

JOSH GOLDBERG

Mission(s) Impossible – 009 (lives)

WHEN I think of New York-based hedge fund manager Josh Goldberg, the music to the film *Mission Impossible* plays in my head. But instead of Tom Cruise, I envision a dark-haired, bearded man with glasses and a yarmulke playing the leading role. Josh has literally achieved numerous impossible missions.

The first mission impossible came in 2009, when Josh launched his firm, G2 Investment Partners Management, with less than \$100M under management. He was advised that the odds of a hedge fund like his growing to over \$100M in assets were less than 1 in 500. When his first client told him that he needed to make 20% in the first year or he would pull his money, those odds became very real.

The fund's returns during the first nine months were lackluster. The client phoned Josh and said he was pulling his money at the end of the year. Josh recalls praying for help. His returns picked up, and he ended up exceeding the threshold. The client still pulled their money – their loss, as things turned out.

Josh's second mission impossible came in 2016, when he was diagnosed with stage four colon cancer and given only a 2% chance of living. Over the next three years, Josh had dozens of chemotherapy treatments, several surgeries and too many nights in hospital. And against all odds, he not only survived, but five years later, he was cancer-free.

Now, going back to 2016 and knowing Josh only had a 2% chance of survival, what are the odds that G2 would have been one of the best performing hedge funds over the following five years? Even if Josh survived all those years of chemo, how could he possibly have the mental wherewithal and physical stamina to pull that off?

Well, it turns out that one of the best things you could have done with your



money in 2016, upon hearing Josh had a 2% chance of living, would have been to invest in G2. By the end of 2021, you would have beaten pretty much every other hedge fund out there. A family office that was aware of what he was going through invested \$100m, while another client said he appreciated Josh sharing the truth with him and vowed never to take his money from him. This tells you something about how highly regarded Josh's talents are.

Josh has a mural on the wall of his office. He received it when he was sick, from former NFL legend Ray Lewis. It reads:

When the impossible seems impossible, God makes it possible. That's what life is and I truly believe that. Pick yourself up. Pick your spirits up. Pick your motivation up and do me this favour. Practise these affirmations every day. I am whole. I am perfect. I'm stress free. My body is completely healthy. I am healed. I am a conqueror. I'm an overcomer. There is nothing I cannot achieve. These are the things that we must confirm in our spirit every day of our life. No disease, no sickness will ever destroy me. It can't win. I win. I always win because I have the efforts and the ability to move forward. Josh, kiss your babies and let them know you're in this fight for the long haul.

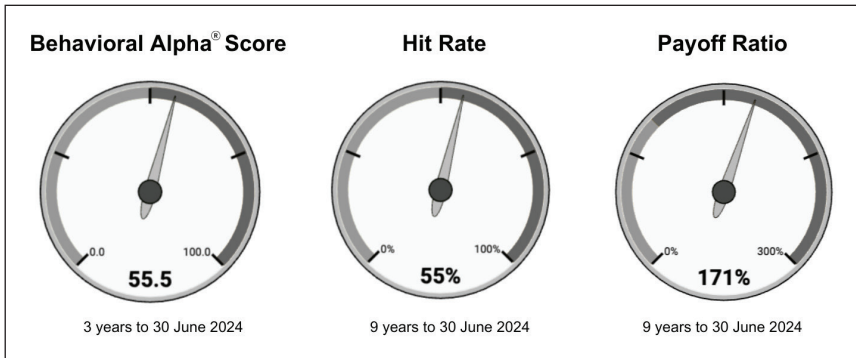
It might not surprise you to learn that Josh attributes his success against the odds to a positive attitude, a personal growth mindset, to being present and to having kids he loves.

WHAT THE STATS SAY

While a very solid Behavioral Alpha[®] Score of 55.5 proves that Josh has been making skilled decisions in recent years, we had the benefit of nine years of data for additional analysis. We can see (in Figure 7) that across the whole long/short fund, Josh has achieved the one-two punch of a high (55%) hit rate combined with a high (171%) payoff. In other words, he's getting it right more often than wrong, and when he is right, he's been 1.71x as right as he's wrong.



Figure 7: Josh Goldberg overall stats



All stats are based on daily holdings data from the Investment Manager and are calculated on returns relative to the Russell 2000 Index[®]. The Behavioral Alpha Score is calculated on the long portfolio only, whereas the hit rate and payoff ratio are calculated on the full long/short portfolio.

HOW JOSH INVESTS

Before examining Josh’s investment strategies in winning and losing scenarios, it’s crucial to understand his investment philosophy, to provide context for his actions.

Josh, I heard that your stint working with legendary investor Phil Hempleman at hedge fund Ardsley Partners strongly influenced the way you invest – is that right?

