DMX
ASSET MANAGEMENT

STRATEGIC VALUE INVESTMENTS

DMX CAPITAL PARTNERS – RISK-ADJUSTED RETURNS

DMX Asset Management, April 2018

SUMMARY: ***DMX Capital Partners is invested only in high quality companies where in our opinion the upside risk significantly outweighs the downside risk. In this article we discuss our risk adjusted returns and how they are achieved.***

Investing in smaller companies offers many long term advantages in our opinion. One of the greatest advantages is the attractive long term risk-adjusted returns which can be generated if the right strategies are employed. We believe the core concept to explore when looking at how these attractive risk-adjusted returns are achieved is upside risk versus downside risk - and how an attractive upside risk versus downside risk ratio reflects itself in long term risk-adjusted returns…

Measuring upside risk

In our experience, determining the upside risks is generally the easiest part of investing in smaller companies. Management teams are usually adept at highlighting where the upside risks will come from over the long term, and it is usually relatively simple to put a value on these positive scenarios.

Measuring downside risk

Measuring downside risk is arguably more challenging than measuring upside risk as you are attempting to value scenarios which will inspire negative emotions across a company's investor base. When investors are feeling negative about a stock, rational valuation parameters often go out the window and a fire-sale mentality takes over.

In our experience, if there is a useful reference point for measuring downside risk it is generally a conservative measure of a company's book value; i.e. the value of a company's net assets (its assets minus its liabilities). If this number is indeed a conservative asset based valuation it can provide a degree of confidence that the stock price is unlikely to trade significantly below this level for a prolonged period.

For example, if a stock is currently trading at 1.5x a conservative assessment of book value, it would generally be prudent to assume downside risk would be around 33% if we are confident in our assessment of book value.

What is an acceptable upside-downside risk ratio?

This question highlights the attractions of smaller companies investing in that an acceptable upside-downside ratio is generally far higher when investing in smaller companies than larger companies reflecting the higher expected returns on offer.

When we are considering new investments, we'll generally only move forward with an investment if the upside-downside ratio is 4 or above. At this level we believe we have an appropriate margin of safety to ensure an attractive long term return looking forward.

Sharpe Ratio defined

"The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Subtracting the risk-free rate from the mean return, the performance associated with risk-taking activities can be isolated. One intuition of this calculation is that a portfolio engaging in "zero risk" investment, such as the purchase of U.S. Treasury bills (for which the expected return is the risk-free rate), has a Sharpe ratio of exactly zero. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return." Investopedia

<u>Sharpe ratio = (Mean portfolio return − Risk-free rate)/Standard deviation of portfolio return</u>

"Usually, any Sharpe ratio greater than 1 is considered acceptable to good by investors. A ratio higher than 2 is rated as very good, and a ratio of 3 or higher is considered excellent." Investopedia

DMX Capital Partners risk-adjusted returns

DMX Capital Partners Risk-Adjusted Returns	
Standard deviation of returns (a)	10.17%
Absolute performance after fees in 3 years since launch (b)	69.4%
Annual alpha after fees in 3 years since launch (c)	21.6%
Sharpe Ratio (c/a)	**2.1**

A sharpe ratio of 2.1 since launch 3 years ago is roughly what we were aiming for at the time of launch given our focus upon high quality, under-valued smaller companies. We'll be aiming to continue replicating our process in the next 3 years to position ourselves to generate attractive long term risk-adjusted returns with minimal correlation with markets and our competitors. Our long term focused investors are well placed to benefit.

<u>CONCLUSION</u>*: DMX Capital Partners' sharpe ratio of 2.1 reflects a focused value approach combined with a discerning high quality definition. We'll be aiming to continue building upon these risk-adjusted returns over the long term.*