Amy Buttell: Hi, I'm Amy Buttell with Jacob Funds. We're delighted that you could join us today for our webinar, the Jacob Wisdom Fund: Economic Value through Return on Invested Capital (ROIC). With us today is Frank Alexander, portfolio manager with the Jacob Wisdom Fund. Frank will take us through the process behind his distinctive ROIC investment approach. Now let me turn this presentation over to Frank. Frank?

Frank Alexander: Thank you, Amy, and welcome everyone. Thanks for joining us today. At Jacob Asset Management we use a slightly different approach to investing in equities for our shareholders. We start with a diversified group of high-quality common stocks, similar to what most managers in the industry do. Where we differ however is in how we define high quality. For us, high quality companies are those with high franchise value businesses, that is businesses with significant barriers to entry driving high returns on invested capital or ROIC.

Turning to our investment selection criteria, as I stated before a high priority in our investment selection process are businesses with high franchise values. This is easiest to define by what these businesses are not. They are not commodity businesses, which have very few or low barriers to entry. Because of this, commodity businesses can only return cost of capital and no more. And the reasons for this are fairly obvious. When a commodity business succeeds, for whatever reason, whether it be good management or some other characteristic in raising the return on invested capital, competition will inevitably come in and offer lower prices. This will drive down the ROIC of the business, reducing it to the original cost of capital level again.

Normally when this happens you find that these companies are driven down to below cost of capital type of returns. The effect of this for all participants is the destruction of capital for shareholders. These are the type of businesses we want to avoid.

The key criteria here is ROIC. ROIC of course is, is one of the most important ratios in finance. You can go back 400 years or so and look at anyone who had capital to invest -- meaning capital beyond what needed to be consumed – and that investor in all likelihood would look to put those funds into something they could earn some sort of a return on. So return on invested capital is a basis of investing, what actually one gets back from the capital that's deployed. From our point of view it determines the success of all businesses.

There are potentially many areas of the decision making process in all corporations that are based on return on invested capital. The usual process for any corporate management is to look at proposed investment projects and try to discern the amount of funds that should be allocated to those options. Executives typically make those determinations based on calculations surrounding the hurdle rate, which is the minimal acceptable return on invested capital for any potential investment.

ROIC is also important in investing because it is the opposite side of the coin for revealing franchise value type businesses and businesses that have high barriers to entry. Usually the higher the barriers to entry the stronger the franchise value, the higher the ROIC. So we're looking for companies with high ROIC which invariably means that they have a strong franchises.

Where we start out the examination of ROIC is the traditional Generally Accepted Accounting Principles (GAAP) concept of ROIC. We see many problems with this calculation due to the distortions built into the GAAP concept of total capital on the balance sheet,. The traditional GAAP ROIC definition is NOPAT or net operating profit after tax over total capital.

NOPAT is a fairly straightforward type of a number that doesn't contain many distortions. The reason we use NOPAT as opposed to net income is that NOPAT eliminates any extraneous type items that may show up in the net income line. So it is considered to be a better measure of what cash is available to shareholders and it's very straightforward, there are no distortions to it because it is simply revenues minus the cost of cost of goods sold minus the selling, general and administrative expenses.

Where the problem with GAAP comes in is in the denominator line, total capital. Total capital is defined as total assets minus non-interest bearing liabilities, which is basis for a traditional balance sheet item in GAAP corporate reporting. All corporations report this way and most participants in the investment community use these ratios to determine various levels of profitability for the corporation. The problem is thatif we go back to the original way we defined our return on investment, meaning what type of cash flow are you generating versus what capital you're putting up, we believe GAAP ROIC doesn't measure it very well because total capital is being distorted by various rules used in GAAP that systematically change that denominator line.

This GAAP ROIC calculation is based on the accounting principle of conservativism. And this , simply stated, is that any time you have two different options to state net income you always choose the one that will give you the lower earnings as opposed to the higher. By the same token if you have two options with regards to stating fixed assets of the two available you always take the one that gives you the lowest asset valuation. This results in the systematic depreciation of fixed assets, amortization of good will and the downward adjustment of impaired assets. This lowers the overall asset base of the corporation, therefore increases the GAAP ROIC calculation because as you lower the denominator the ratio moves higher.