Phil, who has been a lifelong mentor to me, was the first one to impress upon me the importance of companies missing or beating expectations. I recall pitching him an idea where the stock had gone from \$70 to \$25 and I thought earnings would come in around 40 cents below what the market expected. I told Phil that he should buy anyway because the stock was cheap.

He said to me, “Josh, when a company lowers their earnings, you don’t want to own the stock – even if it is cheap.” And that was when it hit me like a ton of bricks – you want to be short companies that are missing expectations and be long companies that are beating expectations.

So, when you started your own firm, G2, you built your strategy around earnings surprises?

Since our founding in 2009, we have focused on finding companies on the verge



of an earnings surprise. The actual type of surprise depends on the industry – it could be an earnings surprise, a revenue surprise, or an EBITDA surprise. The point is, to focus on stocks that deviate from expectations.

Do you try to get ahead of the earnings surprise, to benefit from the pop in the share price?

No. We wait for the first earnings surprise to happen, then we do research on the company. We give ourselves 90 days to do the research and decide whether to invest. In the past, we used to log surprises on a blackboard and then call the company and start doing the research. But now we use technology and third parties who send us data on which companies have surprised and the volume activity in those stocks.

How do you explain the trending nature of earnings surprises once they occur?

Anchoring bias explains why analysts cling to their existing forecasts and slowly adjust their numbers.

Imagine you have a company that analysts expect will earn \$0.25 per quarter for a year. Basically, flat growth. But then in the first quarter, instead of earning \$0.25 as expected, the company earns \$0.40 – that's a \$0.15 earnings surprise. Logically, analysts should increase their earnings forecasts for subsequent quarters too, to reflect the new reality, but they won't do that until some time has passed – they are anchored to their original forecasts. That gap is what we look to capitalise on.

When an earnings surprise occurs and you dig into the work to decide whether to invest, what are you needing to see to convince you to take action?

Once a surprise occurs, and we do our analysis, we need to arrive at a variant perception versus the market. That gives us confidence that the company can continue to surprise.

What do you mean by “variant perception”?

Having a non-consensus view on what could occur. I learned from Michael Steinhardt, at a previous hedge fund, that having a variant perception is key to finding good stock picks.

I've found that focusing on small-cap stocks reveals the most inefficiencies and unique insights. It's hard to have a variant perception in large caps like Microsoft and Google.



What makes small caps such an attractive hunting ground for stocks with a variant perception?

Small caps are significantly under-researched. I love really getting to know companies and understanding their business models. Meeting directly with management is important to gaining a variant perception. I once visited a company and they told me I was their first investor visit in 10 years; clearly, they were under-researched.

I like to attend company meetings and presentations – I want to see how many other analysts are covering the stock. I prefer companies with fewer than five analysts covering them. Less coverage means more chance of a variant perception and an earnings surprise.

When I visit a company, I always visit the cafeteria because I get to ask the employees about the company and the leadership. An employee once told me they hadn't seen their CEO for three months. In small caps, CEOs drive performance. And if the CEO is nowhere to be found, it's not a good indicator of future success.

The firm's name, G₂, is a military term for gathering information in the field. Our team endeavours to do over 1,200 meetings a year. This is important in trying to establish a variant perception. And if we find a variant perception in a company that is surprising on earnings, there is potentially an opportunity for us to benefit from both higher growth and multiple expansion.

So, once you invest, do you then hold on to a stock for as long as the company continues to experience earnings surprises and earnings revisions?

No. What we do is track the time since the first surprise occurred. And we have that information on the front page of our stock idea reports.

We also track how long an idea has been in the portfolio because we have a 15-month rule. The research we've done shows that we usually don't want to hold a winner for longer than 15 months. That's our sweet spot. If we hold on to it past that point, we risk outstaying our welcome and the share price moving against us – we can see that from the data.

How important are stock price charts in influencing what action you take?

I'm a big believer in technical analysis. I dedicate time every Friday to study the technicals of the stocks we own. Technicals work in small caps because when the share price goes up and volume in the stock increases, it attracts attention, and that creates liquidity, which is very important in small caps.

I like to see stocks break through \$10 a share for the first time, as that attracts



bigger buyers, institutional buyers and, thus, more liquidity. And when that happens, it can sometimes lead to the price doubling quickly.

We also look at a stock when the 50-day moving average crosses the 200-day moving average, to try to understand what that is signalling. We're still thinking of how to systematise this filter, because for some of our winners, we could have done a better job had we sold when the 50-day moving average breached and dipped below the 200-day moving average.

We also look at the strength of a stock relative to both its sector and the market. This helps us build confidence in an idea. As the PM, I want to see stocks with relative strength do well in downturns because it enables you to hold on to your long positions.

