under the radar report
SMALL CAPS

CELEBRATING 8 YEARS OF
8
UNDER THE RADAR REPORT

ISSUE 363
26 SEPTEMBER 2019

CELEBRATING OUR 8TH BIRTHDAY!

In this week's issue Frank Villante, founder of Celeste Funds Management, Graeme Carson, founder of Cyan Investment Management and my good self discuss some of the big lessons learned after decades of investing.

We kick off with the start of the round table. It is a must read for anyone who is a music fan like Frank Villante, who actually was once a band manager at high school, I think. Then we talk in detail about other issues:

- If you're not a professional, how much capital do you need to start investing?
- How much time do you need and does the individual investor have any advantage?
- How can small caps help?
- Big winners and losers.

At Under the Radar we are looking to invest in Small Caps for two to three years. Right now more than any other time in the past eight years, it is about good stock picking.

Speaking of which, we have now had three years to demonstrate how our refreshed strategy for Under the Radar's Small Cap Portfolio has been working and our returns have markedly increased to 9.4% a year with an average cash level of 30%.

We look in detail at our performance both from our tips and our Portfolio and re-iterate our strategy for picking stocks. You also get the full rundown of the Portfolio's current holdings.

It's a big issue with some wise commentary from some of the market's best performers. What are you waiting for?

Richard Hemming
Editor

the issue

Small Talk

"We have now had three years to demonstrate how our refreshed strategy for Under the Radar's Small Cap Portfolio has been working. Our returns have markedly increased to 9.4% a year with an average cash level of 30%."
UNDER THE RADAR REPORT

99% of all financial news relates to the 40 to 50 biggest companies. So what about the rest? They're Under the Radar.

Published by Under the Radar Report Pty Ltd
45 Evans Street, Balmain NSW 2041
Telephone +61 2 9106 2167 Email radar@undertheradarreport.com.au

Editor Richard Hemming **Publisher** Caroline Mark
ABN: 65147404662. AFSL: 409518.

www.undertheradarreport.com.au

Frank Villante
Founder of Celeste Funds Management

Graeme Carson
Founder of Cyan Investment Management

Richard Hemming
Editor of Under the Radar Report

WHAT MAKES A SUCCESSFUL INVESTOR?

Frank Villante, founder of Celeste Funds Management, Graeme Carson, founder of Cyan Investment Management and Richard Hemming, editor of Under the Radar Report discuss some of the big lessons they have learned after decades of investing. It is a must read for all investors.

WHAT DO YOU WISH YOU KNEW WHEN YOU FIRST STARTED OUT?

FRANK VILLANTE: As per the Jim Morison lyric, "The future's uncertain, the end is always near", understand that forecasting the future is impossible. Whilst having a view of the earnings potential of a business is important, you are probably much better equipped to glean valuable and robust insights from assessment of historic returns and historic financials, with all their unique nuances. Understand competitive dynamic, and how it can change; focus on historic capital allocation, and consequent returns. Often history is a far more valuable source of analytical insight, a far better indicator of the pedigree of a company, and a better place to allocate time, rather than attempting to forecast earnings out for the short, medium and longer term.

Then there's Miles Davis, who said: "it's not the notes you play, it's notes you don't play." I wish I had listened more when I was younger. Not necessarily simply to what was said, but to word usage and intonation. The gaps give you an insight into what is known, what is hoped for, and what is fantasy. Non-verbal insights can be critical in understanding the strengths and weaknesses of any investment possibility.

I now know that complexity is to be avoided and if possible to gravitate to simplicity. Analysts love to convince themselves that they know the detail, but you cannot understand everything. If you can't explain the business model to your dad, don't invest.

These days I know to always work with people who are smart. I'm also wary of companies where the CEO/major shareholder appears to have employed people to say yes, don't disagree, and are not additive in improving the decision making process.

I also work more now on what motivates people, after all they are the ones making the difference. Great companies at their heart are exceptional people doing any manner of things well. Understand the person, understand what motivates them. Acknowledge that people are different, get to understand the differences and how they can assist. Engage with people – insights emerge from the most unlikely places, listed and unlisted, but only if you are prepared to look, ask, and listen.

My team is also more attuned to demographic trends than was probably the case in the past. These represent healthy tailwinds to some investment possibilities. We also concentrate on accepting the dynamics of change, because these provide opportunities for significant returns, or for wealth destruction.

We find the strengths and weaknesses of any investment we contemplate. If we haven't, we look harder.

I'd like to think that I am now more patient. Sometimes the greatest value can be derived from doing absolutely nothing – plant, water, tend to its needs and wait for the position to bloom.

GRAEME CARSON: *No matter how well you know the company in which you're invested, always assume someone knows more than you.* Small cap investing requires research, and even though you may think you know a company inside-out, you will still make mistakes and you will still get blindsided by things that you didn't expect to happen. I know that when I was younger I would tend to buy aggressively when a company's share price was falling but there had been no obvious reason (such as no ASX released announcement). I would tend to think that the market was getting it wrong and the share price would rebound when the "real story" played out. Unfortunately, more often than not "where there's smoke there's fire" and it's much more prudent to wait and see what plays out and then make an informed decision. All the research forecasts and analysis can change very quickly when something goes wrong! I now rarely buy against negative momentum, because losing good money after bad is one of the most frustrating and expensive lessons in investing.