So these ratios, which are all important, are from our viewpoint, being overstated simply because they don't really represent the capital that was put out to generate the resulting cash flows. They represent something else and it's usually a reduced base of those assets that were contributed to generate the cash flows. So what we have then is a GAAP calculation of ROIC that is directly related to most other ratios used in the investment community to value stocks. That includes return on equity (ROE), return on assets (ROA), price/earnings to growth (PEG) ratios, price/earnings (PE) ratios, all of those things are affected by this accounting process. From our point of view, all of these GAAP ratios, which are widely used in the industry, are distorted and have little value.

So how do we fix this? What we do is create something we call economic value ROIC, which gets back to what we consider the real definition. Basically we use adjusted operating cash flow (OCF) in the numerator which is an equivalent to NOPAT and again it's a very straightforward number. The reason we use OCF rather than NOPAT is rather simple: it's very similar to NOPAT and it's much easier to calculate given the way corporations report. The other advantage of adjusted OCF is that it also takes into account interest expense which makes it a more conservative number than NOPAT. But generally speaking these numbers are very close to being equal most of the time.

The denominator of the ratio is where we differ significantly from GAAP. It's something we call gross capital as opposed to total capital. It consists of the GAAP total capital but adds back all the depreciation, amortization and restructuring charges. This represents the capital of a corporation put up in any investment and can be compared to the cash flows available to the shareholders to give what we believe is a realistic ROIC number.

Now why is this important? It's critically important because when one sees ROICs generated at consistently high levels over long periods of time, we believe that what is at work here is a company that has a high franchise value and high barriers to entry.

Also, much of the importance of Economic Value ROIC lies in the fact that it's very underemployed, underutilized, and under appreciated in the marketplace. Very few people use it. Many value investors know it and use it in their own specific way but most often in the financial press all you'll ever see is GAAP ROA, ROE, and ROIC numbers, which, in our opinon, are terribly flawed. And the beauty of the fact that very few investors use it is that it gives anyone who is willing to do the work and understand some basic concepts the opportunity to find companies that are potentially undervalued in the marketplace because they're not being valued on the basis of this economic value ROIC but rather GAAP ROIC.

A good example is Coke versus Pepsi. If you look at the GAAP valuations of the two companies they are really quite similar. The GAAP ROIC calculation 13.90 percent for Coke, 13.60 percent for Pepsi. If you look at all other types of valuation based on the GAAP analysis most of those are again quite comparable between the two companies. But when we do it on an economic value ROIC calculation we see that Coke is 12.80 percent versus a 9.00 percent for Pepsi. And clearly both are going to be lower based on what I described before; the distortions to GAAP denominator.

But what we see that's interesting is that there's a significant difference between the economic value ROIC of Coke and Pepsi. For example, if you invest $1.00 in Coke you generate 42 percent more operating cash flow than the same dollar invested in Pepsi. This is a huge factor to be aware of and if this particular process was being used widely throughout the investment community you'd see a tremendous difference in the ratio operating cash flow versus enterprise value ratios for the two companies. This is because one would have to price in the fact that the ROIC for Coke is so much higher therefore the returns that an investor would get would have to be reduced to compensate for this significant difference.

What we see in the marketplace however is totally different. We see OCF to enterprise values for Coke and Pepsi virtually the same. We believe this is an anomaly that can be exploited and this is what we try to do at the Wisdom Fund. And this is why we believe that the return for our particular are potentially much greater than the average portfolio of common stocks that one might own through other firms.

For us, the discerning and defining of economic value ROIC is just the start of the process. This is the major filter that we use to eliminate companies that are low return businesses with the potential to destroy capital. So by doing this we identify companies with strong franchise values, strong enduring competitive advantages and high barriers to entry. We think that these are the companies that are most likely to provide worthy candidates for further research.

