THE BULLET POINTS

Small and micro-cap focus

Concentrated (10-15 holdings max)

High quality, simple businesses I can understand

Companies resistant to technological change

Management on my side of the table (significant insider ownership)

Medium to long-term holding period (1-3 years+)

I have no intentions of ever managing a lot of money

INVESTMENT PROCESS: SMALL AND MICRO-CAPS

I first narrow my potential investments down to small and micro-cap companies. Large institutional investors (e.g. mutual funds, hedge funds) ignore these companies because they're too small for the amount of money they manage. Many individual investors avoid small companies because they can be illiquid and volatile. Fewer people watching these stocks allows for more frequent price inefficiencies. Competing with fewer analysts increases my chances of having an informational advantage.

Small companies are also preferred because they're the easiest to analyze. A company that only has 1-2 segments greatly reduces analytical complexity. Fundamental research is easier, partly because I have much greater access to management than I would in larger companies.

INVESTMENT PROCESS: MANAGEMENT INCENTIVES

Within these small companies I only look at ones where management has significant stock ownership. It is human nature to act in one's own interest. If a CEO owns a small amount of stock and is paid a bonus based on revenue growth, he or she is most likely going to grow the company at all costs. On the other hand, a CEO who owns a lot of stock and whose bonus is based on profitability is more aligned with shareholders.

The majority of my net worth is invested in Wiedower Capital and I seek a similar commitment from management teams. Management's stock ownership must be worth multiples of his or her total annual income. This greatly increases the likelihood that they care about the stock price.

I am very strict on shareholder friendly management. Any red flag is an automatic pass—no matter how cheap the stock is. Life is too short to invest in managers that aren't sitting on my side of the table.

PORTFOLIO CONSTRUCTION

Wiedower Capital aims to have around ten holdings at any one time. Having fewer positions to keep track of gives me more time to research other potential investments. Selectivity also creates a high hurdle for portfolio inclusion.

The benefits of diversification (decreased volatility) are subject to the laws of diminishing returns. An average portfolio of ten stocks has a standard deviation of ~24% vs an average portfolio of 1,000 stocks that has a standard deviation of 19.2%.[3] So owning more stocks creates significantly more work, but only decreases the portfolio's standard deviation by a few percentage points. Not worth it in my opinion.

Being both highly concentrated and long-term focused, it's not uncommon that I go months without buying or selling anything. My goal is to find a few great opportunities every year and then stay put.

"If you have a harem of 40 women, you never get to know any of them very well."
– Warren Buffett

STRUCTURAL ADVANTAGE

Small and micro-cap companies have outperformed all other size companies over the stock market's history.[1]

Likewise, companies run by managers that have significant stock ownership outperform those with little or no ownership.[2]

Therefore, my investing universe (small companies run by managers that own a lot of stock) is likely to outperform the broad market just by itself. From there, my job is to find the best investments within that universe.

Concentration has been shown to outperform diversification[3] and focused money managers outperform diversified money managers.[4] Because of this, I invest in only my very best ideas. Diversification leads to investing in less optimal situations and having less time to dedicate to each stock.

SELL DISCIPLINE

Three events cause me to sell a stock:

1. It has appreciated beyond fair value.
2. A new stock is significantly more attractive. Current investments are always understood at a deeper level than potential investments because they have been closely followed since purchase. A new idea must have significantly more upside and/or less downside to make up for that inherent informational difference between current and potential investments.
3. The investment thesis is broken. One of the last items on my investment checklist involves the two or three things an investment hinges on. If any of these items don’t come to fruition, a sell is in order. A deal breaker for all investments is management lying, not doing what they said, and/or taking advantage of shareholders.

A FEW OF MY SUCCESSES

LGI Homes (LGIH) – When Wiedower Capital invested in early 2015, LGI was both the fastest growing and cheapest homebuilder in the country. That shouldn't even be possible, but LGI was also one of the smallest builders ($300 million) and had recently IPOed. Wall Street goes gaga over companies like Twitter IPOing, but many small IPOs like LGI are ignored. The company is still run by its founder (which I love to see) who owns 14% of shares that are worth over 30x his total annual income.

Pro-Dex (PDEX) – This was an example of another situation I like—activist investors that kick out crappy management teams. I like these situations because usually the activists are money managers like myself who have one thing in mind—share price appreciation. That means their interests are aligned with my own. In Pro-Dex's case, the turnaround took a couple years, but in late 2015 they were close to turning the corner and Wiedower Capital invested. Pro-Dex was about to launch several large new products that the market was not giving it credit for, probably because no was paying attention to a $10 million market cap company. Its revenue was on the verge of doubling and the stock price hadn't moved in a year.

A FEW OF MY MISTAKES

Violin Memory (VMEM) – The worst investment I've ever made. Violin sells flash storage arrays that replace hard disk drives. On top of them being a high tech company outside my circle of competence, they were also burning cash like they were going out of business (which they are now on the path to do). I was attracted to them because several of their competitors had been bought out at high valuations and there was some evidence they'd be next. VMEM was responsible for all of my underperformance (and then some) in 2015.

