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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in North American & U.K. Small-Cap Technology

CONOR MCCARTHY, Managing Director of Techinvest Ltd. and Lead Fund Manager for the MFM Techinvest fund, has been Founder and Editor since 1984 of the *Techinvest* investment newsletter. Before devoting himself full-time to Techinvest in 1993, Mr. McCarthy spent 30 years working in the telecom industry for multinational companies in the U.K., Canada and Ireland. Between 1982 and 1993 he led the project management function on major AT&T telecommunications projects for a number of countries, including Ireland, Kenya and Germany.

SECTOR — INVESTING IN TECHNOLOGY

TWST: Would you introduce us to Techinvest and the MFM Techinvest Technology Fund?

Mr. McCarthy: First, I should say that MFM stands for Marlborough Fund Managers, the U.K. legal owners of the fund. This is a structure that is widely used in the U.K. and Ireland by small fund managers, as well as some of the larger ones who don't want to get involved in the daily administrative detail, such as handling client money and general back-office services. This allows them to devote their energies to making and implementing the investment decisions for their fund. The rules of the FSA regulatory authority in the U.K. lay down that the letters "MFM" must form the prefix to the official name for the fund. MFM therefore carry out the weekly valuation of the fund and are also the official point of contact for investors in the fund. However, all the dealings with brokers and all the analysis of stocks, etc., is carried out by the fund manager whose official title is Investment Adviser. But the essence of the fund is about the entity which is making and implementing the investment decisions, i.e., in this case Techinvest Ltd.

TWST: Tell me about the fund itself and your company.

Mr. McCarthy: Techinvest Ltd. was formed originally in 1984 as a part-time operation. At that time, I was an Ireland-based Telecommunications Engineer with the international arm of AT&T, which had recently acquired a small Irish telecommunications manufacturer with considerable experience of international markets. Prior to returning to Ireland, I had spent 10 years in England and Canada, also with manufacturers of telecommunications equipment. So although I started the newsletter as a part-time activity in late 1984, I only went full-time in early 1994, when the tech sector outlook had improved considerably from one of its periodic downturns and the number of subscriptions to the newsletter had picked up to a level that made sense to go full-time.

One of the early things we started up in the newsletter was what we called the "Trader Portfolio." Now, we've had four versions of the "Trader Portfolio" through the years, but essentially it was a hypothetical portfolio, utilizing the newsletter's "buy" recommendations. Over the years the overall performance of that portfolio — albeit it had its ups and downs along the way — was looking very good, especially by the 1992-1993 period. As a result of that, particularly in the second half of the 1990s, some of our newsletter subscribers would say to us, "Why don't you start up a real fund for investors?" However, we didn't want to take on all the hassle and regulatory bother of a stand-alone fund management operation, but then we came across this outsourced model. We waited until we thought the worst of the bear market after the Internet boom/bust in early 2000 had run its course before we launched the fund. Now, the technicalities of launching took a lot longer than we expected, so it was May 2003 before the fund was actually formally open and available to investors. The fund is both ungeared and long-only and is aimed at the retail investor.

TWST: Tell me about the investment philosophy of the fund and how you manage it.

Mr. McCarthy: It's the same as we always had in the newsletter. The focus is on smaller-cap stocks for two reasons. Number one, the large caps tend to be fairly widely followed and therefore, it's a little bit difficult to get a competitive edge there if you are essentially just covering the same stocks as everybody else. So we have always focused on the smaller companies in the sector, and that's where we have made our name. We also always firmly believed that investing in the stock market is a long-term activity. Typically, we tend to hold a stock for a couple of years or more — the average holding period is about 30 months, which is probably a little longer than many funds in the tech sector.