RICHARD HEMMING: Don't invest for the sake of investing. People invest a lot of the time because they fear missing out. When I was younger I invested in gold companies, base metals companies, medical technology companies, hi-tech, you name it. They were all speculative and I was trying to hit the ball out of the park every time, and invariably sold out at exactly the wrong time. Spiderman's uncle said, with great power comes great responsibility. Well, with great risk comes an even greater potential for loss. The most money I have made on stocks has been simply by holding on, and ignoring the stock market volatility and noise. This applies to some initially small mining stocks I've owned, as well as with biotechs like Sirtex (SRX) and early holdings like Commonwealth Bank (CBA) and Telstra (TLS). Also, when the herd is running, it's often best to sit out. Like Public Enemy says, "Don't believe the hype!"

I am a big believer in the power of information. These days I don't invest unless I think I have an edge. When I was an analyst I would see all these analysts at presentations for big companies like Tabcorp, Aristocrat, Southcorp, Fosters and Woolworths and think, how in the world is anyone here supposed to get an edge when you have so many smart people looking at the same thing? In contrast, on my own time I would go and cover smaller companies and notice that there was rarely anyone else on their case. I made more money from following/investing in these small cap stocks than from my salary.

"On my own time I would go and cover smaller companies and notice that there was rarely anyone else on their case. I made more money from following/ investing in these small cap stocks than from my salary."

RICHARD HEMMING

IF YOU'RE NOT A PROFESSIONAL, HOW MUCH CAPITAL DO YOU NEED?

FRANK VILLANTE: I think with capital the issue is more to do with risk tolerance. Simplistically with equity investing any capital allocated need countenance the possibility that it is all lost. Don't invest anything that you wouldn't be prepared to lose.

GRAEME CARSON: Each investor has varying objectives, but generally speaking, investing with the appropriate balance of risk versus return requires diversification. At Cyan, when discussing our investment positions we never talk dollar amounts, it's always as a percentage of our total capital. On average we hold around 25 positions, with a high conviction investment representing 5%-6% of our total portfolio. We also have some self-imposed disciplines, such as no stock holding representing greater than 10% of our capital. We also hold quite a large cash balance, often around 30% of capital, so that we have liquidity available when opportunities present themselves – for that reason we are rarely forced sellers.

For private investors these criteria may not be appropriate with a small amount of capital, but I think they should be things that should be aspired to. Beginning with four or five investments with different company drivers and catalysts is a good start and this can be done with as little $10,000 to $15,000. Small caps require a bit of research and patience, so go in with a two to three year view, but if the company isn't executing to expectation don't be afraid to re-evaluate and cut the positions in which you've made mistakes. Capital invested in good new opportunities is more likely to make you money than waiting for a turnaround story.

RICHARD HEMMING: I don't think you need any capital initially. It's about getting a watch list together and getting comfortable with the risk that you are prepared to take. When you do start investing real money, invest very small amounts relative to your total capital. If nothing else, this gets you used to the communications you experience as a shareholder, or part owner of a company. Everything big starts from something small, and that includes investing.

To understand what your risk tolerance is, invest some money and work out when you are willing to cut your losses and how willing you are to hold on when you are making good returns.

Generally investing in seven to 10 small caps over time is the best way of getting diversification benefits as well as the potential for one or two of them to do an AfterpayTouch (APT).

HOW MUCH TIME DO YOU NEED AND DOES THE INDIVIDUAL INVESTOR HAVE ANY ADVANTAGE? HOW CAN SMALL CAPS HELP?

FRANK VILLANTE: I think Pink Floyd noted "Time is the master, and time could be a disaster". The issue is how you use time: the balance between structured objectives, and flexibility to deal with change. When you engage with companies, formal meetings, it's about understanding the fine line between being very well prepared, whilst still being able to assess new information on the fly. So with meetings you should be sufficiently well prepared that you are likely to know the answers to many of the questions you ask – the real insights emerge when you get an answer that is materially different to what you expect, and that can provide insight, a piece of the jigsaw that is critical to understanding the picture.

Small caps offer lots to the individual investor, but most important would be the kinds of growth rates that can be materially better than their Larger Cap brethren. Any semblance of growth, sustainable growth in particular, in an exceedingly ex-growth world is attractive.

The opportunity set in small caps is over 2,000 companies, which inevitably means that some mispricing exists. This mispricing is only exacerbated by the economics of equity markets, where the bulk of brokerage is generated from the top 100 companies, and hence they are the focus of attention. Often where attention is less, opportunity is greatest.

GRAEME CARSON: The beauty of small caps is that they offer the opportunity to unearth high quality growth investments early in the company's lifecycle, which can result in huge returns if you get it right. But with those sorts of potential rewards obviously comes heightened risk.

After all, there are hundreds of companies to consider, a great majority of which don't have as much readily available information, or certainly as much research, as their larger counterparts. They are often more capital constrained than the larger companies, and crucially, the management teams and associated Boards are sometimes the largest shareholders and have significant influence over capital management, strategic direction and operating outcomes of the business. Getting to know management is very important to us.

All of these things provide challenges to private investors, who often don't have the opportunity to meet with management teams, or even the time to filter through the

> "As per the Jim Morison lyric, "The future's uncertain, the end is always near", understand that forecasting the future is impossible. Whilst having a view of the earnings potential of a business is important, you are probably much better equipped to glean valuable and robust insights from assessment of historic returns and historic financials, with all their unique nuances."

FRANK VILLANTE

myriad of small listed companies. You need to be very careful at the smaller end of the market. After all, we think it's a full-time job to do it properly.

