



**GAGNON**  
SECURITIES



**Gagnon Securities is a team of brokers and Investment Advisors who manage money for our clients on a discretionary basis. Diverse in business experience and perspective, we take a research-intensive, generalist approach to evaluating companies. Our client portfolios reflect the best opportunities we find, assembled stock by stock and balanced to control risk. Because we aim for capital appreciation, we don't restrict ourselves to sectors or market caps, preferring instead to focus on industries and businesses experiencing significant unrecognized change. As a group, we share a core belief that thoughtful and persistent research coupled with disciplined risk-taking will yield outsized returns over time.**

## **What our clients can expect**

Our clients understand and believe in our investment approach. We share one objective, namely, to grow their capital significantly. Working toward that goal involves risk and requires patience. We invest with a long-term perspective, recognizing that periods of volatility, sometimes extreme, are inevitable in this process. Our method is not for everyone. We make mistakes; at times, so do the companies we invest in. Therefore, our accounts experience large quarterly or even yearly fluctuations. We go to great lengths to ensure that clients understand exactly what we do, and more importantly, that our investment approach fits their needs. Establishing this clarity of purpose from the outset enables us to concentrate more fully on what we do best.

We spend our time studying companies. We meet with managements to better evaluate their businesses, plans for growth and incentives. Companies visit our offices, and we frequently travel to their headquarters and other facilities to further assess their prospects. We augment these visits by talking to employees, suppliers, partners and competitors. We go to trade shows

and conferences, read industry-specific publications and speak to numerous analysts to build an information mosaic around the companies we follow. Our craft is to understand the microeconomics of a business, then synthesize information about competitive, economic and internal factors to determine which issues represent opportunities or potential dangers. Capitalizing on these opportunities and responding quickly to downturns requires intensive focus. Timing can prove crucial. Our clients hire us for this ability and give us the freedom to act on their behalf (without authorizing each decision) by signing a limited power of attorney.

### **Commissions and Fees**

Non-Retirement accounts are charged commissions equal to 2% of the net trade amount of each transaction. Additionally a service fee of no more than \$0.05 per share will be charged to your non-Retirement account for each trade. Retirement accounts are not charged commissions or a service fee. Rather they are charged a flat management fee equal to 2.25% per annum.

## **Our approach**

Broadly defined, our interests lie with smaller companies and special situations. Our investment premise is that the universe of lesser-known companies is largely inefficient. Within this vast pool, there exist varying degrees of valuation and investor neglect — companies dominating unrecognized niches, nimble innovators, emerging franchises, as well as many small troubled companies that will not survive. Our efforts are thus two-fold: determine which companies represent under appreciated value, while isolating flawed businesses and bad companies getting worse.

We believe proprietary research yields a competitive advantage. In the search for opportunities, we closely monitor changes taking place within particular industries, product innovations, economic environments, legislative actions, shifts in demographics and even social attitudes. Often the companies that we find attractive are not widely followed by the investment community. Our work, therefore, must be both pioneering and perceptive, grounded in carefully measured assumptions.

## Teamwork

Teamwork is an important component of our investment method. We pool our expertise and contacts to crosscheck and refine ideas. The intellectual breadth and diversity within our group means the companies we target are examined from many angles and considered under various scenarios. The more imaginative, persistent and vigilant we are as a team, the better our results should be.

## Valuation

We believe proper valuation is the key to superior performance. We are rigorous in applying valuation criteria that determine a fair value for our companies, regardless of sector, industry or the optimism or pessimism of the environment. Conventional wisdom assumes that securities prices at any moment in time are in equilibrium, i.e., priced correctly. Our underlying assumption is that the present market price is often wrong. Our focus is on a company's prospects for growth and improvement. Time is an important component in our work, as securities are valued according to the likelihood of certain expectations materializing over time. Like the market, we anticipate.

We project trends in earnings and cash flow to come up with future values for our companies that we view as reasonable relative to our expectations.

