FORUM

European Smallcaps GmbH

Memorandum

To : Board

From : BW

Copy to :

Date : April 20th, 2010

Subject : FORUM European Smallcaps Q I 2010 Results

1. Highlights and Summary

We had a quiet start in the new year: **In Q I 2010 at market values our portfolio was up by 1,9%,** slightly below our benchmarks, but insignificantly so.

More importantly the **Intrinsic Value of our portfolio increased by 4,4%.** As the net effect of currencies was close to 0 in the quarter this implies that we had a slight multiple contraction.

Our l**evel of activity was relatively low with 5% of AUM (gross) bought and sold.** As a result the structural issues in the portfolio remained largely unchanged:

a) **Portfolio concentration**: our largest holding still accounts for ca. 61% of AUM

b) We are still operating with a **Negative Margin of Safety.**

c) **Composition of Intrinsic Value**: More than 50% of the Intrinsic Value of our portfolio is accounted for by the Value from Internal compounding and Management Contribution – which are based on projections of the future. Conversely, less than 50% is accounted for by Net Earnings Power Value – which is based on the more visible track record of the past.

In the last quarterly newsletter we announced that we would be working on the composition of the portfolio in order to address the abovementioned issues and in order to generate cash. We have been slow in executing this task, mostly due to restrictions in trading and to the small liquidity of our holdings. **We promise that we will tackle these issues in Q II and have already had more activity in the quarter to today than in all of Q I.**

Due to the further run-up in share prices since our last report the **pipeline for new investment candidates looks thin.**

2. Benchmarking of Results

For an overview of **our results vs. our benchmarks** we would like to refer to **Table 1**.

2.1 Results in this Quarter

The key observations in this quarter are:

a) **In Q I 2010 our portfolio gained 1,9% at market values**. As in the previous quarters we only had long positions and cash in the quarter. The invested part of the portfolio returned a gain of ca. 2,1%.

b) The **HSBC Smaller European Total Return Index in € gained 8,4% in Q I.**

c) **The European Smallcap Fund of Ennismore in €** - the European smallcap value fund we deem the best and therefore use as a benchmark - **reported a gain of 5,6% in the quarter**.

2.2 Results since Inception

Unchanged from the previous quarter:

We still believe that in public equity investing any meaningful track record starts somewhere between 5 and 10 years. Only after such a period an investment philosophy will have been tested against the vaguaries of market cycles or luck from market timing or individual stock picks.

By the end of 2009 results **our cumulated performance in the 8 years since January 1st, 2002 – the date of our inception - was 28% p.a. – a total increase to 577% of starting value**.

Thus in the 8 years as investors we have exceeded our target of a compounded return of 15% p.a. significantly. After the massive market correction in 2008 it certainly feels as if we have gone through a full cycle – thus these results should reflect investment performance independent of a certain market situation.

Our IRR of 28% resp. to 577% of starting value since inception on Jan. 1st, 2002 compares with IRRs of

a) **7%** p.a. for the **HSBC index in € –** a total increase to **165% of starting value**

b) **8%** p.a. **for the Ennismore fund in € –** a total increase to **162% of starting value.**

2. Sources of Results

Please refer to **Table 2** for an overview over the sources of our gain in Q I 2010.

2.1 Changes in Intrinsic Value

In Q I 2010 the **Intrinsic Value of our portfolio grew by 4,4%.** This increase is the net effect of

- **Changes made to the Intrinsic Values of portfolio companies** due to new information had a **positive net effect of ca. 4,0%** of the total increase.

- a small positive contribution of **ca. 0,4% from portfolio management:** as announced in the last newsletter we sold down several positions which did not provide us with a Margin of Safety any more. As pointed out below, though, we reduced these positions by much less than hoped for.

2.1.1 Contribution from Changes in Intrinsic Values of Holdings

In Q I 2010 **we made six changes to Intrinsic Values of our holdings**:

- In 5 cases we were able to increase the Intrinsic Value of our holdings due to good results delivered in 2009. These changes were largely incremental.

- In 1 case we had to reduce the Intrinsic Value of an investment which we had written down before several times already once more. This company has been delivering disappointing and negative Cash Flows and Owner Earnings for the third year in a row. According to our calculations the Net Earnings Power Value of the business is now practically 0 due to the associated build-up of Net Financial Debt.

- We did not change the Intrinsic Value of our largest holding in the quarter.

We maintain our goal of **a long-term growth in the Intrinsic Value of the businesses we own of 10 – 15% p.a.**

2.1.2 Contribution from Portfolio Management to Intrinsic Value

In Q I 2010 portfolio management, the second source of increasing Intrinsic Value, **generated a gain of ca. 0,4% in Intrinsic Value of the portfolio as me had little activity:**

a) **We sold down one position** with a market value more than 50% above Intrinsic Value

b) **We sold down another position** with a market value below Intrinsic Value, but where we see risks to the sustainability of the business model which is in the internet space.

c) **We increased positions in two holdings** with market values more than 30% below the Intrinsic Values. In relative terms these are the two holdings with the largest Margin of Safety.

d) **We added a small new position.** This investment relates to a Far Eastern company which is in the process of changing the place where its shares are quoted from a

European Exchange to its home exchange. Thus the investment is an arbitrage position which will most likely be liquidated by the end of the next quarter.