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The newsletter, by the way, has always only covered stocks on the London and Dublin markets. It makes no effort to give any regular coverage to North American stocks. However, starting in 1994, in the January issue of *Techinvest* each year, we always give six North American tips for the following 12 months. It's a very common thing in the investment media on this side of the Atlantic to give tips at the start of a year for the year ahead. We had been doing that for some years for the London market and when we started doing it for the North American market in 1994, our focus there was also on smaller stocks. In the December issue of each year, we then give an analysis of how those picks have done over the previous 11 months, their performance for the year. Over the 20 years we have been doing the London tips, the average gain 11 months later has been 45%. For our North American tips, the average gain of the six January tips since 1994 has been 42.9%. Obviously there are huge annual variations within that. For instance, in 2002 the average loss for the North Americans was 28.7% whereas in 2009, their average gain was 158%. The second reason we focus on smaller stocks — it means a lot of hard work admittedly — is that over the long term you can outperform funds or newsletters that are focused almost entirely on large-cap stocks.

Highlights

Conor McCarthy discusses his MFM Techinvest technology fund, which grew out of a newsletter he started in the 1980s. The fund, which invests in small-cap tech stocks on both sides of the Atlantic, has posted remarkable returns over the past several years. Mr. McCarthy discusses how the fund is put together, the tech sector and a few of his favorite names, including a couple of under-the-radar picks from the U.K.

Companies include: Research In Motion (RIMM); Apple Inc. (AAPL); Texas Instruments (TXN); Fairchild Semiconductor International (FCS); Sandvine Corp. (SVC.TO); Bridgewater Systems Corp. (BWC.TO); Cisco Systems (CSCO); Blinkx plc (BLNX.L) and Autonomy Corporation plc (AU.L).

TWST: Tell me a little about the fund's performance.

Mr. McCarthy: The performance in the past few years has been very good. The fund started off, as most of the U.K. funds do, at 100 pence, and the price last Wednesday, which is our weekly valuation day, was 235.3 pence. Over the first few years it had a rather up and down history. Like an awful lot of other funds that suffered badly in 2008, ours fell in that year by 37.8%, ending 2008 at 88.97 pence. So at the end of 2008, it was actually down 11% from its starting price on the 19th of May 2003.

The North American content in the fund in the earlier years was typically around 25% or less, and we were primarily in London stocks. We started to increase this during 2008, and as a result our performance has significantly improved. The fund is now 62% invested in North America, that is 44% to 45% U.S. and around 17% in Canada. We find value in Canada can often be a little bit better; also you don't get quite the same wild price swings in Canada, particularly in the immediate aftermath of results, that you often get in the U.S. The remaining approximately 37% is in London.

In 2009 the fund was up 68.45%. In 2010 it was up 43.21% and year-to-date as of last Wednesday, it was up a further 9.51%.

TWST: In 2010 the U.K. Investment Management Association ranked it number one among technology and telecom funds.

Mr. McCarthy: It was number one also in 2009, and of last Wednesday's valuation, we were also number one year-to-date. Since the end of 2008, we have constantly been number one. Having said that, it's only fair to point out that when we started out, there were 15 U.K. authorized funds in our sector. That is now down to seven, largely as a result of amalgamations amongst our rivals.

TWST: Tell me about some of the keys to your performance in 2010 and year-to-date, over the last 12 months or so.

Mr. McCarthy: There is probably no one key. The undervaluation in the tech sector at the end of 2008 and then for the first couple of months of — if you recall, the bear market I think really ended in the first week of March — was such that of the six North American tips that we gave in the in the January 2009 issue of the newsletter, three were incredibly trading in the market below the net cash per share on their balance sheet, that is, cash minus any borrowings. That was absolutely astonishing. Valuations like that probably had never been seen before in the tech sector, and certainly were valuations of the type that Messrs. Graham and Dodd had written about back in the 1930s, in the aftermath of the U.S. bear markets of that era. Back then you could buy stocks for their current asset value or less.

We don't have any conversations with North American analysts, but we do, of course, listen in to conference calls. Obviously, you can get huge amounts of material from Bloomberg, but we do our own research and we base it very much on the consensus forecasts — even though sometimes for some of the small companies, there may be only one forecast out there. And obviously you therefore have to be a little bit cautious when using just that one forecast. We look at the p/e ratios, the prospective growth rates for the company. We look at price/sales ratios, and we put a lot of focus in the amounts that a company is spending on R&D. We always work out the per-share expenditure of a company on R&D.

