FORUM

European Smallcaps GmbH

Memorandum

To : Advisory Board

From : BW

Copy to :

Date : July 13th, 2011

Subject : FORUM European Smallcaps Q II 2011 Results

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1. Highlights and Summary

Q II 2011 was good to us: we can report a gain of 14,2% at market prices. As we started the year with a small loss, **the cumulated result YTD as of June 30th, 2011 stands at 9,9%.**

The Intrinsic Value of our portfolio increased even more by 15,1% in Q II 2011. As a result of these movements **our Margin of Safety increased slightly to 12% from 11% at the end of Q I 2011.**

We had yet another quarterly **currency loss** due to the continuing weakness of the GBP. In Q II 2011 it amounted to **1,4**%.

Our l**evel of activity was normal**, with 4,1% of AUM (gross) bought and sold in Q II. This translates into an **annualized churn rate of 15 – 20%**

2. Benchmarking of Results

For an overview of **our results vs. our benchmarks** we would like to refer to **Appendix 2**.

2.1 Results in this Quarter

The key observations in this quarter are:

a) In Q II 2011 our portfolio gained 12,2% at market values. We held predominantly long positions and cash in the quarter while building up a small short position for the first time in many quarters.

b) The **HSBC Smaller European Total Return Index in € was up by 2,0% in the quarter.**

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 3,7% in the quarter** – helped primarily by good results of their short book.

2.2 Results since Inception

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 vagaries of market cycles or luck from market timing or individual stock picks.

By the end of 2010 **our cumulated performance in the 9 1/2 years from January 1st, 2002 – the date of our inception** – to June 30th, 2011 **was 24,5% p.a. – a total increase to 803% of starting value**.

Thus in the 9 1/2 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 24,5% resp. to 803% of starting value since inception on Jan. 1st, 2002 compares with IRRs **for this period** of

a) **8,8%** p.a. for the **HSBC index in €** – a total increase to **224% of starting value**

b) **7,9%** p.a. **for the Ennismore fund in € –** a total increase to **206% of starting value.**

3. Sources of Results

Please refer to **Appendix 3** for an overview over the sources of our gain in Q II 2011.

3.1 Changes in Intrinsic Value

In Q II 2011 the **Intrinsic Value of our portfolio grew by 15,1%.** This increase is the net effect of **changes due to**

a) Net increases of Intrinsic Values per share (at unchanged portfolio mix) contributing 13,9%

b) Portfolio management contributing a positive 1,5%

3.1.1 Contribution from Changes in Intrinsic Values of Individual Holdings

In Q II 2011 **we made five changes to the Intrinsic Values of individual holdings**:

- In 5 cases we were able to increase the Intrinsic Value of our holdings due to good results delivered in the quarter. This includes both of our strategic holdings.

- In 2 cases we had to reduce the Intrinsic Value of an investment. One of these companies did a strange operation with their share buybacks. The other is Greek and we took down asset values once more to reflect the rapidly contracting business activity.

We maintain our goal of **a long-term growth in the Intrinsic Value of the businesses we own of 10 – 15% p.a.** The developments in Q II 2011 make us confident that we have been able to put together a portfolio with **strong Compounding Economics.**

3.1.2 Contribution from Portfolio Management to Intrinsic Value

In Q II 2011 **portfolio management,** the second source of increasing Intrinsic Value, **generated a gain of ca. 1,5 % in Intrinsic Value of the portfolio.** This was achieved as follows:

a) **We significantly increased our position in one company** with the share price more than 45% below its Intrinsic Value. By our thinking this has turned 55 cents into € 1,00. He have been increasing this position for several quarters by now.

b) We entered a tiny position with the **market value at ca. 60% of Intrinsic Value.** It was our first venture into a Chinese company and after getting our toes wet we decided to "run": Chinese stocks quoted outside of China are clearly outside of our regional Circle of Competence – at any valuation**.**

c) We exited one position by accepting an IPO offer with a significant premium on the latest share price for one of our holdings. According to our data the take-out price is clearly above our Intrinsic Value.

All purchases **amounted to ca. 1,8% (gross) of AUM**. **Sales amounted to ca. 2,3% (gross) of AUM**. Thus our total activity stands at 4,1% (gross).

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.

3.2 Currency Gains/Losses

Overall the **market result from forex in the quarter was a loss of 1,4%** due to the continuing weakness of the GBP against the €.