Together these sales and purchases **amounted to ca. 5% (gross) of AUM**. Of these, ca. 1% were purchases and additions to positions, 4% reductions or complete sales of positions.

In our analysis we only count the contribution from portfolio management in the quarter in which we make changes. Thus we ignore the longer-term contribution and thereby tend to underestimate its effect.

2.2 Currency Gains/Losses

In **Q 1 2010 we closed a hedge for GBP at a loss.** The hedge was taken at the peak of the financial crisis in 2009 when we were afraid that the banking crisis in the country could bring down government finances. We think that was an ok decision ex-ante as we had an exposure to GBP which was far above the long-term average.

Overall the result from forex in the quarter was close to 0.

2.3 Multiple Contraction/Expansion

By definition the difference between the change in market values, the change in Intrinsic Values and the currency result is due to Multiple Contraction/Expansion. As **in Q IV 2009**

a) we reported **a gain of 1,9% based on market prices**

b) **Intrinsic Values increased by ca. 4,4%**

there was **a minor multiple contraction.**

2.4 Margin of Safety and its Implications

In the last newsletter we stated

a) **We do not have a Margin of Safety any more**, the value of our portfolio exceeds the value of our portfolio at Intrinsic Values.

b) Only one company is trading above its Intrinsic Values. Selling down the position is difficult.

c) As we believe in Reversion to the Mean in valuations we should expect this excess of market valuations over Intrinsic Values to melt down in the next years, **thus burdening our results significantly.**

d) To correct this we have to manage our portfolio actively in 2010.

Everything is still largely true as we have not been able to reduce the weight of the company with the market prices exceeding Intrinsic Value. We hope to do that in the second quarter.

3. Special Aspects of Q I 2010

3.1 Total Number of Holdings and Concentration

At the end of Q I 2010 the total number of positions has increased to 11 from 10 as we have added one position where we want to do an arbitrage between its quotation at two different stock exchanges.

The degree of **portfolio concentration** is still unhealthy: at the end of March 2010 our largest position still accounts for ca. 61,5% of AUM, down only slightly from the 63% at the end of 2009. The share of the three largest holdings combined decreased slightly to 75% from 77% at the end of 2009.

As stated in the last newsletters we are less happy with the other 7 positions making up a combined 13% of AUM. Most of these positions are too small to make any difference, but require a lot of effort for monitoring**. Once more, the conclusion of this analysis calls for decisive action in selling down some positions.**

3.2 Liquidity of Holdings

In the last newsletter we stated that we would try to get out of 1 -2 highly illiquid positions, but have not managed to do so. There was some movement in Q I 2010 – albeit at a discount from market prices in spite of these being very healthy companies. We will bite the bullet anyway as these discounts have barely any impact on the total portfolio.

3.3 Cash and Cash Equivalents

At the end of Q I 2010 **cash and cash equivalents accounted for ca. 7,6% of AUM, up from 5,0% at the end of 2009.**

As pointed out in the last newsletter we want to get back to a level of ca. 20% as

- this is the standard level of cash we want to hold and
- our Macro Dashboard suggests there are above average risks to earnings and valuations. We also pointed out to some event risks like sovereign default.

Thus in Q I we moved a tiny step into this direction. **In Q II we will definitely move towards this goal in a larger step.**

3.4 Shorting

Short exposure was 0 during the reporting period.

In the last letter we announced that we were targeting a short asset allocation to shorting of 0 – 10%, but have – once more - not been courageous enough to act. As you know the risk in shorts is the loss of 100% of the capital. Also, empirical evidence shows that long-equity managers do not well when beginning to short. **Therefore we are very careful in making commitments with single-company shorts.**

From hindsight we would have done very well if we had closed the two candidates we had identified – a producer of solar cells and BSkyB. But when looking back there were risks in both investment opportunities which have not materialized ex-post, but could have hurt us significantly. **Thus I am only slightly unhappy about the fact that I wobbled and did not take on these deals.**

We also announced that we would resort to shorting an index if the allocation suggests building up a short position and substituting this later with company-specific shorts. We have not done that, either. **Given the upside momentum in the market that was – once more – a lucky outcome.**

However, in Q II we will act as valuations have increased further and we view the macro risks as significant.

4. Discussion of Risk Management

4.1 Margin of Safety at Investment Portfolio Level

As pointed out before our **Margin of Safety has disappeared** in the recent run-up in share prices. This clearly increases overall risk **as any errors me made in assessing and valuing our businesses might lead to the risk of permanent loss of capital.**

4.2 Composition of Intrinsic Value of Portfolio

We calculate our Intrinsic Values by aggregating several sources of value. In terms of risk **they can be split into two components:**

a) **Earnings Power Value** adjusted for Net Financial Debt/Cash

b) Value of Compounding and Value of Management Contribution.