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That is a key valuation element for us, particularly if we're looking at a stock that is in recovery mode or is in the early stages of recovery, and you can't see value in the stock on a pure p/e basis. What we do is we add the earnings per share to the R&D per share to get a single figure, and we divide that into the price and that gives us what we call price-to-growth flow factor. We look at that and we will also divide that with what we think is the company's growth rate going forward. We also look carefully at the net cash per share. Only in exceptional circumstances will we buy a stock that actually doesn't have positive net cash on its balance sheet; the more that's there, the better. We find that gives a very big comfort and safety factor, particularly as we tend to be on the lookout for stocks that are beaten down or have lost favor, ideally only temporarily.

So we had a number of very successful picks throughout 2009 coming from that background. By the way, the average gain for those six stocks at the end of 2009 was 158%, and all of them were actually also in the fund. The fund typically holds a large number of stocks. We don't have a concentration really in any one stock. We typically have about 100 holdings in the fund. The largest is about 4%, and that touches on risk. That means that we're not hung out to dry if two or three of the stocks let us down badly. Of course, if two or three do absolutely brilliantly, it means our overall gain isn't quite as large either.

TWST: Do you feel like being spread out across the sector allows you to manage the sector risk, if you will?

Mr. McCarthy: Yes, I think if you've got small-cap stocks, you are quite limited as to how easy you can get in and out of a particular stock by the size of your holding. There is an amazing difference in market liquidity between the London markets and the U.S. or Canada for a stock of equivalent size. I would reckon that the North American markets provide at least 10 times, if not 20 times, the liquidity that you will get in London for a stock of the same size. The difference is quite startling. So it's far, far easier to get in and out of North American small-cap stocks than for stocks of a similar size in London.

TWST: How do you pick the fund's stocks?

Mr. McCarthy: We very much believe in individual stock picking. That is the essence of our approach. We tend to pay a lot of attention to value parameters. We look at a long list of data. I think, obviously, we like to see a stock making a profit, but we wouldn't necessarily exclude one that doesn't. We have a Bloomberg terminal, from which we can get analysts' consensus forecasts. By the way, we don't have contacts with any of the U.S. brokerages other than the trading desk for Merrill Lynch in London. We place all our orders for North American stocks through them and they give us a fantastic service.

We also look at the short interest for a stock and if we find a high level of short interest, even though everything else might look great for that stock, we will most likely forget about it. It's a huge warning sign for us. We believe the shorties are guys who do their homework very thoroughly and only heavily short a stock if they feel pretty confident that it is going to go down. They're not always right, but it's amazing how frequently they are. If the short interest is over 5%, we are concerned and worried, and if it's over 10%, we need an awful lot of convincing to buy that stock. Almost invariably, sooner or later, if there's a high level of short interest, something nasty comes out of the blue which tends to be of an accounting nature.

We also look at the technical picture of the stock. We look at the charts, and what the charts might be trying to say. We don't do that in an overwhelming way, but the larger cap the stock the more valid chart signals can be. For instance, we recently bought — you're probably familiar with the company,

Research In Motion (RIMM), which does the BlackBerrys — it has been somewhat out of favor for some time. We looked at the fundamentals for the company and we could not believe what we were seeing. The stock had a prospective p/e of nine. That's ridiculous, we thought. Makes absolutely no sense for a company that is about to do a great big new product launch in April; and a couple of things we read about it indicated in fact it would get a good, warm reception which could re-accelerate the company's fortunes.