Fortunately there is a lot of information out there, beyond the company releases. Much more than in the past. There are many conferences where company CEOs present a snapshot for half an hour or so. Small cap funds generally release monthly updates containing commentary on their high conviction positions and of course there is Under the Radar!

The one clear benefit that private investors do have is liquidity. Generally, they are investing with smaller amounts of capital, so can be nimble. Professional investors can often take a month or two to build a position in a small company – purely because there is not enough turnover in the stock. This can cause problems when entering, but much greater problems when something goes wrong and they are looking to exit a position. Private investors can buy and sell positions much more easily without facing liquidity risks on their mistakes.

RICHARD HEMMING: I think you need to build up the amount of time according to how much you are investing, as it relates to your total asset base. The more you are investing, the more serious you need to be. We're talking about your future, after all.

In most cases, the most productive use of your time is your job. Beyond that, you should be putting in at least two hours a week reading material that relate to your investing. You should always be looking for the edge. That might occur when your at a Smiggles store if you are interested in Premier Investments (PMV), or looking to see how many a2 cans are in stock in the supermarket. It never stops, really.

It's important to note that the little guy really does have a competitive edge because you can buy a lot of stocks that most fund managers don't bother with because they're too small. You can invest with a small amount of money which means it's much easier to buy and sell without impacting the share price.

The small investor now has more access to information and research than ever and the cost of trading using discount brokers is also lower than ever.

We always tell people not to invest more than 25% of their total equity portfolio in small caps, which we define as stocks with market caps of less than $500m. There is a lot of volatility in this space, but it is combined with big potential. When the big rewards come, they are not to be scoffed at. Our top ten tips have returned ~650% on average. These are the winners of course and not all stocks perform at this level. You need a portfolio of 7-10 stocks, which you are comfortable with holding for the long term.

BIG WINNERS AND LOSERS

FRANK VILLANTE: I hope that my biggest winner is still ahead of me, or at least I am still very focused on finding it. At Celeste we have had pleasing results with the likes of:

- ARB Corp (ARB) – entry point $2.75, last sale $19.64
- Breville (BRG) – entry point 64c, last sale $15.71
- Reece (REH) – entry point $1.53, last sale $10.89

My biggest disappointment in recent times was RCR Tomlinson (RCR), which went into administration late in calendar 2018. With disappointments and mistakes understand that you will make them, its inexorable, it's part and parcel of what you do. Critically with disappointments and mistakes, it's important learn from them, to try and understand where you went wrong, and what you need to do in the future to try and ensure it doesn't happen again. Disappointments and mistakes are also valuable in that they help you understand your own strengths and failings, the human condition if you will, where you may have weaknesses, and consequently adjust accordingly. In addition, being brought up to be a supporter of the South Sydney Rugby League team has been quite character building for most of the past 50 years.

> "Small cap investing requires research, and even though you may think you know a company inside-out, you will still make mistakes and you will still get blindsided by things that you didn't expect to happen."

GRAEME CARSON

Ed note. Frank was happy that Souths beat Manly on the weekend, but agrees that the team may need divine intervention to beat Melbourne Storm (if they get the chance).

GRAEME CARSON: The biggest winner we have had is AfterpayTouch (APT). Its story is now widely known, and its business model and valuation are a topic of wide debate. It was no different when I first met the management team of what was a fledgling business at pre-IPO stage. At the time I liked the concept, but wasn't sure that they had a true competitive advantage and any protected IP, other than the relationship with Touchcorp on the processing side. But I was very impressed by both Nick Molnar (then CEO) and Anthony Eisen (then Chairman). They had a clear and well communicated strategy, first mover advantage and a product the consumer appeared to love. We invested at the IPO and added to our position as soon as it listed. To this day I still think it's the best executed growth strategy I've seen. Obviously the metrics they've delivered have been phenomenal, but the conversation gets harder when the valuation has grown from $165m at IPO to more than $8bn today!

A more recent success is Alcidion (ALC). We purchased ALC in March 2019 through a discounted sell-down of stock from a BlueSky Fund. At a price of 4.5 cents per share. ALC has been listed since 2011 and provides medical software products for patient management and hospital communication. The company has had a recent step-change with the acquisition of MKM Health and the associated appointment of a new CEO Kate Quirke, who really impressed us. ALC is now profitable and cashflow positive, is delivering strong revenue growth and has a product that is truly scalable, is gaining obvious traction contained in a business model that is not capital intensive. It currently trades at 25 cents per share, but we are still believers.

One that we got wrong is Motorcycle Holdings (MTO). We viewed the company as a genuine growth story and didn't respect the risk of cyclicality in the business. MTO owns motorcycle dealerships in was continuing to acquire more in what was still a very fragmented industry in Australia. It was the sort of company that would pop up on all the quantitative filtering due to its growth and high return on equity. We liked the management and the roll-out strategy. There two main issues that changed its fortunes, at least in the short term. Firstly, they acquired Cassons, an accessories business, raising both equity and debt to do so. This constrained the balance sheet and changed the ROE profile. Second, they faced a severe industry downturn in motorcycle sales and were hamstrung to do much about it. At one stage we had lost around 60% of our capital, but it has partially recovered recently.

RICHARD HEMMING: On a personal front my big winners have been small cap miners as well as Telstra (TLS) and CBA which I simply held and held. The growth was far more explosive on the mining front, but I've also had some big losers to offset some of those capital gains.

Of course, this is not to ignore many failures. One that stands out is Pro-Pac Packaging (PPG). I underestimated the effect of the drought, which undermined its big bet on flexible packaging. Also, although I got into AfterpayTouch (APT), we realised gains too early. Often when you are sitting on gains in small caps there is a temptation to take some profits quickly. I'm guilty of this. Hindsight is a killer!