Our style is forward-looking — that is, we attempt to make timely purchases of growing companies and to be opportunistic towards those experiencing significant change. We tend to invest early, hoping to capture the full trajectory of a company's success. Winners here provide the high compounding returns we seek. Alternatively, we've found our mistakes may prove far less costly if we paid a fair price up front.

## **An ever-changing environment**

The existence of every innovating company is threatened by the possibility that somewhere, someone has a cheaper, more effective way to solve problems for its customers. Technology companies in particular are characterized by continual shifts in leadership, often leading to large valuation discrepancies. Companies that are marketing- and process-efficient gain ground on less able competitors; new products replace old ones, at times displacing companies; key customers suddenly become threatening competitors; meanwhile, the push to innovate is constant, and time and again, the fast beat the slow.

Spotting these developments in today's fast-paced, highly connected world demands that we sift through what seems like a geometrically increasing amount of information. Often we must keep on top of corporate, economic and political events across multiple geographies. To accomplish this work we are organized around central themes and work together as a team. We must be selective in our investment focus to do the best work possible for a limited, focused portfolio.

## **Volatility, short selling and risk**

Our accounts are inherently volatile. We view this volatility as a market phenomenon. Risk is the potential for capital loss. We don't believe risk can be removed from the investment equation and still allow us to deliver high returns. We chose instead to better understand our investment risks and mitigate them through detailed due diligence and a disciplined short selling strategy.

Short selling allows us to focus on our principal strengths — distinguishing between fundamentally promising, undervalued companies and overvalued ones with deteriorating fundamentals. We meet with a lot of managements: some are neither realistic nor forthright about their business prospects, while others are unfocused or simply naive. Less seasoned companies are easily herded into mistakes by investment bankers.

We have also noticed that weak managements tend to reproduce the errors of the past with remarkable frequency. Poorly run companies, short lived consumer fads, credit-financed booms, product obsolescence (and the corollary theme of new products swiftly becoming commodities) are all fertile areas for short selling. A likely candidate will have an income statement or balance sheet

that defies basic economic laws, a convoluted financial stratagem, years of capitalized expenses, or a geometric appetite for cash, but not enough revenue to cover expenses. We initiate short positions after our financial research reveals something seriously wrong.

While short selling is complementary to what we do, it is not without risk. In the majority of our accounts, we employ margin. This means we borrow money to buy or sell stocks — a practice that’s commonly viewed as taboo. We view margin as increasing your dollars at work — it increases the potential for both gains and risk. Importantly, this unconventional facet of our program enables us to initiate short sales — literally, the sale of stock you don’t own — to reduce risk from our long exposure. Selling something that doesn’t belong to you is a counter-intuitive notion not widely understood, despite the long history of this practice in the financial community. It can be, at times, a risky proposition.

### How short selling works

The process works like this: brokerage firms are permitted to lend shares to one another for their clients’ accounts. (This deposit creates interest

income for the lending broker, who shares this with us, but we do not pass it on to our clients.) When we identify a company we deem vulnerable, we borrow shares from these brokers to sell, and if our research bears out, repurchase them at a lower price. Sometimes we misjudge — if so, we cover it at a loss. It's also possible that a powerful, unselective market runs our short positions against us, forcing us to buy back shares at escalating prices. Thus, we are always vigilant, recognizing that the theoretical risk of a short position is infinite. That market's strength will likely boost our long positions, too, but there's no guarantee.

As investors, we constantly evaluate our risks. Have we missed a crucial aspect of a company's business? Is there a change in fundamental outlook? Are we giving sufficient weight to a new opportunity? We sell (or cover a short sale) when we determine that we haven't properly calibrated a business risk, or when a far better risk reward opportunity emerges. Our optimization process means that every stock earns its place in the portfolio — if it doesn't, it is replaced with a stronger alternative.

## **An invitation**

This booklet tells you something about us, and hopefully answers a few questions. There is no substitute for meeting in person, and we welcome the opportunity to visit with you in our offices. It takes a long, confidential conversation or two to reach an understanding of both our investment approach and how that may fit with your financial needs.

We hope you will accept this invitation to pay us a visit. If so, please call to set up an appointment. And if you can't come in, please call and we'll arrange a telephone interview with you.

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