
Graham and Microcaps

At 180 Degree Capital, we employ an activist approach to managing a concentrated portfolio of small and microcap companies. Despite poor performance in 2022, we have utilized this approach to generate outsized returns since 2017, the year we began operating as 180 Degree Capital. Since then, we have generated a gross total return of 225.0% in our public market investment strategy.

Today, we would like to focus on our value investing strategy that provides the basis for our historical success. It is definitely not overstating the matter to say that we believe our Graham and Dodd approach is the most important feature of our investing style and of the corresponding success it has produced since our inception.

Put simply, we believe that the price that we pay for a stock is the most important driver of investment returns. We would like to explore in some detail what this looks like when applied to the microcap market that we invest in and why, in fact, we see the microcap market as being ideal for its application.

“A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price.”
—Benjamin Graham, *The Intelligent Investor*

In order to uncover companies that are undervalued, we begin by sifting through the market for companies that meet one or more of the following conditions:

- A stock that trades at half the market on price/book value
- a price to earnings ratio or price to cashflow ratio that is no more than 2/3rd the market;
- an above average dividend yield; or
- a stock that trades at less than 1x enterprise value to revenue.

This is the same process utilized for years and years at Merrill Lynch Asset Management and BlackRock; albeit there it was mostly employed for the analysis of large capitalization companies.

This initial vetting process is just the top of the funnel. The real work begins after our initial winnowing down is done and involves taking a much deeper dive into the companies that have made it through our screening process. The next steps in our process include developing a deep and thorough understanding of the company's business, its management and its Board. By the time we elect to add a company to our portfolio, we will often have had multiple calls with management and/or key Board members as well as with other large holders of the company's stock. We will have spent significant time sifting through the company's financial statements and will have formed an in-depth understanding of the company, its industry and ultimately its prospects going forward. Questions we often ask include:

- How is a company situated within its industry?
- Why is its stock down?
- Is the decline in the stock price industry related or is it company specific?
- What is the company's strategy to combat what is usually an underperforming share price?
- How can we, as bottoms-up oriented active investors, help?

Most importantly, and before we ultimately commit capital, we will have identified a catalyst or set of catalysts that we see as the keys to unlocking the value that we see in the company. The determination of these catalysts for success is the final piece of our process that will then lead to an investment in a given company. As constructive activists, generally working collaboratively with leadership at our portfolio companies, we often endeavor to work with management teams and Boards to achieve these catalysts. Sometimes, our activism increases to where we become the change agent or catalyst. Ultimately our goal is for our activism to lead to stock price appreciation for common stockholders.

While the above may appear straightforward, we believe that following an extremely disciplined approach to valuation and business analysis is the road less traveled among investors. Consider that for a security to trade at the discounts to the market we insist upon, generally there are real or perceived "warts" to the story. We ask ourselves how or why this might change, whether counting on such change is realistic and how much downside exists if our assumptions prove optimistic. Probably the most important qualitative assessment made during this process revolves around people and is rooted in our view that high quality management goes a long way towards creating the latent value we believe resides in our portfolio. We never underestimate the ability of a great management team to transform an average company into a great company, and conversely, never underestimate the ability of a bad management team to ruin a great company. The story of 180 Degree Capital is we are a turnaround based on turnarounds. And if we limit our entry price to a low valuation, we will limit our downside.

“The schoolteacher asks Billy Bob: ‘if you have 12 sheep and one jumps over the fence, how many sheep do you have left?’

Billy Bob answers, ‘None.’

‘Well,’ says the teacher, ‘you sure don’t know your subtraction.’

‘Maybe not,’ Billy Bob replies, ‘but I darn sure know my sheep.’”

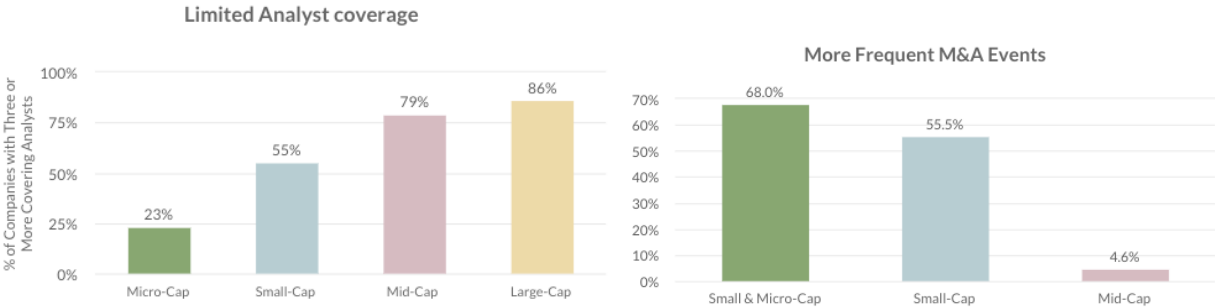
—Benjamin Graham, *The Intelligent Investor*

Like Billy Bob's sheep, stock market investors have always loved chasing a trend. As value investors, we are constantly looking to avoid being part of the herd. Our goal is not to be contrarian just to be different, but rather to uncover opportunities and value where others see none, or oftentimes, simply aren't looking. This applies to individual stocks as described above but also to the market that we invest in at 180 Degree Capital.