At Under the Radar Report, we have leveraged our experience in the biotech field to invest in some big winners here – Sirtex Medical, Clover Corp (CLV) and Medical Developments (MVP). We've also picked some gold stocks early, namely Northern Star Resources (NST) and Evolution Mining (EVN). Although we've had some duds, the losses have been more than offset by the huge gains from these gold titans. We've also picked the food sector early have benefited from spectacular performances in individual stocks here – Bellamy's Australia (BAL), Freedom Foods (FNP), Capilano Honey and Tassal Group (TGR).

> **"I now know that complexity is to be avoided and if possible to gravitate to simplicity. Analysts love to convince themselves that they know the detail, but you cannot understand everything. If you can't explain the business model to your dad, don't invest."**

FRANK VILLANTE

WHY INVEST IN SMALL CAPS?

We look at what is a Small Cap, our performance, and how we choose the stocks to recommend as buys from our universe of over 2,000 stocks.

HOW WE'VE GONE IN THE PAST EIGHT YEARS?

We've picked some winners and the occasional loser, but the investment gods have favoured us over the past eight years since we launched our first issue. The average return for the stocks in our universe is over 50%; while the performance of our Best Buys has been 60%.

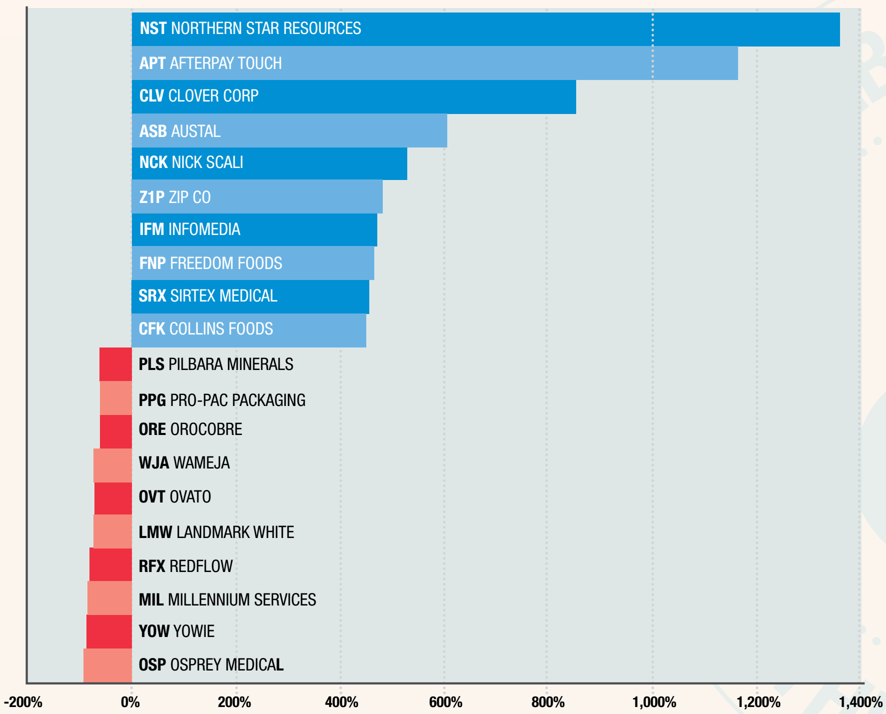
There are risks in any investment, but when you are paying very low prices for assets that have relatively big potential, there is less that can go wrong if there are hiccups. You can have many of these types of stocks in your portfolio and a lot won't do anything. But for the ones that do, it will be worth the ride.

The share market goes up and down, but historically it tends to rise more than it falls. This occurs in seven out of ten years. If you average out its returns, you are looking at about 10.5% a year. And your timing has to be good to generate this return, and even over a number of years.

To generate the sort of wealth to fund your retirement needs you need to do better than this: you need to hit the ball out of the park on one or two investments. This is what Small Caps can do.

8 YEARS: OUR BIG WINNERS & LOSERS

The returns of Under the Radar Report's top 10 winning and losing tips 2011-2019



What are Small Caps?

The term is bandied about a lot because many fund managers want to be associated with a part of the market that signifies above average growth. The reality is, however, that the definition many use stretches the concept of a small listed company.

Fund managers often say that a small cap is a listed company outside of the S&P/ASX 100 Index. This means that many companies they invest in have market capitalisations of greater than $1 billion.

The S&P/ASX Small Ordinaries index contains companies that could hardly be described as small. These are companies at the lower end of the top 300 companies by market cap, known as the S&P/ASX 300 Index. The ASX Small Ords has an average market cap of over $1bn and which go all the way up to $11bn! Hardly small.

There are almost 2,300 listed companies on the ASX with a combined value of $2.1 trillion. The median market cap of the 200 biggest is close to $2bn. But it's in the long tail where most action is for shareholders looking for better than average returns.

Over 90 per cent of these companies, numbering close to 2,000 have market caps below $500 million. It's these companies that Under the Radar Report classes as Small Caps, and for these companies it is normal for there to be few announcements other than to report profit numbers. At any time we cover between 90 to 110 stocks.

ITS CELEBRATION TIME, COME ON!

We are celebrating eight years of picking winners (and some losers) and most importantly recently, we've been taking profits.

