come down significantly.

We are aware that other value investors are reporting that they see a plethora of opportunities. As far as we can see from their portfolios they use different Investment Policies

a) **Value investors in the large-cap segment** (e.g. Tweedy, Browne) appear to be willing to pay multiples for the strongest Franchise Businesses (e.g. Nestlé, Diageo) which we would not be willing to pay as the expected returns from Internal Compounding would not clear our hurdles.

b) **Value investors with a similar focus on mid-caps and small-caps** we follow (e.g. Ennismore, Bestinver) appear to be willing to invest in bombed-out Execution Businesses expecting a recovery. Many of these businesses would not meet our qualitative hurdles for Franchise characteristics and again would not have the long-term Internal Compounding characteristics we seek.

So in Q I 2009 we will focus our search for new investments on two areas:

a) **Additions to existing holdings** – we have always done that in the past

b) **Purchases in related instruments**, e.g. corporate bonds or companies which are exposed to the commodity cycle – which is down at present.

As always we feel no pressure to spend our money and **will only swing if the opportunity appears outstanding.**

Appendix

Table 1: Results and Benchmarking

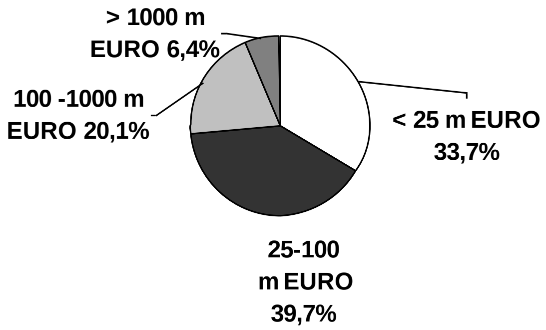
Period	FORUM	HSBC European Smallcap Index €	Ennsimore European Smaller Companies Fund €
Q IV 2008	-29%	-29%	-17%
FY 2008	-52%	-52%	-28%
Since Inception (1.1. 2002)			
Return p.a.	14%	1%	7%
Index (1.1.2002 = 100)	246	106	156

Table 2: Sources of Results

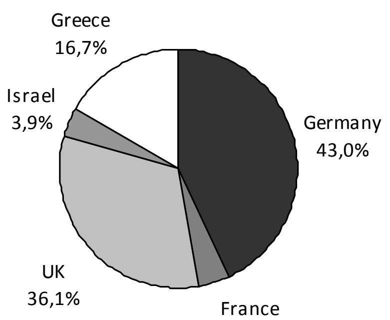
Period, FY 2008	**Q I**	**Q II**	**Q III**	**Q IV**	**FY 2008**
Change in Intrinsic Value	-2,7%	-0,4%	-16,0%	-16,8%	-32,2%
thereof Earnings Power	-3%	-2%	-19%	-23%	-42%
thereof Portfolio Management	0%	2%	3%	6%	10%
Currency Changes	-3,4%	-0,2%	0,0%	-3,5%	-6,0%
Multiple Expansion / Contraction	-8,4%	1,0%	-4,0%	-8,6%	-13,5%
Total	**-14,5%**	**0,4%**	**-20,0%**	**-28,9%**	**-51,7%**

Table 3: Portfolio Structure

Portfolio Allocation by Market Capitalization



Portfolio Allocation by Resident Country



Portfolio Allocation by Industry