Oil and gas – This is one of the most massive, global, impossible-to-predict, inevitable-to-be-destroyed-by-technology industries there is. If only I admitted that to myself in 2015. At that point I invested in three oil and gas companies after analyzing world supply and demand and thinking a rebound is inevitable. I came to a new realization and sold in 2016. It'll probably rebound in 2017 and make me look stupid, but that doesn't change the fact that renewable energy is eventually going to crush the hydrocarbon industry and I don't like the idea of picking up pennies on a railroad track. The longer this downturn lasts, the greater chance this current downturn and future renewable energy meet in the middle, with no oil rebound between them.

TAKEAWAYS FROM MY MISTAKES

1. Commodity industries suck. I focused on the potential upside if I was right as opposed to the downside if I was wrong. Most of my investment mistakes can be traced back to focusing too much on valuation and not on business quality. And the vast majority of businesses in commodity industries are of low quality.

2. Only invest in what I know. After a hundred hours of research it's easy to trick myself into thinking I understand a company and/or industry better than I do. Realizing this made me think hard about what businesses I understand and what type of things I can and can't predict. For example, while specific technological advances are mostly unpredictable, I'm very confident technology as a whole will continue increasing at an exponential rate.

These takeaways have led to me focusing on simple companies with competitive advantages that should either benefit from, or be resistant to, technological change...

I MADE FIVE CORE INVESTMENTS IN 2016:

Armanino Foods (AMNF) – sells frozen pesto to foodservice clients and benefits from a barrier to entry through the industry's largest redistributor. Only one real competitor.

Fogo de Chao (FOGO) – a Brazilian steakhouse chain that has never closed a store, has industry-best margins, and consistently gets excellent Yelp reviews. Full write-up here.

Interactive Brokers (IBKR) – leading the way as Wall Street becomes more electronic, automated, and efficient. I use their products every day and love them.

Where Food Comes From (WFCF) – third party food verifier benefitting from many regulatory and consumer tailwinds expanding their niche. Full write-up attached here.

Winland Electronics (WELX) – a tiny company that dominates a tiny niche of commercial sensors for temperature, humidity, and water.

All these companies have high returns on capital, a durable competitive position, generate a lot of cash flow, and have high insider ownership.

WHY I LOVE MANAGING MONEY

More than anything else, I love learning. Investing gives me an unlimited runway of knowledge to obtain. There will always be more companies, industries, and countries to learn about. Beyond that, a lot of outside disciplines help me understand the world better and thus indirectly help my investing. In 2016 I read books on psychology, behavioral economics, physics, venture capital, technology, space travel, Eminem's autobiography, and of course a lot of investing books.

One of my biggest goals is to make my initial investors (family and friends) a lot of money. Because of this, I have no desire to scale to a large AUM. The more money I manage, the harder it is to outperform. And that would be disingenuous to those first investors who put the most trust in me. I want to manage enough money to support myself and live a good life—full of traveling—but that's it. I don't have an exact number in mind, but I will close my doors before I get to $100 million under management.

HOW I GOT HERE

Self-taught investor

Former professional poker player. After that I co-founded two companies in the foodservice industry. Investing was always a side passion.

Degree in Entrepreneurship

Other things I enjoy: traveling, boating, backgammon

What I look like (on a good day) →

STRUCTURE, FEES, AND MINIMUM INVESTMENT

Wiedower Capital is a Registered Investment Advisor started in February 2015. Client funds are held in separately managed accounts through Interactive Brokers. All client accounts (including the manager's) are invested in the same investment strategy. This strategy is long only and uses no leverage or margin. Wiedower Capital is solely focused on maximizing the long-term returns of this one portfolio and that's it.

For individuals, fee schedule depends upon net worth. If a client's net worth is over $2 million (excluding primary residence), he or she is considered a qualified client. Qualified clients pay a 1% management fee paid quarterly, plus 20% of net profits on returns over 4% (above the client's high water mark) paid annually. Non-qualified clients pay a flat 2% management fee paid quarterly.

Retirement accounts (e.g. IRAs) are allowed.

Minimum investment is $10,000. There are no restrictions on withdrawals.

CONTACT INFORMATION

Website: wiedowercapital.com

Investing blog: traviswiedower.com. Here I post write-ups on companies that Wiedower Capital is invested in, in addition to more general topics related to investing—psychology, economics, government policy, etc.

Phone: (513) 236-9817

Email: travis@wiedowercapital.com

CRD number: 173610. Visit adviserinfo.sec.gov for regulatory filings.

REFERENCES

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[3] http://www.lazardnet.com/us/docs/sp6/3048/LessIsMore-ACaseForConcentrated_LazardInvestmentFocus.pdf?pagename=Financial+Advisors

[4] http://eprints.lse.ac.uk/24471/1/Best%20ideas(published).pdf

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