It's not an accident that we've been telling people to take profits in the past few months. Asset prices have more than doubled in the past ten years, while income levels have barely moved. People are going further up the risk curve to get more bang for their buck.

HOW WE PICK 'EM. GROWTH, NOT DIVIDENDS, IS THE KEY

Although their ardour is waning a little, most Australian investors remain in love with dividends. However, it is earnings growth that is the key to making money. Small Caps do not have the luxury of paying out all their earnings in dividends like some of the big companies do. This works out to the investors' advantage, however.

It is always important to remember that it is the movement of share prices, not the dividends paid, which dictates the returns investors make, over any period of time.

From 2000 to 2012, the return from Telstra's dividends was 73 per cent, but its price return was -47 per cent. It delivered a measly annualised return of less than 2%.

Companies only grow when profits are reinvested, and when a company's sole objective is to maintain a high dividend yield, it doesn't augur well for long-term value.

Compare Telstra's return with the gold producer, Newcrest Mining. The miner delivered an average annual dividend yield of 0.78 per cent between 2000 and 2012 with the annual dividend increasing from 5 cents in 2000 to 35 cents in 2012.

An investor that bought Newcrest in 2000 would have achieved a total return of 406 per cent in 2012, comprising a 363 per cent price return and a 43 per cent dividend return.

A LACK OF INFORMATION

There is risk in buying Small Caps. But there is risk in buying any investment, especially in the stock market.

Even though there has been some weakness recently, stocks like the banks, Telstra and some internet companies continue to trade near record high levels because investors perceive that there is relatively high certainty that their earnings will appreciate, delivering growing dividend income. These companies have high "price risk". If there is any softening of their earnings growth, their share prices are extremely vulnerable to big falls.

In contrast, what you see with Small Caps, is "information risk". In these companies their historic earnings performance can often bear little resemblance to their future earnings.

UNDER THE RADAR HELPS SOLVE THIS "INFORMATION RISK"

The companies Under the Radar Report covers and advocates buying are often not covered anywhere else. Fund managers are often not interested in them, because they are too small and it is hard for big funds to get a meaningful stake.

Under the Radar Report adopts a proprietary investment process in order to look for Small Caps that match our criteria. In addition to analysing company announcements and financials, we spend a great deal of time speaking to the management of the company.

> **TO GENERATE THE SORT OF WEALTH TO FUND YOUR RETIREMENT MEANS YOU NEED TO RETURN BETTER THAN 5-10% A YEAR. YOU NEED TO HIT THE BALL OUT OF THE PARK ON ONE OR TWO INVESTMENTS. THIS IS WHAT SMALL CAPS CAN DO.**

How do we pick stocks?

Below are the categories we use to look through our universe and pick companies to buy.

1. Genuine Growth

Small companies growing fast. Often these are stocks you need to grab onto even though they might look expensive. More often than not they have a great business model involving little capital investment to fund fast sales growth.

There are a number of examples from our past issues. These include fintechs such as Afterpay Touch (APT) and Zip Co (Z1P), biotechs such as Clover Corp (CLV) and Sirtex Medical (taken over), as well as specialty pharmaceutical companies including Medical Developments (MVP), plus the organic baby formula marketing group Bellamy's Australia (BAL).

2. Once Were Warriors

Big companies can often have cyclical earnings and low profit margins, or they may have been bought down by a difficult division or a change in their business model. In the latter case, the share price fall can often be attributed as much to how investors perceive them as declining profitability.

This is very much an opportunistic category, which can come along either because of a broader market decline, or as company specific problems emerged. Examples include big contractors like UGL (UGL) as well as rural services group Elders (ELD) and the ship builder Austal (ASB).

3. Value industrials

Often Small Cap industrial companies have cyclical earnings but they have more resilience than the market gives them credit for. Sometimes they even have a strong balance sheet. You hope that they have a defendable niche. Good examples in past issues include the furniture retailer Nick Scali (NCK) and the food group Freedom Food (FNP).

4. Secret Santa

For some reason the true value of these companies is hidden by loss making assets or assets which are equity accounted. Good examples include cloud technology provider Macquarie Telecoms (MAQ) and the financial services software provider GBST (GBT).

GENERATING STRONG RETURNS WITH QUALITY SMALL CAPS

In 2016 we changed from investing in index-linked funds and small caps to a pure Small Cap fund. The result has been a success and below we look at why, which includes the importance of holding cash and being prepared to take profits.

WHAT'S HAPPENED THREE YEARS ON

When we published a comprehensive review of the Under the Radar Report Portfolio in 2016 for our 5th birthday edition, we had deliberately invested the portfolio as we would for a balanced investor i.e. with the majority of their funds in index linked or blue chip and listed investment company securities; with only 25% in Small Caps.

Over 2011 to 2016, while we made money, the results did not reflect our Small Cap stock picking because almost 50% of the return for the investments came from distributions and this was offset over those first five years by an average level of cash of 42%.

