DMX

STRATEGIC VALUE INVESTMENTS

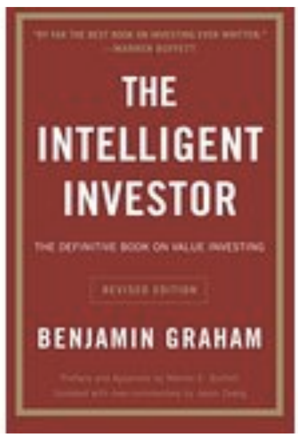
OUR APPROACH TO VALUE INVESTING

DMX Asset Management
June 2016

SUMMARY: ***Value investing requires discipline and an ability to see through the noise so as to buy when others are fearful. With a good degree of self-awareness and an open mind we strongly believe it remains a superior investment strategy, and one which can lead to substantial outperformance. This article addresses key value investing terminology and strategies as an introduction to this lucrative investment approach.***

INTRODUCTION: KEY TERMINOLOGY

The Intelligent Investor by Benjamin Graham remains the value investors' key reference work 67 years after it was first published in 1949. Warren Buffett has long been a devotee of the principles in this book. The majority of value investing terminology we use today came from this book, such as:



- "**Investment operation**" - "An investment operation is one which, upon thorough analysis, promises safety of principle and an adequate return".

- "**Mr Market**": Investors should think of the market as a person, Mr Market, who is usually reasonable and offers you a price for your securities close to your view of fair value, but sometimes Mr Market becomes emotional and volatile, and becomes overly optimistic or pessimistic.

- "**Margin of safety**" - A key tenet of value investing is the idea of factoring in a margin of safety to take into account the fact you may be wrong in your assessment of fair value. e.g. If you think a stock is worth $10, with a margin of safety you may be prepared to pay up to $7 for it. As Mr Graham explains, "The margin of safety is the difference between the percentage rate of the earnings on the stock at the price you pay for it and the rate of interest on bonds, and that is to absorb unsatisfactory developments".

OUR APPROACH TO VALUE INVESTING

At DMX Asset Management we are passionate about value investing and believe a disciplined value investing strategy will significantly outperform the market over the long term. **We search for companies where the conservatively estimated intrinsic value exceeds the share price by a sufficiently large margin that it affords a margin of safety which maximises the chance of long term outperformance.**

Our value investing approach is based upon **<u>fourteen investment beliefs</u>**:

1. **Knowledge and expertise are more important than diversification.** We believe it is more important to know a small number of companies intimately than to know very little about a lot of companies. Risk increase the more diversified you become. As a result, <u>DMX Capital Partners holds only 15 high conviction positions we know extremely well.</u>

2. **The key valuation measure is cash flow, after allowance for the required capital expenditure to keep the business going over the long term.** The intrinsic value will vary over time as cash-flow certainty and the discount rate change.

3. We reject the idea that risk is the standard deviation of historic returns, and believe that **risk is the probabilistic assessment of something bad happening** (i.e. the distribution has a single tail and is forward looking).

4. **The share market can wildly mis-price companies relative to their intrinsic value** but over time we believe shares prices will move towards fair value. In the short term, the share market is effectively a popularity contest, but over the long term share prices will reflect economic fundamentals. As a result <u>we are only focused on the long term.</u>

5. **We think of ourselves are part owners of businesses.** This helps us understand each business better and allows us to take the long term view required.

6. **"Mr Market" should be your friend.** Bi-polar "Mr Market" provides prices every day – sometimes high and sometimes low. We believe investors should exploit his moods – buy when he is down and sell when he is high. DMX has a long term investment horizon which allows us to opportunistically profit from these mood swings.

"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgement is sound, act on it- even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right. Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand." Benjamin Graham

7. **We will only invest when we have a sufficient margin of safety.** This means there should be a large gap between the intrinsic value and the current share price to allow for any inaccuracies in the assessment of the intrinsic value.

8. **We believe management should be invested in their businesses** to ensure their interests are aligned with shareholders, and that they treat other shareholders as partners.

9. **Investment opinions should be based upon a considered appraisal** of a business/investment case against all known facts with the expectation that on average a superior return can be achieved. This contrasts with speculation which is short term and more akin to gambling.

"***By speculating instead of investing you lower your own odds of building wealth and raise someone else's" Jason Zweig***

10. Value investing **can be applied to both low and high growth businesses;** the key is to invest when the intrinsic value is well above the current share price.

11. The distinction between price, book value and intrinsic value: Price is the current share price; the book value is the value of the assets minus liabilities as reported in the accounts; and **the intrinsic value is the true underlying worth of the business.**

12. **Macroeconomic factors are very hard to forecast accurately** and, given the long term nature of value investing, frequently of only **limited relevance**.

"The buyer of bargain issues places particular emphasis on the ability of the investment to withstand adverse developments." Benjamin Graham

13. **Non income producing assets have no value** in the value investing framework.

14. **Often family companies perform well** because decisions are generally made with a longer time horizon and higher level of engagement in mind.

VALUE INVESTING EXAMPLES IN THE DMX CAPITAL PARTNERS FUND

1. **Buying stocks with a strong asset backing. e**.g. We bought into EZA Corp (ASX:EZA) when it was trading at a 25% discount to its net cash value. This may seem surprising but is illustrative of the inefficiencies of the smaller company universe. The stock has since been suspended from the ASX whilst management decide on an acquisition. When the stock re-lists, if a sensible acquisition is announced, we believe the stock will move to a premium to its net cash value which implies significant share appreciation from the acquisition price.

2. **Keeping the portfolio less than fully invested (20% cash on average)** in order to keep our powder dry for a market calamity, or to cover any outflows. This has served us well thus far as it allows us to profit whilst others are fearful. <u>We expect to out-perform in falling markets as a result.</u>

3. **Focusing on stocks with a long history of trading** so we can effectively analyse and value the businesses. We do not invest in start-ups, we only invest in well established businesses. e.g. One of the fund's top 5 positions is Fiducian (ASX: FID), a leading fund management and financial planning group. The company listed in 2000 (and was established in 1996) which provides a significant amount of data to analyse and thus value the business. As a result we have high conviction that this is an excellent long term investment.

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INTEGRITY, TRUST, EXPERTISE

4. **Focusing on low PE stocks -** The vast majority of the fund's holding are trading on a single digit PE based upon FY16 earnings which represents a significant discount to the market average. e.g. Dental supplier, SDI (ASX: SDI), is currently trading at 8x '16 earnings, which appears deeply under-valued for a quality international business with solid growth prospects. Investing in such low p/e stocks is a typical deep value investment strategy.

5. **Take a long term investment horizon at the time of investment -** Over the past year the fund has only sold 2 of its 14 positions which implies a turnover ratio of under 15% and an average holding period of around 7 years. We do what we say we do in terms of taking a long term view at the time of investment.

6. **We do not set out to replicate the market in any way; we are aiming for significant positive absolute returns -** We are completely benchmark unaware as we are looking for the most compelling smaller company opportunities across all sectors. This is how the fund out-performed the All Ords by 53% in the year to March 2016. <u>We remain confident regarding future returns.</u>

CONCLUSION

We view true value investing as one of the most potent sources of investment out-performance available. Whilst it is a remarkably simple investment style, it requires immense discipline, patience and dedication. We believe our investors are well placed to benefit.

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