1-Year Daily Chart of Research In Motion

Chart provided by www.BigCharts.com

If you look at its long-term growth record over the past 10 years, it has actually got a better growth record than **Apple** (AAPL). But **Apple** is on a p/e of 15 or 16; **RIMM**, **Research In Motion**, is on one of nine. So we went looking at the charts and collectively, the chart signals at which we were looking seemed to us to be about to turn positive. So we watched them very closely for about 10 days, and then we spotted where we thought this is the point where you buy, and we bought them at $63 approximately two weeks ago. They have since touched $70 and look set to go higher. So we also pay attention to the charting situation, albeit that the weight we attach to it tends to diminish the smaller a stock is.

TWST: Years ago, you said you wanted to show private investors that it's possible to outperform the market by limiting investments to the technology sector. What is it about the sector that made that possible?

Mr. McCarthy: I think there is a long-term history there. Going back many decades, the tech sector has been producing many of the most interesting, exciting growth stories. If you go back at least to the 1950s or even further to 1928, 1929, one of the greatest growth stories back then was **Radio Corporation of America**. Radios were just starting to come into cars and homes, and that was the great tech growth story of the time — although probably nobody viewed it in that exact light. I think in the late 1950s, you had stocks associated with integrated circuits. The integrated circuit was discovered in 1958, and then we had the first semiconductor boom led by the likes of **Texas Instruments** (TXN) and **Fairchild** (FCS). You then had the stocks associated with the advent of the mainframe and with space research, with John Kennedy, in the early 1960s, committing to put a man on the moon before the end of the decade. And I think ever since then, the tech sector has been recognized as the preeminent high-growth sector, albeit with wild swings along the way.

TWST: Would you speak to some of your best ideas, best stories at the moment from within the fund?

Mr. McCarthy: Research In Motion is one, but that's a big one and it's a well-known stock, so we have only taken a 2% position. There's a Canadian company called **Sandvine** (SVC.TO). The two key themes that have been exciting us in recent months, and we think this is going to give several exceptionally great years to the tech sector, is the whole thing of the mobile, the explosion in the whole area of mobiles and data and video. Those three words together. The other is the whole social media thing is coming, although there's very few stocks that give public exposure to that just yet, at least for the stock market investor. There's another Canadian stock as well, **Bridgewater** (BWC.TO); it's in an area directly adjacent to **Sandvine**, but they're both in the business of the facilitation and control of data traffic for mobile network operators.

1-Year Daily Chart of Sandvine Corp.

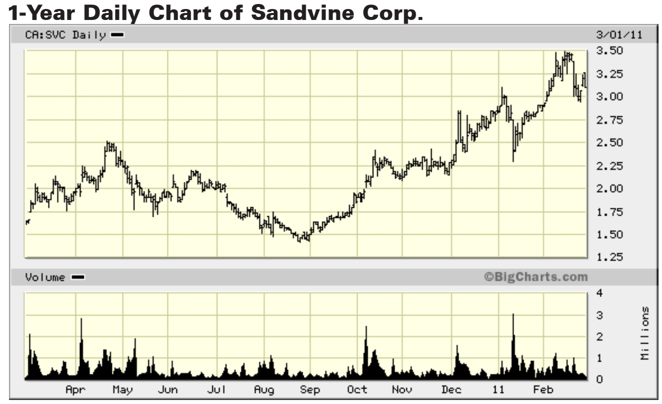

Chart provided by www.BigCharts.com

Sandvine's key technology is called deep-packet inspection, and they're the leading company in that sector with a 28% market share. They have over 200 customers in 80 countries, so they're very much focused on international markets. We like the management behind **Sandvine** because they have previously built up a private company, which they sold to **Cisco** (CSCO) in 2001 for some $400 million. They then used the proceeds to found **Sandvine**, which went public about four years ago. The stock has been up and down a little bit since, because the early hopes were a little bit slow to materialize; however, it's the leading company in what is an absolutely vital sector going forward.