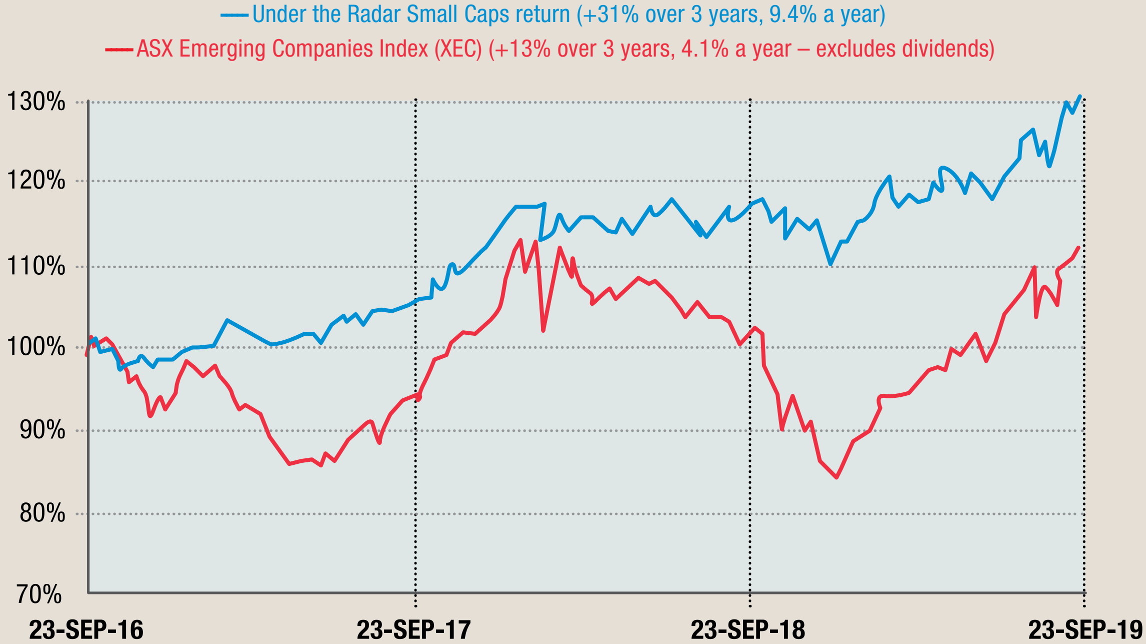
EXCLUSIVELY SMALL CAPS: LOWER RISK AND HIGHER RETURNS!

By 2016 Under the Radar's universe of small caps we cover was large enough to commit the portfolio wholeheartedly to a Small Cap strategy, and we sold all our larger holdings over the period from April to August 2016.

We have now had three years to demonstrate how our strategy has been working, and Under the Radar Report is pleased to report that returns have markedly increased. We have achieved 9.4% a year over the last three years with an average cash level of 30%.

SMALL CAP PORTFOLIO: LOWER RISK AND HIGHER RETURNS!

Under the Radar Small Caps Portfolio against ASX Emerging Companies Index (XEC) over three years.*



*Measured by First DollarTM

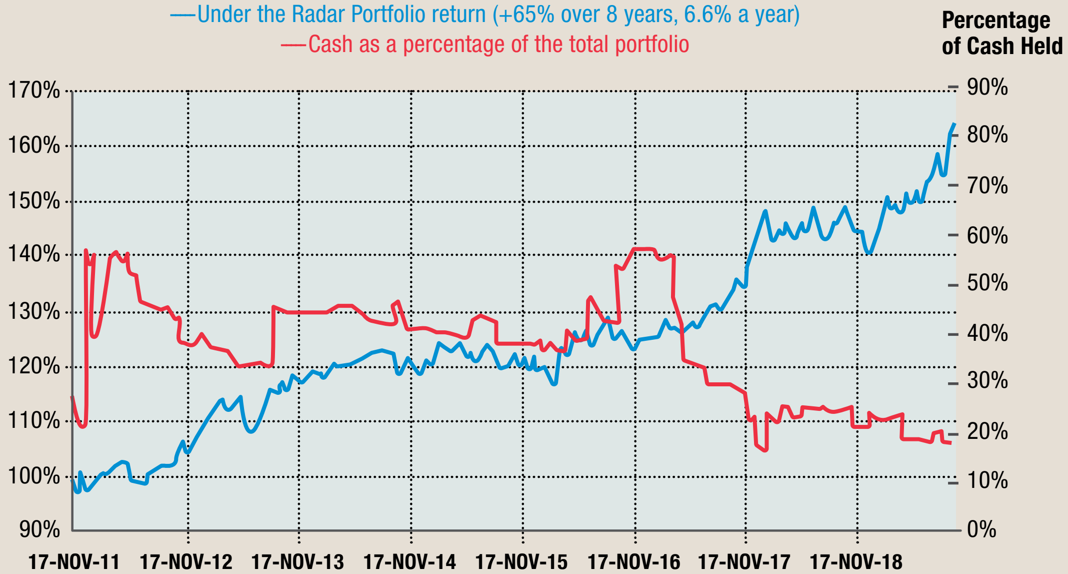
The previous chart compares the portfolio's performance over the last three years with the **ASX Emerging Companies Index (XEC)**, which includes some of the companies we cover. The clear advantages of a diversified and cautious approach has managed to avoid the wild swings of the Index and yet is 5.3% pa ahead over the three years. Lower risk and higher returns!

WHY CASH IS CRUCIAL TO INVESTING

One of the conservative ways in which we manage this portfolio is through the cash level we maintain. Average cash over the eight years is around 24% and is currently 19%. The full eight year record is shown in the chart below, measured against the percentage level of cash. Cash provides flexibility and ensures that you retain choice over which stocks to make a priority when companies raise capital.

8 YEAR PERFROMANCE SHOWS SMALL CAP GROWTH EFFECT

Under the Radar Report Portfolio return against the average cash level over 8 years.*



*Measured by First DollarTM

WHY ARE YOU INVESTING?