3.3 Contribution from Multiple Expansion/Change in Margin of Safety

By definition the difference between the change in market values and the change in Intrinsic Values leads to Multiple Expansion resp. Contraction. As in Q II 2011

a) we reported a gain of 12,2% on the Market Value of the Portfolio

b) Intrinsic Values increased by 15,1%

we increased our Margin of Safety slightly. At the end of the quarter the market value of our portfolio was 88% of Intrinsic Values – **implying a Margin of Safety of 12%.**

4. Developments by Segment

4.1 Strategic Holdings: Companies with a significant Stake and Board Involvement

4.1.1 Immunodiagnostic Systems Holdings

We discussed out reasoning for being invested in Immunodiagnostic Systems Holding ("IDS") in detail in the last quarterly report – including the risks. Since then the company has published its full FY 2011 results which ended on March 31st, 2011. They largely confirmed our investment thesis. As a result **we rolled over our valuation by a year which lead to an increase in our Intrinsic Value.**

In Q I 2011 the **share price of IDS gained 24%** in local currency in Q II 2011. **YTD the gain amounts to 11%, i.e. slightly above the rate of overall gain.**

4.1.2 Pulsion

We also discussed this position in the last quarterly Letter to Clients, in particular the risks facing the company:

a) an attack by the market leader Edwards Life Sciences

b) a lack of innovations.

At this point we are confident that we can handle both risks, in particular as the management team has been strengthened significantly in the last 12 months.

In Q II 2011 the **share price of Pulsion gained 2%. YTD the gain amounts to 15%, i.e. slightly above the rate of overall gain.**

4.2 Tactical Portfolio

We finally made **some progress in cleaning out the Tactical Portfolio: we exited two positions** which we had tried to get out of for many months, one of them via a tender offer. As we have added a small new position we are still at 9 positions.

As a result the share of the Tactical Portfolio declined to 7% of AUM, down sequentially from 12%. We expect another decrease in Q III as we have received a tender offer for another position which has already been accepted.

As of June 30th, 2011 the Tactical Portfolio had a **Margin of Safety of to 27%, up from 23% at the end of Q I 2011.**

4.3 Cash and Cash Equivalents

At the end of Q II 2011 **cash and cash equivalents accounted for ca. 10% -** up from 6% as of March 31st, 2011.

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

- this is the **standard level of liquidity** we want to hold in order to be able to take up attractive opportunities which may arise any time.

- our Macro Dashboard suggests there are **above average risks to earnings and valuations.**

5. Special Aspects of Q II 2011

5.1 Shorting

We entered our **first new short position in Q II 2011**, a mid-sized manufacturer of wind mills. We see the sector undergoing a rapid change in competitive dynamics as technological requirements increase sharply, mainly due to the growth in offshore parks. At the same time the Chinese competitors are breaking out of their Chinese home market, thus increasing price pressure on the Western competitors.

We believe Western players with sub-critical size will have difficulties surviving the industry consolidation which we expect to occur fast.

6. Discussion of Risk Management

6.1 Margin of Safety

We believe the main protection against risks and uncertainties is the Margin of Safety. As mentioned above our **Margin of Safety increased slightly to 12% at the end of Q II 2011.**

Of the 11 companies we own **two have a negative Margin of Safety, i.e. an Intrinsic Value below the current market price**. They are very small at 1% and 3% respectively.

6.2 Composition of Intrinsic Value

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

a) **Net Earnings Power Value, i.e. Gross Earnings Power Value** adjusted for Net Financial Debt/Cash

b) **Value of Compounding**

c) **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 forecasting of changes. 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) and c) requires forecasting and judgment.

At the end of Q II 2011 the Net Earnings Power Values of our Investments stood at 51% of their Market Values. As a result ca. 62% **of the market value of our portfolio including cash is now covered by Net Earnings Power and cash, down slightly from 67% at the end of Q I 2011.**

The picture looks significantly better in the Tactical Portfolio: in this part of our AUM N-EPV at the end of June 2011 accounted for 80% (77%) of the respective IV-T. Even better, **N-EPV supports 110% of the market value of the Tactical portfolio, up from 100% at the end of Q I 2011.**

6.3 Company-Specific Risks

6.3.1 Risks Modelled (“Known Unknowns”)

Our **exposure to Greece** at the end of Q II 2011 was slightly down at 1,1% of AUM.

6.3.2 Risks Materialized

In Q II the following risks materialized:

a) **Market price risk**: our Greek holdings continued their loss of market cap. We believe these will be transitory and there will be a Reversion to the Mean.

b) **Permanent Impairment Earnings Power Risk**: We reported above that we had to downgrade the Intrinsic Value of two of our holdings. These holdings combined accounted for 0,8% of AUM.

c) **Financial Risk**: An unexpected deterioration in the financial position at one of our Greek holding has increased the Net Debt to a level which clearly increases financial (survival) risk.