Bridgewater is in a very similar space, but is much more focused on the individual mobile user giving mobile operators the tools to enable them to be flexible in how they might set charge plans for different things. What's really going to be the ballbreaker for all these network operators is the incredible explosion in video stuff. Video occupies so much more bandwidth than does an individual voice signal, and the forecasts for growth in mobile data traffic over the next four years or so are just absolutely enormous. The one that's more slightly cautious is the more recent one; I'm not sure whether its from **Cisco** or from Mary Meeker of **Morgan Stanley** (MS) or whether the two are using the same data source, but the forecast is for up to a 30-fold increase in digital traffic over networks between now and 2014. So that is why we particularly like **Sandvine** and **Bridgewater**. The two of them give you 100% exposure to that particular area.

It had also become cash generative and for us, that was transformational. We immediately doubled our holding in the stock, and it has gone up over five times since. It did most of that in the six months after May, but has done little in recent months. **Blinkx** is a U.K.-registered company, but they report in dollars because they basically operate out of San Francisco; that's where their operational base is. The company is expected to report turnover of $60 million for the year ending this March, and for the following year, expectations are for revenue of at least $100 million. Current market cap is about $450 million. Admittedly on a forecast earnings basis, the p/e is pretty high, but at least **Blinkx** is now in the situation where it is actually nicely profitable and generating cash.

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1-Year Daily Chart of Blinkx plc

Chart provided by www.BigCharts.com

TWST: Any names on your side of the Atlantic that you'd like to share?

Mr. McCarthy: In fact our largest holding in the fund at the moment is a London stock called **Blinkx** (BLNX.L), and that is in video search. As far as we can tell, it's the number one company in that sector. Have you heard of a London stock called **Autonomy** (AU.L)? It's the biggest software company in London, and it does extensive business also in the U.S. It's a specialist in what they call the "management of unstructured data," a much more complex form of data than that derived from financial figures. It's into words and text and that sort of thing. **Blinkx** was started off within **Autonomy**, and they spun it out three years ago on the London market at a very early stage of the company's existence.

Only in the past nine months or so have the company's shares sprung to life. On the 16th of May, they came out with a transformational set of results, which showed revenue up over 100%, with the company just breaking into profit for the first time.

TWST: What's your outlook for the sector and the fund over the next year?

Mr. McCarthy: I would tend to answer that by first saying that we pay little attention to short-term fluctuations in the market. Our philosophy is that markets go up and markets go down, and we've never heard of anybody who is able to actually predict on a consistent basis whether the market is going to be up or down in three or six months time — we've just never come across anybody. So we tend to pay little to no attention to short-term fluctuations in the market, albeit we seem to have a very good sense of when the markets are getting overheated. We certainly spotted it back in 1987, when we were warning our newsletter subscribers for two months before the October crash to take profits; not to necessarily sell out of everything, but just where they had good profits to sell at least part of their holdings. And again in the internet boom of just over a decade ago, the tech sector just exploded in the last three months of 1999 and into the first quarter of 2000. Again, our advice to subscribers then was to take profits.

But apart from those two periods of excessive optimism, we by and large tend to ignore through the years the shorter-term fluctuations of the stock market. So for the next six to 12 months, who is to know? The markets have gone up for two years now. You could say that having got two good years, there is a good chance that the next year won't be quite as good. But it seems to us that it probably will be. On a three- to four-year basis for the tech sector, we think the outlook is exceptional. I would argue that anybody ought to have significant exposure to the tech sector over the next three to four years, while accepting at the same time that there may well be fluctuations along the way. Hopefully things won't then get as overheated as they did in early 2000. I reckon we're probably at 1996 at the moment and, if you do recall, Wall Street took a 15% dive in the autumn of 1997, and also took a nastier 20% dive in the autumn of 1998. So there will be volatility along the way, but I think that the outlook for the tech sector for the next three years is exceptionally good against the background of what's happening with the mobile sector, combined with data, video and the whole social media phenomenon.

TWST: What are the two or three best reasons for a long-term investor to look closely at your fund?

Mr. McCarthy: We're the only ungeared long-only retail fund that gives over 90% exposure to the small-cap tech sector on both sides of the Atlantic. We're not aware of any other fund out there that does that.

TWST: Thank you. (MJW)

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