When a stock breaks down technically, you have to be careful. You really have to ask yourself, 'Why is there so much selling of this stock? What might reverse the stock's decline in the face of such heavy selling at those price levels?'

You've mentioned the importance of liquidity a few times. Can you elaborate on just how much of a factor it is in how you invest?

Having big positions in small caps can really hurt you. You can make a lot of money, but you can also really get crushed. In small caps, you really don't want to have all your eggs in one basket. Sometimes clients want you to have over 3% in a great idea, but they don't fully appreciate the small cap-specific risks.

Liquidity matters. Small caps can turn into cockroach motels: you can check in, but you can't check out. If a stock has a big drawdown, you often really cannot get out. For this reason, 80% of our portfolio is invested in stocks that would take us fewer than five days of average trading volume to exit.

Also, I want to be able to invest in a company on the first day that I believe it is a buy. I don't want to gradually acquire the position over days and weeks and be constrained by liquidity.

Beyond liquidity considerations, do you find that there is information value in the volume of shares traded following an earnings surprise?

Following a surprise, an increase in volume lets you know that other analysts and investors are now paying attention.

In small caps, perhaps counterintuitively, we have found that buying after a stock gaps up is often the best approach. Likewise, with shorts, a gap down can often represent the best time to initiate a short position.



How do you size your positions on entry, given you are dealing with small caps?

When a company has their first earnings surprise, we will typically invest 50 basis points in the idea and put it in what we call the ‘farm system’³ while the analyst starts the work. We used to put 1% into these farm names but have learned over time that many of them don’t pan out, so now we halve our initial position.

From there, I focus on working out how big a position we should have before the second earnings surprise. Ultimately, a stock will fall into one of three size buckets, depending on conviction levels.

We never know which stocks could double, so it doesn’t make sense to have a couple of huge positions. Sometimes our biggest winners are the seventh or eighth largest holdings in the portfolio.

As an investor who focuses on earnings revisions, what do you do when a company you’re holding misses its earnings forecast?

Since I started the firm, there have always been two key reasons I will sell a position – I consider them rules.

The first rule is that if a company misses earnings, even after a prior positive surprise, then I will sell. Even if the stock goes up on the news, I will sell. My investment approach is to invest in companies with positive earnings revisions. So, if that does not happen, I sell.

The second rule is that I never want to lose over 1% of the capital of the fund on any one idea. So, if I have a 3% position, that translates to selling out when the share price is down 30%. You cannot take the same risk when you are down 10 or 15% as when you are up 10 or 15%. When you lose 30%, you need to win back 50% just to break even. The art of cutting losers is so critical to maintaining positive performance.

What about macro stuff? Does that influence the way you invest?

My time studying with Professor Jeremy Siegel at Wharton highlighted the crucial role that interest rates play in influencing stock market performance. But beyond that, I don’t look at the macro picture. My time at Morgan Stanley made me realise that what I liked most was meeting with companies and focusing on

3 In baseball, a ‘farm system’ refers to a Major League Baseball (MLB) team’s network of affiliated minor league teams used to develop and cultivate young players. These minor league teams serve as a training ground for players, allowing them to gain experience and refine their skills before potentially being called up to the major league team.

the micro. I always loved stock picking, whereas foreign exchange and making big macro calls never appealed to me.

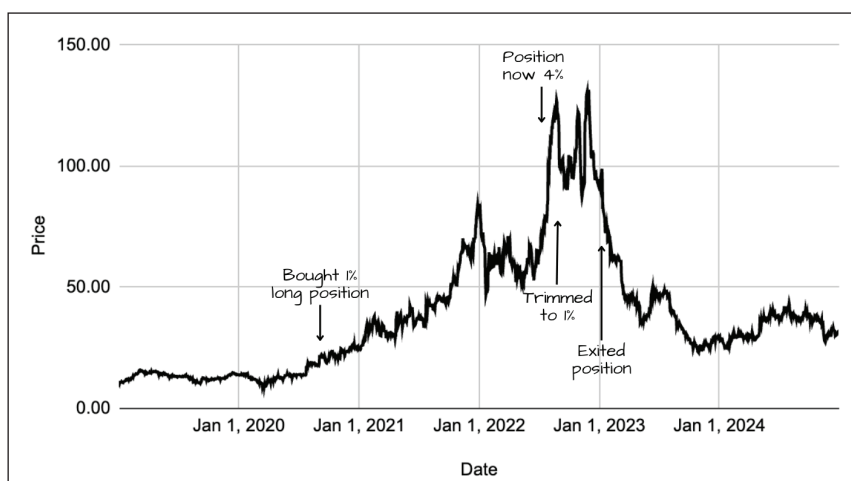
WINNING - WHAT DOES JOSH DO?