As described previously, we invest exclusively in the microcap market. We believe that this market perfectly suits our Graham and Dodd approach. The massive size of the market, in terms of the number of companies, combined with the small size of the companies themselves, creates uniquely fertile ground to find and unlock hidden value. For example, there are around 5,000 publicly traded companies listed on US stock exchanges with market capitalizations of less than \$500 million. By

comparison, there are only 3,700 small, mid and large cap publicly traded companies with market capitalizations above \$500 million listed on US exchanges.

The small size of the companies in our investment universe results in other attributes specific to the microcap market that we believe also creates opportunity, specifically microcap companies often have limited analyst coverage and undergo more frequent M&A events.



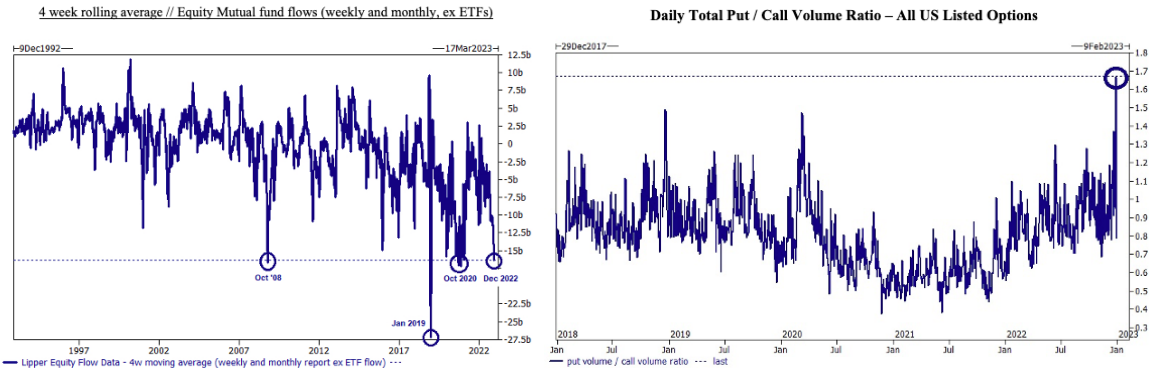
Sources: Bloomberg, <https://medium.com/the-investors-handbook/market-cap-a474214c1368>, and Kenneth R. French and CRSP, 12/31/1990 to 12/31/17

We believe that being value investors in this type of marketplace significantly enhances our ability to unearth companies that have the opportunity to significantly outperform the market over our 1-3 year time horizon. Additionally, we can, and often have, benefitted from our portfolio companies being acquired by larger entities. What could be more true to Graham and Dodd principles than investing in a market with more breadth and fewer scrutinizing eyeballs?

“Abnormally good or abnormally bad conditions do not last forever.”
 –Benjamin Graham, Security Analysis: Principles and Technique

“The intelligent investor is a realist who sells to optimists and buys from pessimists.”
 –Benjamin Graham, The Intelligent Investor

2022 saw a significant market selloff in the face of strong macroeconomic headwinds. In particular, high inflation, the corresponding interest rate hikes from the Fed, the war in Ukraine and ongoing supply chain issues combined to push market indices significantly lower on the year. The microcap market experienced this as much or more than any other market, with the Russell Microcap Index dropping 22.0%. The fear that exists in the market is well-illustrated by the two charts below.



Source: Goldman Sachs & Co.

“The intelligent investor realizes that stocks become more risky, not less, as their prices rise—and less risky, not more, as their prices fall. The intelligent investor dreads a bull market, since it makes stocks more costly to buy. And conversely (so long as you keep enough cash on hand to meet your spending needs), you should welcome a bear market, since it puts stocks back on sale.”

—Benjamin Graham, The Intelligent Investor

As value investors, a bear market like that of 2022 signals to us an opportunity if we can get our stock picking right. One glance at the charts below and it's easy to see why, at least for now, we believe we are buying a collection of companies trading at significant discounts relative to large capitalization public companies.



Source: Bloomberg

These charts depict a market that has experienced a serious correction. Further, we know that these price levels reflect a viewpoint that earnings will be falling even further even though companies have already significantly slashed their earnings outlooks. To us, this dynamic looks a lot like a perfect opportunity to do the work and unearth companies that have been taken down with the market, but whose prospects and earnings potential remain strong.

To summarize, at 180 Degree Capital, we view market dislocations as opportunities. When the stock prices of good companies get taken down with the market in general, we see a chance to identify those companies and then take a meaningful stake in them. We seek to identify catalysts in these companies that we believe can lead to a 100% return over 1-3 years. As we enter 2023, we see numerous such opportunities and are excited by what that can mean for our investors over the next few years if we successfully execute on our strategy.

“Plant trees that other men will sit under.”
—Benjamin Graham, The Intelligent Investor

Note: The information discussed above is solely the opinion of 180 Degree Capital Corp. Any discussion of past performance is not an indication of future results. Investing in financial markets involves a substantial degree of risk. Investors must be able to withstand a total loss of their investment. The information herein is believed to be reliable and has been obtained from sources believed to be reliable, but no representation or warranty is made, expressed or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of the information and opinions.