7. Outlook

7.1 Macro Outlook

We refer to our Macro Dashboard for Q II 2011. The highlights are:

a) C**orporate profit levels** have come down slightly, but are still at 15 – 30% above their historic averages.

b) **Valuations** have continued to increase and now stand at a level of **40 – 50% above their historical averages** depending on the metric used. As valuations have been volatile in the past this implies a standard deviation of slightly more than 1 on most metrics. Thus this is still not becoming statistically significant.

c) This implies **expected returns on equities in the next cycle below average, ca. 3 – 4% p.a. in real terms**.

d) We continue to see the major risks to the global economy. The most important ones – in terms of impact are:

- the structural weakness in the USA, largely due to overindebtedness and stagnating purchasing power
- sovereign debt levels in the developed world with little political will to tackle it
- China bubble risk

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

b) cash quota of 20%

c) **net short position of 5 – 10%**.

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

7.2 Status of Watchlist

Our watchlist equities long prio 1 - which contains investment candidates trading below Net Earnings Power Value - has evolved as follows:

	June 30th, 2010	Sept. 30th, 2010	March 31st, 2011	June 30th, 2011
Greek	4	4	3	3
Non-Greek	2	6	6	2
Total	**6**	**10**	**9**	**5**

Whilst this looks positive at first glance we assess the business quality of each of these candidates as average to below-average: **they would definitely lower the average of what we own.** At this point in time we have therefore decided that we would rather want to "keep our powder dry" for better opportunities.

7.3 Target Structure of the Portfolio in one Year

We are trying to **de-risk the portfolio**, while at the same time **increasing the upside potential**.

This involves the following actions:

a) As a matter of policy we do not comment on our Strategic Holdings

b) **We plan to clean out the Tactical Portfolio further.** It can be a good investment policy to do that at times to drive out all the biases like endowment bias and "frog-in-hot-water bias" which tend to creep into the investment process once the original assumptions for an investment had to be revised.

c) Our next priority would be the **addition of more short positions.** We demand that they drop independent of the market, i.e. have a catalyst leading to such a re-valuation. Stocks that are just overvalued and likely to underperform the market do not pass our criteria.

d) We are also looking increasingly into other non-long equity asset classes, **mainly relative value and merger arbitrage.**

e) **If we find them we target 1 – 2 new equity long positions.** But as mentioned above our pipeline looks ok in terms of valuations, **but not intriguing in terms of business quality.**

8. The Firm

8.1 New Analyst

In the last Letter to Clients we mentioned that we had made several offers to new staff. All of them have accepted by now. After they have all started by October 1st, 2011 **we will have a rounded team:**

a) **Three analysts** covering Western Europe for equity long positions. They will work along three regions with a few sectors allocated to them as well across Europe.

b) **One analyst** for Special Opportunities, Shorting and Risk Management.

c) BW as **Portfolio Manager.**

The larger team size has many advantages. One of them is the possibility to ask one of them to take on a contrarian position to an investment idea without being biased from having conceived and formulated it. This is an aspect of the investment process which we have standardized by now.

8.2 New Fund

We are still in the process of launching our first funds. It turns out to be more complicated than we anticipated – but there are no inherent structural road blocks. **Thus we expect to finish this exercise by the time we publish the next Letter to Clients**. In the BW has to confess that he does not have his heart in this aspect of asset gathering.