In this section, we shift our focus to how Josh behaves when he finds an idea he has invested in is working and making money. To do this, we will review a few of his big winners: **Clearfield Inc**, **OptimizeRx Corp** and **Fiverr International**.

Clearfield Inc - Case Study 1

In this case study, Josh and I discuss his winning investment in Clearfield. Figure 8 shows the share price for Clearfield from 2019 through 2024.

Figure 8: Clearfield share price - Jan 2019 to Dec 2024



Let's discuss Clearfield, because this is a stock that really exhibits your mastery of execution. Tell us a bit about the company.

Clearfield is managed by a CEO named Cheryl Beranek and it is under-covered by Wall Street. There are only a couple of sell-side analysts⁴ covering it.

Clearfield provides the fibre for broadband in small, tier three population cities. It was sitting on a lot of cash, was profitable, and with the help of Covid, it was able to benefit from the increased demand for broadband in these remote cities.

So, let's talk about what got you to buy the stock. It looks like you bought it in 2020 and exited in early 2023, netting a profit of \$3.6m. You made 100% gain during a time the market was up only ~17%.

We were quick to spot the opportunity that would arise from Covid, as people started working remotely from more rural locations. This led to demands being placed on the government to improve and speed up broadband coverage. We initiated a position in Clearfield to benefit from this expected increase in demand.

Interestingly, when we first got in, nothing was happening in the stock. If it were a heartbeat, you would say it was stable. In July 2020, the company surprised on earnings and the stock went from \$14 to \$17 on massive volume: 668,000 shares. Edison Chu, our head of research, was convinced that it was time to buy. So, we started building the position at around \$18.

Did you scale into the position slowly or quickly, given that backdrop?

Three months later, it had another positive surprise and Edison said, "let's add". Then they had a couple more earnings surprises, and we kept adding. The 15-month rule that I mentioned earlier, gives me the time frame to buy more – that's very helpful. At this point, the stock was trading at \$31 and our average price was in the low \$20s.

I then let the position ride. It grew to be 4% of the fund by mid-2022. If you looked at the other holders, no one had as large a percentage of their portfolio in the stock as we did.

Can you tell us more about how you use the 15-month rule in these situations?

Essentia Analytics is a firm that we use to measure the 'back of our baseball card'. We strongly believe in measuring what we do well, and how we can improve.

⁴ In investing, the 'buy-side' refers to institutions (e.g., asset managers, pension funds and endowments) that invest money to earn returns. The 'sell-side' includes firms like investment banks or brokers that create, analyse and sell investment products or research.



Essentia's alpha decay analysis showed that, on average, our ideas stop generating incremental alpha around the 15-month mark. After that, the odds move against us. So that gives me the time frame to at least know when to think about selling.

The 15-month mark makes sense because, at that point, the company could be on its fifth, sixth or seventh earnings surprise and it's likely that analysts will have caught up. Meanwhile, future surprises might not happen or be as big as prior ones, right at a point where more analysts are paying attention to the stock.

When the stock was at \$31, I was only six months into the 15-months, so I felt good about staying invested and not yet taking profits. That was important because by this point, having reached \$31, the stock wasn't doing much. But then it popped and went a lot higher, to \$90.

Wow. That demonstrates the power of having a plan, or a framework for executing your winners. Were there any other factors influencing how you behaved?

I am always conscious that once you are in an idea for over a year, you have to be careful. The story that got everyone excited last year is not that exciting anymore. I learned this from Steve Shapiro, at Intrepid Capital, a Julian Robertson 'Tiger Cub' fund. What works one year for a stock often does not work the following year. Things like a new product cycle or new management team have limited impact. Each year, you have to think again about what story will drive the stock. This is one of the many lessons I have learned from Steve, a friend and longtime mentor.

I love the saying, 'The future isn't what it used to be', because markets change. And what worked before, or last year, might not work again. You must adapt to change.

With Clearfield, as we got closer to the 15-month mark, I trimmed the position down to 1%. Then there was an analyst conference call, and I recall telling Edison that if the stock does not react well, we needed to cut it back and take some chips off the table. That happened, and I exited the stock between \$70 and \$80.

That's interesting. The 15-month rule stopped you from roundtripping and ensured you kept a lot of your gains.

Maybe I could have done better, but the discipline of the 15-month rule meant we made a lot of money. And since exiting the name in February 2023, the stock has dropped more than 40%.

Do you think you could have got the same signal to exit the stock when you did from using the stock chart and doing some technical analysis?

