



September 1st, 2018

To Focused Compounding Capital Management Clients:

Andrew here. Since there are no portfolio updates to report this month, I thought I would spend this letter giving some general thoughts on two types of overlooked stocks that we own and why we chose this group of stocks for the managed accounts- that being Spinoffs and Illiquid Micro-caps. If I had to boil our general investing thought process down to a few words, I would say it would be: **Fish Where the Fish Are.** What do I mean by this? Let's see.

Spinoffs: Geoff and I have long said that our favorite investing book of all time is Joel Greenblatt's *You Can Be a Stock Market Genius*. In the book, Greenblatt writes about a research study that was completed at Penn State that illustrated Spinoffs outperforming the S&P 500 from 1964 - 1988 by an annualized rate of 10% per year. While that study was from over 30 years ago, it's interesting to also look at a study fellow value investor Mohnish Pabrai completed for a [Forbes article](#) from 2000 - 2017 on spinoffs, which again showed a significant outperformance - spinoffs beat the S&P 500 by 7.9% annualized during that time. There are many reasons why spinoffs tend to outperform other groups of stocks, but the big takeaway is it is an inefficient spot in the market and one where Geoff and I spend a lot our time "fishing" for potential ideas. Currently, everyone owns one spinoff - and we're seriously considering purchasing another one very soon.

Illiquid Micro-caps: There has been a lot of questions around Geoff and I investing in illiquid micro-caps. I think micro-caps tend to be misunderstood due to most liquid micro-caps are typically just trading vehicles for day traders, which puts a bad taste in other investors mouths for all micro-caps. Illiquid micro-caps and liquid micro-caps are two entirely different groups of stocks. Smaller companies tend to outperform larger ones. We want to participate in this outperformance. I came across an excellent whitepaper that was written by a professor at the Yale School of Management titled *Liquidity as an Investment Style*. In the whitepaper, the author compares the returns from micro-cap stocks all the way up to large-cap stocks and relates the level of liquidity to the relationship of returns you would have received if you had bought a basket of these stocks. I will include an interesting table on the next page for you to look over. What sticks out to me is illiquid micro-caps from 1972 – 2017 compounded at 16.05% per year while liquid micro-caps during this time compounded at a lousy 0.11%. That's a huge difference. The table then expands on this overall idea of liquidity to show how liquidity affects all stock returns and not just micro-caps. One outcome persists – lower liquid stocks outperform high liquid stocks no matter how big or small the company is. Currently, I would say all of our stocks are on the illiquid side when comparing them to most investors portfolios.

Expect a letter from Geoff in one month's time.

Sincerely,
Andrew M. Kuhn

Table 2: Size and Liquidity Quartile Portfolios 1972 – 2017

Each stock within the top 3,500 market-cap universe is assigned separate and independent quartile rankings for both year-end market cap and trailing 12-month turnover ratio (liquidity measure), at the end of each year from 1971 to 2016. Reported for each equally-weighted intersection portfolio are the annualized geometric mean (compound) return, the arithmetic mean return, and the return standard deviation. The average number of stocks in each quartile-pair portfolio is also shown.

Quartiles		Low Liquidity	Mid-Low	Mid-High	High Liquidity
Micro-Cap	Geom. Mean	16.05%	15.68%	9.57%	0.11%
	Arithm. Mean	18.38%	19.23%	14.77%	5.23%
	Std. Dev.	22.67%	28.52%	34.54%	33.07%
	Avg. No. Stocks	345	181	124	98
Small-Cap	Geom. Mean	15.65%	14.32%	12.26%	6.00%
	Arithm. Mean	17.29%	16.83%	15.52%	10.11%
	Std. Dev.	19.35%	23.73%	26.86%	30.09%
	Avg. No. Stocks	199	201	173	174
Mid-Cap	Geom. Mean	14.03%	13.88%	12.89%	8.40%
	Arithm. Mean	15.38%	15.54%	14.99%	11.87%
	Std. Dev.	17.59%	19.47%	21.54%	27.35%
	Avg. No. Stocks	130	177	203	238
Large-Cap	Geom. Mean	11.44%	12.28%	11.97%	9.07%
	Arithm. Mean	12.66%	13.39%	13.46%	11.99%
	Std. Dev.	16.22%	15.40%	17.61%	24.53%
	Avg. No. Stocks	74	188	248	238