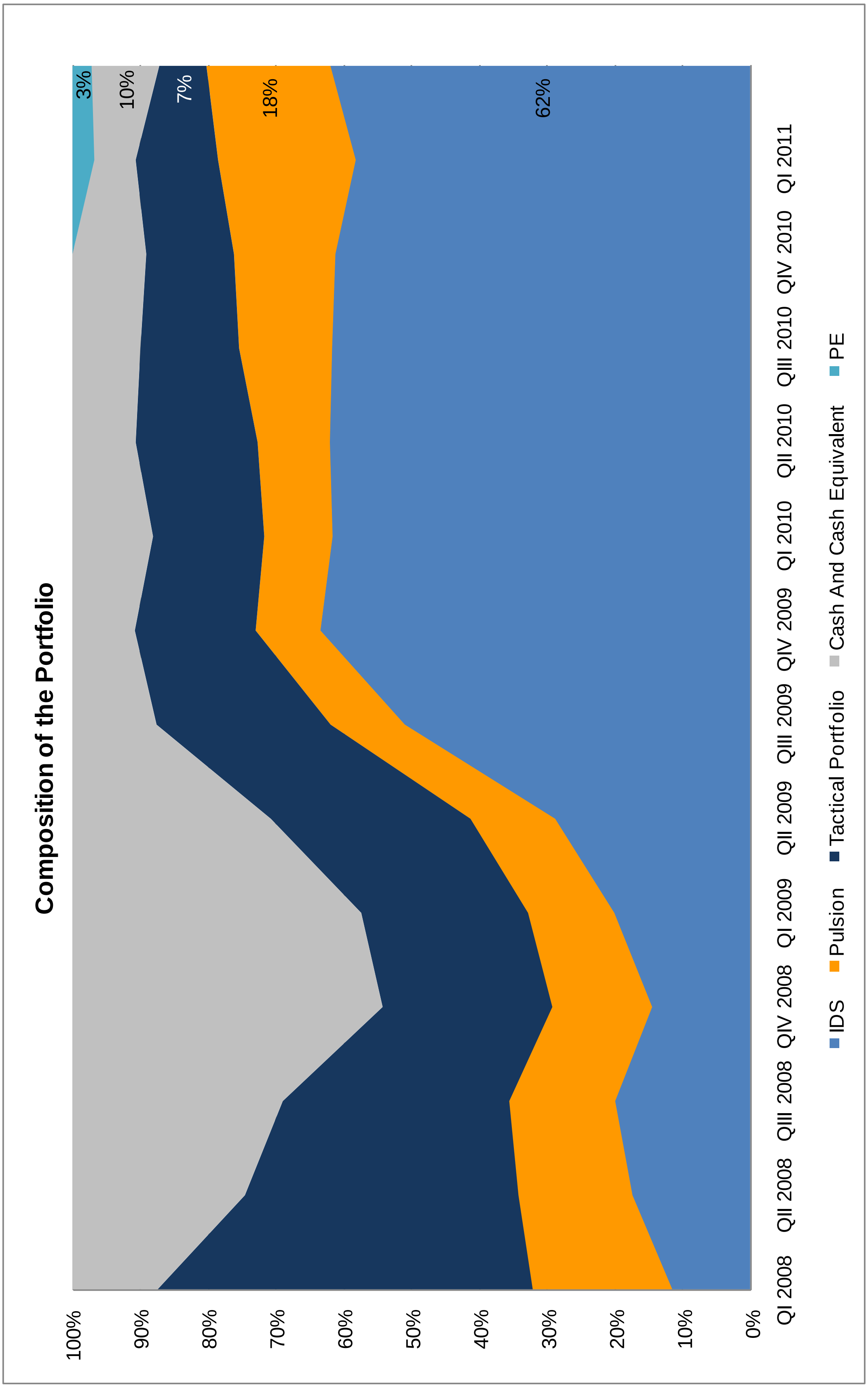
8.3 New Premises

As of September 1, 2011 we will move to new premises in Munich. It is an old building which has been renovated with a lot of attention to detail. **We will expand our space by ca. 60% to house our new staff .**

The new offices are located in a Munich district called Schwanthalerhöhe which is a relatively quiet area next to the Theresienwiese where the Octoberfest takes place. Thus we are counting on a large number of guests and visitors around the second half of September.

Appendices

Appendix 1: Evolution of the Portfolio's Composition



Appendix 2: Benchmarking of Results

Since Inception (2002), p.a.	FORUM		HSBC European Smallcap Index		Ennismore NAV in €	
	Percent	Index	Percent	Index	Percent	Index
2002	-9%	91	-25%	75	0%	100
2003	77%	161	38%	104	20%	119
2004	74%	280	24%	128	23%	147
2005	183%	794	36%	175	34%	197
2006	-37%	498	33%	232	11%	218
2007	1%	501	-6%	219	0%	218
2008	-50%	250	-52%	106	-28%	156
2009	129%	574	56%	166	4%	162
2010	27%	728	26%	209	23%	199
2011 YTD	10%	803	7%	224	3%	206
IRR 2002-YTD	24.5%		8.8%		7.9%	

Appendix 3: Sources of Results 2011

Period, FY 2011	Q I	Q II	Q III	QIV	YTD
Change in Intrinsic Value	**8,4%**	**15,1%**			**25,1%**
Thereof Portfolio Management	0,8%	1,5%			2,3%
Thereof Revaluation	7,6%	13,9%			22,5%
Market Value of the Portfolio					
Currency gains/lossses	-1,6%	-1,4%			-3,0%
Multiple Expansion/Contraction	-2,2%	-15,7%			13,2%
Total (= Results at Market Prices)	**-3,8%**	**14,2%**			**9,9%**

Appendix 4: Relative Changes of Portfolio Components