Charting would not have helped me decide to sell when I did. The price did not

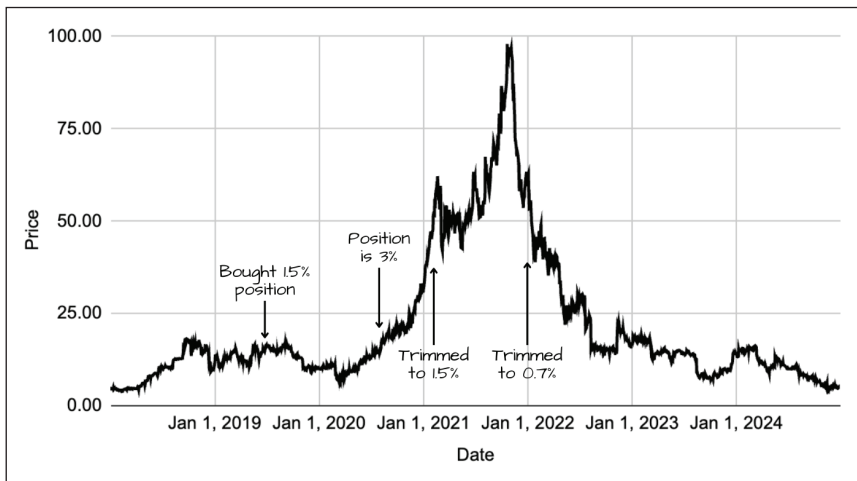


break below the 200-day moving average, which is what most people (including me) look at. It broke the 100-day average, at certain times, but it did that when the stock was still in an uptrend. It never broke the 200-day average through the entire period I held it.

OptimizeRx Corporation – Case Study 2

Figure 9 shows the share price for OptimizeRx from 2018 through 2024.

Figure 9: OptimizeRx share price – Jan 2018 to Dec 2024



Let's discuss OptimizeRx. This is a position that went up 10× before doing a complete round trip. If an investor had bought and held, they would have made no money. I would be seriously depressed if I had invested \$1,000, seen it reach \$10,000, and then plummet back to \$1,000. But this is one where you made a lot of money and avoided getting too beaten up, despite the reversal in the share price.

Yes, it's an interesting one. I held the stock all the way up and all the way down, but because I trimmed and took a lot of profits off the table on the way up, it helped insulate the impact and ensured that we still made money.

So, tell us a bit about the company and what got you excited enough to buy it.

OptimizeRx does digital advertising for drugs. The way the advertising model works is that adverts pop up in the electronic medical records of patients on the doctors' systems. For example, it might say something like, 'this patient



currently uses X but have you tried Y because studies suggest it is more effective or cheaper than the current drug'. This seems like a more attractive approach than the traditional model of pharmaceutical company drug reps trying to convince doctors to use their companies' drugs. And the return on investment is 7 to 8× better than traditional rep performance.

I knew the CEO well – Will Febbo – and it was clear that drug companies were beginning to embrace this approach rather than relying on reps even before Covid. But when Covid hit and reps couldn't just walk into hospitals, OptimizeRx really benefitted.

The concept sounds amazing. I understand your attraction to the company. Let's talk about how you executed the idea. What was the trigger to get you to buy?

I initiated a position when I saw volume pick up and the stock break through both \$10 a share and its 200-day moving average. Investors were getting excited about the stock.

How did you manage the ride? From the price chart, it seems the stock went up 8× over the following year with no meaningful pullback.

It got off to a good start. There were positive earnings surprises and even as soon as July 2020, it had gapped up to over \$20. I'd been in it for a few months and we already doubled our money.

When the stock got to over \$30 the price looked extended, so I sold some stock and took some profits.

What was your analyst saying at the time?

Our analyst visited the company and came back saying, "We are onto something – it could easily top \$50 a share." I had just trimmed the position and now he was telling me he thought it could double from there, so I should not sell the rest.

Sure enough, the stock ran up to \$60 before pulling back to \$50. At that point, we had made 5× on our initial investment and figured the second leg had done its move, so I sold half of the remaining position.

But kept some chips on the table?

Guess what? The stock continued to go higher – it went to over \$90. At that point, we were past the 15-month mark, so I took profits but left a small position on the table. The reason being that the CEO had changed his compensation package



from restricted stock to options that vested at \$130, \$160 and \$180. This suggested that he believed the stock was undervalued and might double.