From a risk point of view a) is the most reliable as it is based on the past track record and requires no forecasts. For this aspect for valuation we just have to make sure that Average Future Conditions at the company do not deviate negatively from the last 10 years. Conversely, quantifying b) requires forecasting and judgment.

In the last newsletters I have described our problem that only ca. 40% of the Intrinsic Values of our investments are accounted for by Net Earnings Power Value. Again, this is largely driven by our largest holding where we are restricted in selling. As we have not been able to re-shuffle our portfolio towards investment with a high Net Earnings Power Value - at best with a market price above Net Earnings Power Value **– this problem is largely unchanged.**

As is the case with the general Margin of Safety issue described above **we expect the portfolio to be changed significantly in Q II 2010.**

4.3 Company-Specific Risks

4.3.1 Risks Modelled ("Known Unknowns")

At the level of risks modelled in our risk assessment **no significant new risks were added to our watchlist in any of our portfolio companies during the period.**

4.3.2 Risks Materialized

We do not have to report any significant risks becoming reality in Q I 2010.

4.3.3 3% Risk Tolerance

At the end of Q I 2010 one of the risks modeled in our risk assessment for our largest holding **would reduce the Intrinsic Value of our Portfolio by more than 3%.** It relates to our largest position which makes up ca. 45% of the total Intrinsic Values we own. If the largest risk materializes at this company this could reduce its Intrinsic Value by more than 6 2/3% - thus reducing total Intrinsic Value by more than 3%.

The consequence is already known: we reduce the weight of this position in the next quarters.

5. Outlook

5.1 Macro Outlook

We refer to our Macro Dashboard for Q I 2010. The highlights are:

a) In Q IV 2009 **corporate profit levels** have continued their rise to levels significantly above historical averages

b) **Valuations** based on Shiller's CAPE and Tobin´s q are at 130 to 170% of their long-term averages. This reduces the **most likely return on equities to in the next cycle to 0 – 3% p.a. in real terms**.

c) We believe the **risk** from a sovereign default has increased significantly and feel that the fallout from the first default – e.g. Greece – will be far larger than priced into credit and equity markets today.

As a **conclusion of this Macro Outlook on our asset allocation** we have confirmed the goals set in the last macro Outlook:

a) a **cash quota of 20%**

b) a **net short position of 0 – 10%** if we find suitable occasions.

As always we will mostly be driven by such opportunities – and not by the tops-down allocation model.

5.2 Status of Watchlist

Our watchlist prio 1 – which contains companies whose Net Earnings Power Value is below their share prices - as of April 12th, 2010 **contains a single candidate** – a catalogue-based B-to-B business with market leadership in its niche. We are worried about a competitive risk from an internet-based supplier which we deem significant.

6. The Firm

6.1 New Analyst

We are still trying to hire a full-time analyst. We have a reasonable flow of applicants – but as we do not compromise on the quality of staff either it is about as hard to find a good person who is motivated by work in a boutique-type contrarian operation which happens to be located in a German-speaking city.

We are glad to report that we have found one intern for the summer, a Spanish national reading for his MBA degree at the Harvard Business School. We are looking forward to having him her during the summer to do an update of the Southern European markets.

Appendices

Summary of Results

Table 1: Results and Benchmarking

Since Inception (2002), p.a.	**FORUM**		**HSBC European Smallcap Index**		**Ennismore NAV in €**	
	Percent	Index	Percent	Index	Percent	Index
2002	-7.0%	93	-25.0%	75	-0.3%	100
2003	78.0%	165	38.0%	103	20.0%	119
2004	7.0%	287	24.0%	128	23.0%	147
2005	178.0%	798	36.0%	174	34.0%	197
2006	-37.0%	502	33.0%	231	10.0%	216
2007	1.0%	504	-5.5%	218	0.0%	216
2008	-50.0%	252	-51.5%	106	-28.0%	156
2009	129.1%	577	55.8%	165	4.0%	162
IRR p.a. since Jan. 2002 til Sept 2009	28.0%		6.7%		6.5%	
Q I 2010	1,9**%**		**5,6%**		**8,6%**	

Table 2: Sources of Results 2010

Period, FY 2009	**Q I**	**Q II**	**Q III**	**Q IV**	**FY 2009**
Change in Intrinsic Value	4,4%				4,4%
thereof Intrinsic Value lfl.	4,0%				4,0%
thereof Methodology	0,0%				0,0%
thereof Portfolio Management	0,4%				0,4%
Currency Changes	0,0%				0,0%
Multiple Expansion / Contraction	-2,4%				-2,4%
Total (= Results at Market Prices)	**4,4%**				**1,9%**