When building your own stock portfolio, it is critical to be clear about the purpose for which the portfolio is being developed, and the timeframe within which cash from this portfolio may be needed. It is also important to understand your level of risk tolerance within that context. It is no good having stocks which have doubled or tripled or even more, if due to your own lack of faith you have sold some or all when they have lost 50%. Because if a stock can double, then it can surely halve. Look at IMF Bentham (IMF), which went through a long period in the wilderness in 2015/2016, but has since tripled our cost price. We took profits on 60% of our holding a year ago, but the stock has recently hit new highs.

With 20/20 hindsight, we all wish that we had most or all of our portfolio in Afterpay Touch (APT), or some other exciting stock. But our retirement needs a portfolio for all seasons, and we are reasonably happy that at the moment it is delivering as advertised.

WHY TAKING PROFITS IS SO IMPORTANT

Although the ideal holding period for a stock, as Warren Buffett has it, is eternity, we have to accept that the number of stocks that will meet a criteria of offering valuable growth at a reasonable price for that length of time is probably limited. At Under the Radar we try to find as many of them as we can, but in the process we will also trip over some non-starters.

One of the reasons for taking profits on Small Caps is that the market for some of these companies is relatively limited. In a downturn, the universe of investors and speculators willing to invest in a particular type of small company will shrink.

You are more likely to find a buyer for the stock you want to sell in an uptrend, and it is part of our general philosophy to ensure that we take advantage of a positive market while we avoid having to sell into a weaker market.

We managed to carry out this part of our function as portfolio managers quite well recently with the ship builder

Austal (ASB), where we took profits at the first peak of a market in which the stock had doubled in the course of around 6 months, but after a 20% pullback, the stock advanced a further 20%, ahead of our sale price, and thus we have left money on the table. The first point is that we sold only 30% of the holding, essentially taking all our costs out, leaving the portfolio's holding now only the gains that we have made. As subscribers know, we continue to like ASB although we will not be upgrading at these prices. But it is not always honey and roses, and we have also sold stocks at exactly the wrong time, for example Specialty Fashion (now CCX).

MEASURING OUR RETURNS

Over the years, we have measured the portfolio's performance against a number of different indices, while observing that no individual index provides a suitable benchmark. This is partly because of the heterogeneous nature of many of the companies that we follow, and partly due to the fact that we are more interested in absolute returns rather than relative performance. A professional fund manager who returns -10% in a period where the market returns -20% might outperform and get paid fees for doing so, but he or she doesn't suffer any consequences for losing money.

The portfolio has not matched the performance of the average Under the Radar Report stock. This is partly due to the high level of cash, but also due to other constraints that we put on the portfolio, such that we only invest in stocks that we have been covering for some time, as well as the impediment of telling subscribers in advance what our planned transactions are.

GOING FOR GOLD

We have been particularly pleased with the performance of our holdings in the Gold ETF (GOLD) and Evolution Mining (EVN) - one of the large miners that we cover - as it illustrates the benefit of the hedge that gold can provide in uncertain times. And we certainly live in those. Gold has gained favour in recent months due to the trillions of dollars of negative government bonds throughout the world. This means that the cost of financing gold holdings for professional and institutional investors is relatively low and the alternatives do not yield much more.

LOW INTEREST RATES ARE GOOD FOR SMALL CAPS

What is clear is that individual companies can continue to earn good returns over the medium term from small and focused business, and these earnings returns can be the basis for a very attractive and sustainable dividend yield.

We have been particularly happy with the performance of Ingenia Communities (INA), where its income is derived from thousands of individuals for whom their accommodation rentals is the first call on their income. As long as the company can remain healthily financed, it is an attractive income/growth story even though its current yield is not much more than 2.5% since the shares have increased so far.

Some of the stocks that we hold have less reliable yields, but over the years they have proved more reliable than the market has discounted, delivering fully franked yields in some cases of 5% to 10% pa over the medium term. Examples include Select Harvests (SHV), Pacific Group (PAC), even Capral (CAA), although its shares have been

WE HAVE NOW HAD THREE YEARS TO DEMONSTRATE HOW OUR STRATEGY HAS BEEN WORKING, AND UNDER THE RADAR REPORT IS PLEASED TO REPORT THAT RETURNS HAVE MARKEDLY INCREASED. WE HAVE ACHIEVED 9.4% A YEAR OVER THE LAST THREE YEARS WITH AN AVERAGE CASH LEVEL OF 30%.

particularly disappointing as the company has struggled with high energy costs and import dumping.

In the last chart, we isolate the components of the returns achieved by the portfolio over the last three years to compare with the first five years. What it demonstrates is that since we moved to an all small caps strategy, we have made 11.5% a year from the capital appreciation of the stocks we have owned, pre commissions. This capital appreciation has been enhanced by 2.5% a year in distributions, before the level of cash reduces the overall returns by 3.8% a year to 9.4% a year, essentially doubling our net annual returns over the previous five year figures.