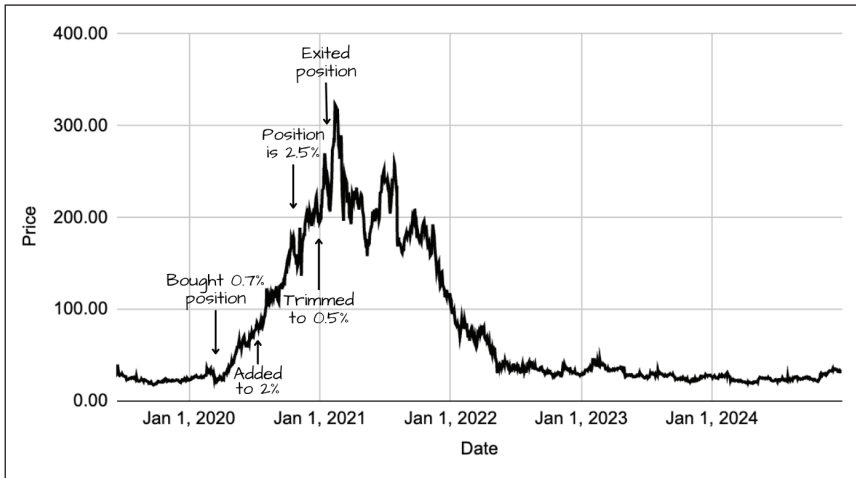
But that did not happen – and now the stock is at \$7.

If Josh had adopted a buy and hold approach he would have lost money. And yet OptimizeRx was a big winner for him because of how he executed the idea. This highlights the critical role of effective execution.

Fiverr International – Case Study 3

Figure 10 shows the share price for Fiverr International from 2019 through 2024.

Figure 10: Fiverr International share price – Jan 2019 to Dec 2024



Let’s talk about your success in trading Fiverr. It’s been one of your biggest winners. What does Fiverr do?

Fiverr operates a marketplace for freelancers. They benefitted during Covid because employers were realising they could hire people far away from the physical location of the business and people who were working from home could now do a bit of freelance work on the side of their regular jobs.



OK. Walk me through how you executed the position. From what I can see, you entered the stock in early 2020 and exited around a year later having made 5x. Not bad!

Shortly after Covid hit, we waited for the stock's first positive earnings surprise. When that happened, the stock went above \$20 and I started to build the position. I added as it traded up through the twenties and into the thirty-dollar range. Our average price paid would be in the mid-\$30s.

Seven months later, the earnings surprises continued and the stock climbed to \$61. By the 12-month mark, it was trading at \$230. The price had gone up nearly 10x and I'd only held it a year!

Wow, that's incredible. You knew you had to press and build the position quickly in the beginning and it really paid off. And I'm even more impressed by the fact you stayed invested. I would imagine most people would have sold after doubling their money. Hell, most people would have likely sold after having made a quick 20% or 40% given the Covid backdrop. So, the obvious question is, what got you to sell when you had made 10x? Why not keep riding the winner?

In a nutshell, the 15-month rule. The stock got up to a high of around \$300 and then it fell back to \$240. We were approaching the 15-month mark, so I spoke to the analyst. I was wrestling with whether this stock was purely benefitting from a pull-forward effect from Covid or whether things would persist. I concluded it was purely a pull-forward. So, reflecting on the fact we had made nearly 10x in a year and it was approaching the 15-month mark, I sold.

Looking at the share price, it continued to fall. Are you tempted to get long again?

I am considering getting long again. Short sellers represent 19% of the free float, and I would suggest it is a stale short. The stock price is basing and the longer the base, the higher the potential breakout. This quarter, they did not surprise on revenue, but the stock behaved a lot better. If they surprised now, the stock could attract some interest on the long side again, so we are watching it closely.

GENERAL POINTS ON HANDLING WINNERS

My conversations with Josh revealed some general points about how he handles winners that I include here as a catch-all to supplement and enhance the specific case studies we went through, and to give a more comprehensive account of how he thinks about executing ideas when they are going his way.



I hear that when you find yourself in a winning idea, you like to step on the gas. Tell us about that.

When I am winning, I add to the position. Stanley Druckenmiller once said something like, “When you are up 10%, take more risk. And when you’re up 15%, take more risk.” I agree. Your current P&L in a stock matters in determining how you execute.

We did a study that showed that if a stock has a second positive earnings surprise and the share price reacts positively, then we should step on the gas and make the position a bigger part of the portfolio.

From a theoretical point of view, this also makes sense because more sell-side analysts will pick up coverage of the stock at that point. You can see this because volume picks up post earnings, indicating that more people are paying attention.

Knowing I will do this is why I keep my five largest positions below 25% of the portfolio, collectively. It gives me room to add to winning positions outside of the top five and really make them count.

The possibility of mean reversion means I don’t take outsized risks when winning. I don’t want to be caught too long, too big in size, at the wrong time. Just because a stock has risen sharply, for instance, from \$20 to \$60, then to \$80 before retreating to \$60, doesn’t mean \$60 is a bottom. Don’t believe it can’t go lower – it can!

How important is the 15-month rule when you’re winning? Does it really matter if you let a winner run another month or two?

Yes, it does. In fact, the 15-month rule was reinforced in early 2022 when I was letting our winners run and several continued for over 16 months. What happened? They had bad drawdowns. I should have cut the names early and recycled the profits. It reminded me to always re-underwrite every name in the portfolio as it approaches the 15-month mark, instead of just riding it and thinking it has the legs for another year or two.