In this regard there are a number of steps that we go through after we do this initial screen, which we're not going get into in depth here today. These would include shareholder friendliness of management, potential for growth, various competitive threats that might be forthcoming for the particular company or industry, the financial strength of a company and most importantly the price one pays. And this goes back to whether you have to pay a much higher price for a strong ROIC company and what the extent of that price premium should be.

The last few slides have some background information about how to invest in the fund and about my background. I would now like to open it up to questions if there are any out there.

Amy Buttell: Thank you very much, Frank. Actually we do have our first question: what other kind of characteristics do high ROIC companies tend to possess? Do they pay dividends, throw off a lot of cash flow, have high return on equity for example?

Frank Alexander: Some of the above. They generally throw off a lot of cash, that goes without saying because they're generating a higher return on the capital that they employ. Now what, in varying companies the cash may be used for different things. If the company is a high growth company the cash will probably be plowed back into to financing that growth. For companies that are moderate to lower growth the cash is usually excess and they'll be using it to raise dividends or buy back stock. And these are very shareholder friendly moves that we like to see.

We don't necessarily have a bias toward growth but growth is a positive if it's available. Generally speaking we believe it's a positive because we're expanding the assets upon which we're generating those high returns and that's always a positive assuming you pay the right price for it.

Amy Buttell: Thank you. Here's the next question: the difference between your calculations on the economic value ROIC for Coke and Pepsi, although wider than the GAAP calculation doesn't seem to be all that significant. Can you comment further?

Frank Alexander: Yes,, it doesn't seem like a great deal of difference between 12.80 and 9.00 percent but it works out to a huge difference over the long haul because that return on invested capital is over 40 percent higher in the case of the 12.80 over the 9.00. So you generate 40 percent more operating cash flow on every dollar you invest. This is a huge advantage over time for any company who has this type of differentiation.

Amy Buttell: Well, that's our last question. Again, thanks to Jacob Funds and all our participants. Have a great afternoon.

Important Disclosure:

Mutual fund investing involves risk. Principal loss is possible.

Investments in foreign securities involve greater volatility and political, economic and currency risks, and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. These risks are greater in emerging markets.

Investments in micro-cap companies may involve greater risk, as these companies tend to have limited product lines, markets and financial or managerial resources. Micro cap stocks often also have a more limited trading market, such that the Adviser may not be able to sell stocks at an optimal time or price. In addition, less frequently-traded securities may be subject to more abrupt price movements than securities of larger capitalized companies.

As of June 30, 2013, the Jacob Wisdom Fund held 2.19% Coca-Cola Bottling Co. and 0% Pepsico, Inc. Fund holdings are subject to change and are not recommendations to buy or sell any security.

Diversification does not assure a profit or protect against a loss in a declining market.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 888-522-6239, or by visiting www.jacobmutualfunds.com. Read it carefully before investing.

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Definitions of terms:

Cash flow measures the cash generating capability of a company, calculated by subtracting total liabilities from total assets.

Economic Value is the amount (of money or goods or services) that is considered to be a fair equivalent for something else.

Generally Accepted Accounting Principles (GAAP): The common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

Operating Cash Flow (OCF) is a measure of the amount of cash generated by a company's normal business operations

Price to Earnings (P/E) Ratio is a common tool for comparing the prices of different common stocks and is calculated by dividing the current market price of a stock by the earnings per share. The P/E ratio is not a measure of future performance or growth.

Price Earnings to Growth (PEG) Ratio is an indicator of a stock's potential value by taking into account earnings growth and is calculated by dividing the P/E Ratio by the Annual Earnings Per Share Growth.

Return on Assets (ROA), is an indicator of how profitable a company is relative to its total assets; it gives an idea as to how efficient management is at using its assets to generate earnings.

Return On Equity (ROE), also know as return on net worth, is the amount of net income returned as a percentage of shareholders equity; it measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on Invested Capital (ROIC), also known as Return on Capital, is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns.