

Quality as a Tail Risk Hedge

Given the economic and market events of the past 2-3 years and the potential for unforeseen future disasters, the latest trend (understandably) is fiduciaries looking for, and money managers providing “tail risk event” protection. Tail risk or Black Swan events are catastrophic events or extreme downturns in the market that are not detected or predicted by Wall Street’s financial models. 9/11 or the Lehman bankruptcy in September 2008 are examples of tail risk events that had catastrophic consequences for the financial markets.

The average investor has had two very real lessons in risk this past decade, courtesy of the investment school of hard knocks.

	1/12/00 - 10/9/02	10/9/07 - 3/9/09
Dow Jones Industrial Average	-37%	-54%

Consequently, investors and fiduciaries are searching for “hedging” strategies using options and credit derivatives along with a variety of exotic hybrid strategies to protect against cataclysmic market corrections.

Unfortunately, these strategies are complicated, require careful implementation and execution, are expensive, and frequently limit the investor’s access to liquidity. Given the infrequency of Black Swan events, it is difficult to know when a fiduciary will see the expected “protection” or returns these strategies promise and makes defending the high fees difficult at best.

Hedging strategies are almost always hard to explain and even more difficult to understand. Given the disastrous results of the credit default swaps and asset backed derivatives in the demise of Lehman (a Black Swan event), there’s one lesson pension managers and institutional investors should have learned: “If most people can’t understand it, we probably shouldn’t be investing in it.”

An Alternative to Alternatives

Here is a simple, old fashioned idea that is easy to understand and cost effective to implement: **choose quality stocks that inherently build-in downside protection.**

Buy companies that do not need to borrow money to leverage their business model, whose leadership does not manage earnings for Wall Street quarter-to-quarter and whose stocks are already trading at a discount. To invest in a company with a high level of conviction one must conduct deep due diligence on the company, its leadership, its business model, and its balance sheet. Good ol’ Graham & Dodd value investing is not sexy but when high flying story stocks, with little to no earnings, drop due to a sharp correction, or worse a “Black Swan” event, the “simple” strategy sometimes proves to be the better strategy. The downside to this approach? It takes a lot of hard manual work to conduct the necessary “forensic accounting” analysis to find quality companies. The concept is simple, but the execution is not easy.

At Morgan Dempsey Capital Management, Brian Rafn, the Portfolio Manager for our Small/Micro-Cap Value Strategy, believes there are four primary characteristics to stock selection that intrinsically provide protection against tail risk & Black Swan events.

Discount To Computed Intrinsic Value

We buy companies at a discount to our computed intrinsic value. Consequently, when the market corrects or crashes, our companies are already on sale and tend to not have as far to fall. We measure the leveraged buyout private market value, relative historic value and a discounted free cash flow value in an attempt to find companies selling at a 30%-70% discount to our computed valuations. The old adage that value investors are running into a burning building when everyone else is running out is true. Not only do value stocks typically not have as far to fall in a crash, but corrections and panic events can be opportunities to buy.

Fortress Balance Sheets

In a correction there is often a “flight to quality” factor that tends to provide a cushion for these companies. When credit dried up in 2008 and 2009, it was usually only an issue with our company’s customers not with their own credit needs. Typically our companies avoid debt like the plague. We look for companies that have little to no debt, tangible assets, cash reserves, and who do not have excess goodwill on the balance sheet. They have the ability to generate free cash flow and often are self funding. Companies that exhibit quality core earnings and excess free cash flow serve as a valuable hedge against unwanted volatility.

Founder-Owner-Operator

One of the first characteristics consultants look for when conducting due diligence on hedge funds and private equity is determining manager ownership and investment in the strategies they manage. The basic logic is they want to find managers that “eat their own cooking.” We also believe this factor is important to the due diligence process when choosing securities to own. We look for companies with a leadership team who has a vested interest in the long term survival and prosperity of their firm. These are people who manage their firms for the long term, not quarter to quarter trying to maximize earnings for the benefit of Wall Street or their own compensation plans.

Long Duration, Buy and Hold

The majority of our sell discipline is built into our buy discipline. We may only add 2-3 new positions per year, so we’re very careful about what we buy. When we do buy a new security, we scale in, taking a partial position and slowly building to a larger position as we deepen our knowledge and understanding of the company over time. We plan on holding our companies for a full market cycle which we view as 5-7 years; our average holding period is in excess of 6-7 years.

Hedging With Stock Selections

While it is nearly impossible to predict certain types of Black Swan events, one can prepare for certain scenarios by holding companies that hedge against possible calamities. For example, in the event of another terrorist attack or a natural disaster Morgan

Dempsey has positions in companies that provide equipment and materials to first responders such as Lakeland Industries Inc., Cubic Corporation, FLIR Systems Inc. and Mine Safety Appliances Company Inc. These firms already meet our quality screens and have flourishing businesses in a normal economic environment but have the added advantage of providing additional protection to our portfolio should a crisis occur.

What were the results of our unique approach in 2008 and 2009? In 2008, this strategy lost a mere -13.99% net of fees while fully invested with only a 1% cash position. This decline was less than half that of our benchmark the Russell 2000 Value index. In 2009, this strategy gained +20.44% net of fees almost matching the Russell 2000 Value which was up +20.57%. From 2003-2007 this strategy posted 5 straight years of double digit positive returns. As of June 30th, 2010 the strategy has a 5-year net annualized Alpha of 8.21% with a 0.77 Beta vs. the Russell 2000 Value.

We’re not in the business of “Tail-Risk Hedging” and we certainly are not saying an institutional investor should not consider such strategies; obviously there is a demand and a market for the new products. Nor are we guaranteeing that our approach will mitigate any unforeseen disaster. What we would argue is that fiduciaries should find managers who will put in the “stubby pencil” work, who know how to invest in solid American companies with “fortress balance sheets” and excess free cash flow, and who know a good deal when they see one. Ours is a low cost, easily understood and explained strategy that has a place in many portfolios. When the proverbial “Black Swan” hits the fan, this strategy, like the companies which underlie it, have a better chance of outperforming their peers.

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Morgan Dempsey Capital Management Investment Performance Disclosures



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and description of firm composites is available upon request. 7. Total firm assets represent total discretionary assets managed by MDCM. The number of portfolios in the composite is as of year end. The quarterly standard deviation is calculated as the average dispersion from the mean return of all accounts included in the Composite for the quarter. The annual standard deviation is the calculated average dispersion of accounts in the Composite for the full year. Note 1:n/a (<5 portfolios). During 2002 and the first quarter of 2003 results relate to one account and the account used was not the same from year to year. 8. The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss. Returns reflect the reinvestment of dividends and other earnings. 9. Gross performance result calculations include the deduction of securities transaction charges but not investment advisory fees. The results include the reinvestment of all dividends and other income. Actual portfolio returns are reduced by the amount of such fees. Over time, the deduction of fees reduce the value of a portfolio on a compounded basis. 10. Net performance result calculations include the deduction of securities transaction charges and investment advisory fees. The results include the reinvestment of all dividends and other income. 11. Historical net performance numbers are calculated using the highest management fee charged by MDCM. (1.00%). 12. Fees: Standard management fees for the composite are as follows: first \$10,000,000=1.00% MDCM will negotiate fees for a structured small account program. MDCM will negotiate fees for accounts of substantial size. 13. Percentage of composite represented by non-fee paying accounts = 0.00%. 14. One-on-One Presentation: This report is used exclusively for one-on-one presentations to qualified individuals, pension funds, universities and other institutions. 15. The information herein is for informational use only. Under no circumstances does this information represent a recommendation to buy or

Year	# of Portfolios	Composite Assets	Firm Assets	Composite Dispersion	Composite Gross of Fees	Composite Net of Fees	Benchmark Performance
2003	1	363,200	137,315,376	0.00%	32.87%	31.68%	46.03%
2004	3	2,225,425	72,707,427	0.00%	23.82%	22.59%	22.25%
2005	6	3,140,055	68,492,815	0.95%	16.60%	15.47%	4.71%
2006	7	3,904,553	190,286,996	0.20%	19.74%	18.57%	23.48%
2007	8	4,556,445	186,950,509	0.43%	11.94%	10.83%	-9.78%
2008	10	4,642,480	145,295,212	2.37%	-13.11%	-13.99%	-28.93%
2009	12	6,547,423	172,535,243	0.84%	21.64%	20.44%	20.57%
6/30/2010	14	12,649,284	173,420,751	0.11%	0.30%	-0.20%	-1.63%

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