8/25/2021

"If you don't know who you are, this is an expensive place to find out." – Adam Smith[1], The Money Game

Usually, a quarterly investment letter describes actions and events that took place during the previous quarter (in this case, the 2nd quarter). But I want to discuss an event that took place earlier this month. One of the positions in my portfolio was AudioEye (AEYE), a software company that made websites more accessible for those with hearing and visual impairments. As an investor this was not the type of company that helps you sleep well at night. The company was not profitable, had an interim CEO, and it was rebuilding the product team. Despite these risks, the growth potential for this company was tremendous. In my original report on the company, I said in the first paragraph

"This is very much a speculative bet. My investment in this stock is based on a potential growing trend, significant ownership by management (although not an operator and not a permanent solution, more on that below), and significant revenue growth along with increasing margins."

I finished the report summarizing the bet I was making

"This is a speculative bet. If the company faulters in its execution, the market decides it doesn't need its service, it can't increase operating margins and become cash flow positive, or the world figures out another way to address internet accessibility, I will have lost this bet. But the upside is very big, and I am willing to take the bet given the risk/reward."

Unfortunately, I lost the bet. The company's growth began to slow, shareholders were being significantly diluted as the company issued stock to finance its operations and pay its sales team, and the company struggled converting free users to paid users. I took a 50% loss when I sold this stock earlier this month.

Losing money is never an enjoyable experience, but it is key to learning and becoming a better investor. Losing money has helped me understand what companies I want to stay away from. Because of the vast number of companies that I could potentially invest in, I need to have a significant number of negative filters that allow me to quickly say "no" to potential investments very quickly. This allows me to move on so I can spend my time researching companies that have a strong probability of generating attractive investment returns.

I will not bore you with the list of new filters in my investment process, but I do want to point out one. AEYE's risk/reward proposition was very attractive given the potential upside, but the risk was the company fails and losses significant value. This leads to Lesson 1: **I am not an investor that is willing to make investments where permanent loss of capital is a reasonable outcome.** A permanent loss of capital is a loss so great; an investor is unlikely to ever recoup his original capital in the investment. A venture capitalist is willing to make investments where a permanent loss of capital is a reasonable outcome because most start-ups fail and the venture capitalist only needs one or two companies to succeed to have her portfolio generate attractive returns. But as an investor in the public market, even in microcap stocks, I am not willing to make the same type of investment, even if the upside potential is enormous.

[1] This is not The Wealth of Nations Adam Smith, rather it is the pseudonym for the writer. The Money Game is an account of Wall Street in the 1960s, an era of the stock market not dissimilar from the current market. It describes the participants of the market and the motivation for their actions. It is a fascinating study on human psychology. If you want to understand what is going on in the market today, this book is a good place to start.

Art not Science

When I first started investing, the process of investing felt very akin to science. The formulas used to value a company, reading the numbers of financial statements, and the discussions of the quantitative factors of a company provided measurable certainty in the process and understanding of a company. But the more I have learned the more I understand that the conviction provided by numbers and formulas provide nothing more than a false sense of security. Yes, we can measure the profits generated by a company and the value of a company should be the value of the company's future cash flows discounted back to present value, but no one is capable of accurately predicting what the actual profits of Apple will be in five years or at what rate to discount those future profits. But in science, accurate predictions of the future are possible. In 2015, the New Horizons spacecraft passed Pluto after it was launched from Earth in 2006. According to NASA, the trip of the spacecraft took **one minute** less than predicted. To achieve that type of accuracy in measuring a journey on Earth would mean being able to predict the duration of a trip from New York to Boston within four millionths of a second. I don't think anyone is confident enough to subscribe 99.99998% accuracy to their prediction for Apple's profits in 2026.

Businesses are run by humans, and increasingly humans are creating the products being sold, not machines. The quality of a piece of software is not a reflection of the computers it was built on, but rather the quality of the humans that wrote the code. Humans are emotional, flawed, and riddled with inconsistencies in their actions and behavior. The late Nobel Prize physicist Richard Feynman once said that physics would be a lot harder if electrons had feelings. The game of investing is not won by the best scientists (unless your name is Jim Simmons[2]). Rather it is won by those who understand that precise and accurate predictions are unattainable over the long-term and instead focus on the qualitative aspects of a business.

Performance

Since I started investing on 7/27/2020, I have generated an overall return of 14.29%.

Destination: Unknown

I stated in my first letter that I had no idea what these letters would lead to, if anything. I don't have a specific goal I am trying to achieve other than writing four letters every year and sending them to willing and unwilling readers. This is still true today. Some of you have been very kind and not only read these letters, but asked me to invest some of their own money. I am honored that you all trust me to manage some of your hard-earned money. But I am not ready to take on that responsibility, at least right now. "Trust the process" is one of my favorite phrases but in order to trust the process, you have to first build a process. I am still in building mode. And while a process is never fully completed (adapting to a changing world is key to long-term success), my process is not yet at a place where I can trust it. While investing in small & micro-cap companies is something I love, I am also exploring the possibility of another path I can take with my skill set that delivers greater value for more people.

Thank you for taking time to read this letter and if I have wasted your time, below is some humor to make up for doing so.

Sincerely,

Casey Wolf

[2] Jim Simmons is a mathematician and former code breaker for the NSA who started a hedged fund and generated an average annual return of 39.1% per year between 1988 and 2018 using computer-based models to predict price changes in financial instruments. He is arguably the greatest investor of all time.

"O.K., all set up—you want to eat the sandwiches and then maybe start packing up?"