I’ve learned that very few companies become the next Amazon or Google. They have their day in the sun and part of my job is to get as much flesh out of them while I can. I think that is something I am good at. That being said, selling a stock when it is winning and we have spent thousands of hours of work on it, is very difficult to do.



It seems like many of the ideas you buy have a limited shelf life during which you have to make as much money as possible.

Whatever the case may be, the initial story that got you to buy into the stock and that has been working does not necessarily work as well in the second year.

You have to be careful of a winner that bleeds performance, because you don't even realise it – that is alpha decay. If you are up \$15m and the price bleeds away, before you know it, you could end up exiting with only a \$3m profit. Is that a \$3m gain or a \$12m loss? Avoiding this is something I work very hard at.

What do you do in situations where the stock spikes up and massively outperforms the benchmark over a short period?

If the price looks extended, say 100% above its 200-day moving average, I will sell some of the position and take down risk because sentiment has become too excited and often it pulls back.

Selling some shares on the way up is key to protect you from the potential round trip, when it unwinds. You have to avoid round-tripping winners. In my mind, good investors know when to buy, but great investors know when to sell.

Do you think there is any informational value or signal in multiple expansion that is helpful to selling?

My experience is that price often leads fundamentals. So, if a stock sees its multiple contract, say going from 15× earnings to 13× earnings during a period where earnings are still positively surprising, I would get out. Not always, but most of the time. I always speak to the analyst first before taking action. If I decide to stick with a stock, it is because we see that we will benefit from the next leg up in earnings.

If valuations are OK, the target price is way above the current price, and the markets are not reacting poorly, then I would likely continue to hold the stock.

Given you operate in small cap companies, how much of a signal is it when a CEO or key member of the management team resigns?

It can be an incredibly important signal. Take CarParts.com, for example. The CEO resigned and the stock has fallen a lot since then. The stock price was telling you something.



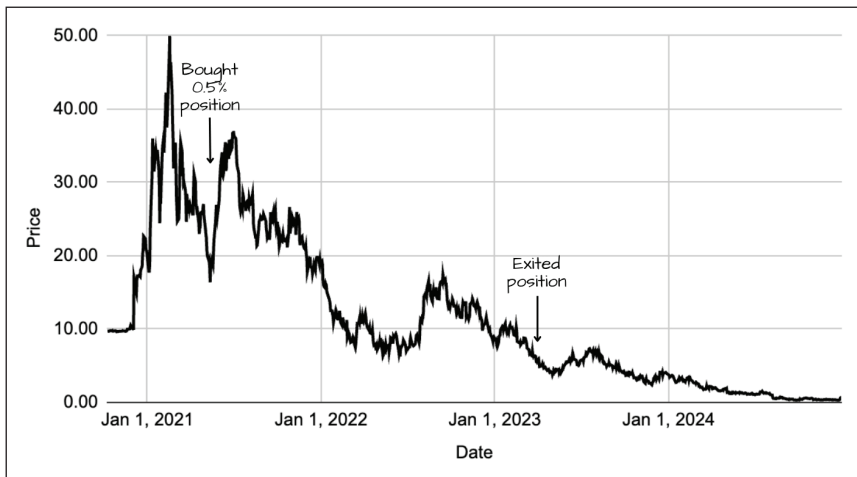
LOSING - WHAT DOES JOSH DO?

In this section, we shift our focus to how Josh reacts when he finds an idea he has invested in isn't working and he is losing money. Let's start with a real-life example: **Stem Inc.**

Stem Inc - Case Study 4

Figure 11 shows the share price for Stem Inc, from 2021 through 2024.

Figure 11: Stem Inc. share price - Jan 2021 to Dec 2024



I want to talk about Stem Inc. because to me there are so many lessons from this in how to manage a big loser. It nicely shows the importance of your rule of not losing over 1% of the capital of the fund on any one idea. So, what was the story here?

Stem is a company that went public via a SPAC in 2020. The CEO, John Carrington, was highly regarded, having been recruited from General Electric.

The company helps store electricity during times when there is less usage, allowing it to be used later, when peak demand kicks in.

Why did you decide to buy the stock when you did?

When the stock went public, it spiked from \$15 to \$42. We did not buy in the IPO



because we were still doing the work on it. The stock then fell back to \$20 and we initiated a position in 2021 at around \$21.

Then what happened?

For the first year, the price did little. Then it started drifting down. About 15 months in, it was back at the IPO price. The analyst's view was that the earnings were still good, and the thesis was still intact.

This was before we started working with Essentia Analytics, so we didn't yet have our 15-month rule – if we had, I would have gotten out at that point and saved a lot of pain. Instead, we added to the position. But it just continued to slide. Two years into the position's life, it hit our 1% of capital limit. And that was it – I got out.