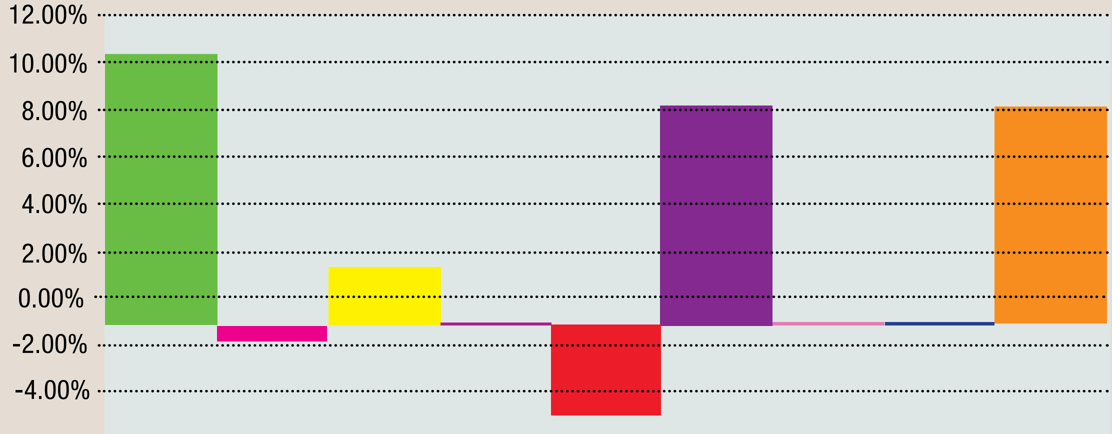
DIVERSIFICATION IS PARAMOUNT

An investor needs to understand where the decline of a stock may be a temporary phenomenon, however long one has to wait, or whether you are about to establish a permanent loss of capital. In that context, we were pleased to see a recovery over the course of 2019 in Village Roadshow (VRL), until it went into reverse caused by the appointment of the family member as the CEO, but the results and 5 cents dividend has gone a long way to improving the company's marketability to investors. Further progress on the results will need to be seen, but a 10% uptick after the FY19 results were released was a start.

We try to ensure that the big holdings are sufficiently different from each other and sufficiently good value to help achieve some positive progress while at the same time watching for opportunities to add to or introduce other holdings within the portfolio.

RETURNS ANALYSIS OF UNDER THE RADAR SMALL CAP PORTFOLIO

A detailed financial return analysis of Under the Radar Small Cap Portfolio over past 3 years.*



COMPOUND ANNUAL GROWTH RATE	11.54% Pre Commissions	-0.55% Cost Of Commissions	2.46% Distributions	0.00% Tax	-3.78% Contribution To Return From Cash	9.35% Investment Performance Ex Management Fee	0.00% Cost of Management Fees	0.00% Gain/(Loss) From Deposits/ Withdrawals	9.35% Financial Returns

*Measured by First DollarTM

UNDER THE RADAR SMALL CAP PORTFOLIO

ASX CODE	COMPANY NAME	LAST TRANSACTION	NUMBER HELD	TOTAL COST	Price @ 23/09/2019	CURRENT VALUE	PORTFOLIO WEIGHT
ASB	Austal	19/07/2019	3500	-$5,527	$4.200	$14,700	11.1%
BOL	Boom Logistics	02-11-2018	25000	-$3,653	$0.162	$4,050	3.0%
CAA	Capral	21/12/2018	60000	-$9,610	$0.115	$6,900	5.2%
COE	Cooper Energy	22/12/2017	10000	-$3,228	$0.610	$6,100	4.6%
EVN	Evolution	22/12/2017	2000	-$5,208	$4.770	$9,540	7.2%
GAP	Gale Pacific	05-04-2019	30000	-$10,885	$0.290	$8,700	6.5%
IMF	Bentham IMF	21/12/2018	1500	-$2,065	$3.610	$5,415	4.1%
INA	Ingenia Communities	08-12-2017	3500	-$9,699	$3.840	$13,440	10.1%
MNF	MNF	19/07/2019	1500	-$7,058	$5.000	$7,500	5.6%
MVP	Medical Developments	13/10/2017	800	-$4,407	$4.710	$3,768	2.8%
MYX	Mayne Pharma	05-04-2019	10000	-$6,505	$0.525	$5,250	4.0%
PAC	Pacific Group	09-03-2018	1000	-$5,397	$6.860	$6,860	5.2%
PRT	Prime Media Group	30/08/2019	15000	-$2,878	$0.160	$2,400	1.8%
PXS	Pharmaxis	05-04-2019	25000	-$7,760	$0.210	$5,250	4.0%
RKN	Reckon	19/07/2019	4000	-$5,824	$0.745	$2,980	2.2%
SHV	Select Harvests	04-04-2017	1000	-$4,935	$7.590	$7,590	5.7%
SLC	Superloop	20/03/2019	2111	-$3,656	$1.010	$2,132	1.6%
VRL	Village Roadshow	26/07/2018	4770	-$14,406	$2.730	$13,022	9.8%
WJA	Wameja	30/07/2019	10000	-$2,215	$0.092	$920	0.7%
GOLD	ETFS Physical Gold	04-11-2014	30	-$3,868	$210.360	$6,311	4.8%
Shares	81%					$132,828	
Cash	19%					$32,065	
						$164,893	

WHAT IS CLEAR IS THAT INDIVIDUAL COMPANIES CAN CONTINUE TO EARN GOOD RETURNS OVER THE MEDIUM TERM FROM SMALL AND FOCUSED BUSINESS, AND THESE EARNINGS RETURNS CAN BE THE BASIS FOR A VERY ATTRACTIVE AND SUSTAINABLE DIVIDEND YIELD.

under the radar report

SMALL CAPS

99% of all financial news relates to the 40 to 50 biggest companies. So what about the rest? They're Under the Radar.

Published by Under the Radar Report Pty Ltd
45 Evans Street, Balmain NSW 2041
Telephone +61 2 9106 2167 Email radar@undertheradarreport.com.au

Editor Richard Hemming **Publisher** Caroline Mark
ABN: 65147404662. AFSL: 409518.
Website www.undertheradarreport.com.au