What happened after you sold?

I exited around \$7. Today it is trading at 41 cents. So even though I was crystallising a loss, selling when we did prevented us from holding it all the way down.

Wow. The stock fell another 98% after you sold. Your rule of limiting losses to 1% of the fund's value helped you dodge a bullet. Well done.

GENERAL POINTS ON HANDLING LOSERS

My conversations with Josh revealed some general points regarding his approach to executing ideas that are going against him. I've included these to expand upon the case study, offering a more thorough understanding of his approach when facing losses.

When you find your idea is losing money, do you add to the position?

I never add to losers – I never double down. It's terrible to do that. As Paul Tudor Jones once said, "losers add to losers".

One benefit of selling out of a loser, as opposed to adding to it, is it frees up the analyst's mind – and mine – to focus on other ideas. The disproportionate amount of brain capacity a loser takes up when it is just one line item out of many means it is just not worth it. That is what I have learned after 15 years of doing this: cut the loss and start with a fresh face. That's the real benefit of cutting your losses; you're saving yourself a lot of mental anguish.



How is your approach to dealing with losing ideas influenced by the fact that you're investing in small caps?

Unlike large caps, where a 2% move in a day is big, small cap stocks regularly move a lot in a day and gap up or down. The way you deal with the volatility if things are going against you is through position sizing and portfolio management. I actually enjoy the volatility and thrive on it. It does not scare me.

But that being said, in small caps you have to manage downside risk. You have to know if a company is a one-trick pony and how important the CEO or CFO is, because these are things that can affect a small cap share price.

In fact, I am very wary of companies that switch the CFO. This not only results in their books being audited and their filings being delayed, but it also makes investors nervous and less likely to be buyers.

In the small cap arena, meetings with management can be very important for helping to decide what to do. I've done over 18,000 meetings and you develop a sense of when to worry if a CEO acts a certain way.

What about debt? Some investors say you should never mix operating leverage and financial leverage - I guess in the small cap arena, the impact could be material when things go wrong?

I rarely own stocks that are heavily indebted, for exactly that reason. But monitoring the debt of a company and how it is trading can give signals as to what the bond guys think of the stock in terms of risk. It's another data point and another set of eyes.

Are there other signals you pay attention to that influence whether you sell?

I place a lot of importance on the best idea in the fund. If your number one holding is not doing well, it suggests something is out of sync. I want to see that position acting like the captain of a ship ensuring a steady ride, doing well on down days and outperforming on up days. This is something else I learned from Phil Hempleman: if your best idea is performing, you gain confidence that you can drive performance through the rest of the portfolio.

KEY TAKEAWAYS

General takeaways

- A variant perception versus the market is essential to picking stocks that can win big. Josh focuses on small caps because they are less well-covered by the sell-side and therefore offer more opportunities for variant perception.
- Earnings surprises have significant informational value. Josh waits for the first earnings surprise before allocating capital to an idea. He adds more capital to an idea that keeps surprising.
- In small caps, he keeps a close eye on management changes – especially CFO exits – as they often precede trouble.
- Liquidity matters, especially in small caps. Josh avoids ‘cockroach motels’ – stocks where you can check in but can’t get out, by limiting positions to a maximum of five days of trading volume.
- Position sizing should accommodate adding to winners while avoiding excessively large, high-risk bets. Josh’s top five positions represent no more than 25% of the fund’s total assets.
- Analysing price and volume data through technical analysis provides Josh with useful signals to determine optimal entry and exit strategies.
- Your best idea’s performance is a key signal. If his top stock pick isn’t performing, it’s a red flag. If it is working, it is a sign to be more confident in allocating to and running winners.

I’m winning – key takeaways

- Josh agrees with Stanley Druckenmiller that when you’re winning, step on the gas and take more risk.
- Alpha decay analysis from Essentia Analytics led to Josh’s 15-month rule – it has helped him make good exit decisions. It makes sense to him, as he has often found that the story that drove a stock in the first year loses steam in the second year.
- Taking small profits on the way up, e.g., when the stock price is 100% above its 200-day moving average, can result in making good money even in a stock that round-trips.
- Josh keeps an eye on the technicals. A significant price decline coupled with heavy trading volume often leads fundamentals and can signal it is time to get out.

I'm losing – key takeaways

- Never add to a loser. Josh agrees with Paul Tudor Jones' advice that “losers add to losers”.
- He uses a strict 1% capital loss rule: if a position loses 1% of the fund's capital, Josh exits.
- If a company misses earnings, Josh gets out – even if the share price reacts positively.
- Exiting a loser has hidden benefits, such as freeing up brainpower to focus on other ideas.