4th Quarter 2021 Newsletter

FIRST WILSHIRE
SECURITIES MANAGEMENT, INC.
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January 15, 2022

Dear Clients,

We are happy to report another positive performance for the 4th quarter. This marked the 7th consecutive positive quarterly return for our Separately Managed Accounts Composite (individual account performance may vary). The composite return for the year 2021 was 31.7%, outpacing all major indices. We are proud to have stuck to value investing amidst a highly speculative environment, while providing satisfactory returns for our clients. As we look forward, we like how our portfolio is positioned relative to the overall market: We continue to invest in companies we believe to be fundamentally sound and trade at reasonable valuations.

2021 has been an unusual year, to say the least. First it was Delta, and then it was Omicron. Inflation reached the highest level in decades. Speculation ran rampant: meme stocks, SPACs, cryptocurrencies, NFTs, to just name a few. We've discussed these speculative excesses in our past newsletters. If the recent price actions in the market were any indication, these bubbles are in a very painful process of bursting, which we've repeatedly warned about. We sincerely hope our clients have heeded at least some of our warnings. Looking forward, to see what's potentially in store for 2022, we'll begin the discussion by assessing the overall economy.

The view on the economy often varies with one's political affiliation and income level. We're not trying to make any political statement, but simply to observe the general economy based on the data that's coming in. Overall, the economy is strong, although inflation continues to eat away at our purchasing power, especially for the lower-income. The American economy is largely driven by consumers, and consumers are currently spending 25% more than the pre-pandemic levels. That's a high number even taking inflation into account. Consumers and businesses have *healthier* balance sheets now than before the pandemic, an outcome few would have predicted. Of course we could never know what surprises may be around the corner, but the economy looks good at least in the short term.

A strong economy, a low unemployment rate, and high inflation have begun to force the Federal Reserve to tighten its monetary policies. The Federal Reserve has learned its lessons from the past when it rattled the financial markets in the so-called "taper tantrum", and is now attempting to send plenty of signals to the markets first. But make no mistake about it - the Fed is clearly pivoting. This matters significantly to the financial markets, especially for the pockets where speculation has been rampant. In 1999, during the height of the Internet bubble, Warren Buffett made this statement in the Fortune magazine, "[Interest rates] act on financial valuations the way gravity acts on matter." This statement may seem esoteric to those of us without a physics degree, but what it basically meant is that, in general, the lower the interest rates, the higher the

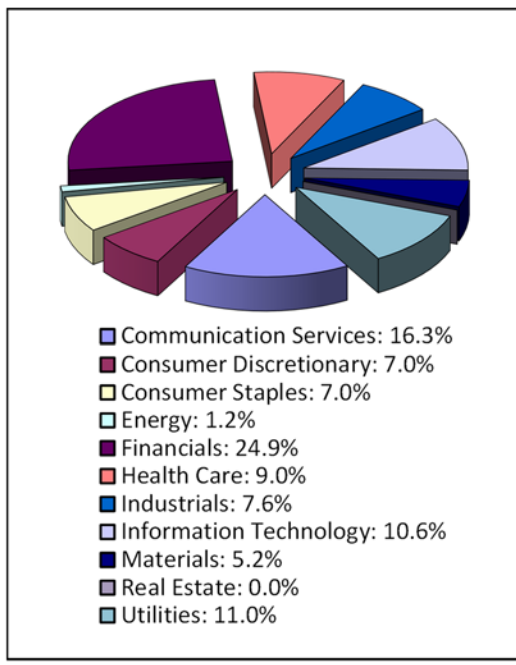
Key Statistics

As of 12/31/2021, our top 30 positions traded at a discount to the major indices, with an estimated median P/E of 12.7 for 2022 versus higher estimated P/Es for the S&P 500 at 21.6, NASDAQ-100 at 29.0 and Russell 2000 at 23.9. The chart below is an overview of key valuation measures and sector breakdown of the First Wilshire composite portfolio as of 12/31/2021.

Valuation Measures*	
P/E Ratio (TTM)	16.4
P/E Ratio (2022 est.)	12.7
Price/Book	1.6
Debt/Equity	69%
Market Capitalization ($MM)	619
Price/Revenue (TTM)	0.8

*Figures in the table above are median of the top 30 stocks of the aggregate portfolios on 12/31/2021 (individual portfolios may not have the same stocks or concentration). "P/E (TTM)" is price divided by the EPS for trailing twelve months. "P/E (2022 est.)" is price divided by 2022 earnings estimates. Source of estimates is Bloomberg or First Wilshire; some estimates are not available. All other figures are the latest available data at quarter-end.

Sector Allocation**



**As % of invested portfolio, using Global Industry Classification Standards. (GICS). Source: Bloomberg financial valuations, and vice versa. In the last two years, the Fed pushed interest rates to zero and significantly expanded its balance sheet in its effort to save the economy. In this "zero-gravity" environment, we have seen valuations of certain stocks soar to absolutely amazing heights, for no good reasons whatsoever. It's almost like seeing a sumo wrestler doing a somersault 100 feet off the ground, which became possible in a weightless state. It sure was a sight to behold.

Now we're moving into a different era. As the Fed re-exerts its gravitational pull, we have begun to see some stocks coming down to earth. The fall has been almost as spectacular as the rise. The original meme stocks, Gamestop and AMC Entertainment, have both declined about 80% from their 52-week intraday highs (The chart below shows the dramatic declines in just 3-plus months). We've discussed them in the past, and let's just say we are not surprised. These are not isolated incidents, of course - they're a reflection of the overall mood of the investing public. But speculation always ends badly; what the Fed is doing now is simply hastening its demise. High-flying stocks have been declining sharply as the U.S. 10-Year Treasury yield rose from 1.5% to 1.8%. But given where the economy is, it's not inconceivable that the yield can move to 2.5% or even higher. In that scenario, we could see even more speculative stocks making a crash landing. Or as we warned in our newsletter a year ago, "Speculators don't have the reputation of sticking around... When prices go in reverse, they may get out just as quickly. What's left is just high altitude and lots of air below."

All in all, the year 2021 was a clear repudiation to the efficient market hypothesis, which asserts that market prices reflect all available information, and therefore, there are no mispriced securities. Unfortunately, a perfect world doesn't exist anywhere except in the heads of finance professors.

Here's another example that demonstrates the market is not always efficient. Towards the end of 2021, we witnessed some stocks experience selling pressure while their businesses were doing fine. We believe (although we could never prove it) that in a strong-market year such as 2021, many investors have realized significant capital gains, and to help offset these gains they had to search for unrealized capital losses. However, the number of "losers" is lower than usual. In other words, the big selling pressure became concentrated in few stocks, further driving down their prices. We decided to purchase some stocks because of this phenomenon. There are always unique circumstances that could cause stock prices to deviate from the underlying value.

So why aren't there more value investors who seek to take advantage of the inefficiencies in the market? We believe there are a few important challenges. But first let's define what value investing is, at least in our minds. Value investing doesn't mean just buying stocks that are cheap - it means buying stocks that are cheap relative to their value. As any shopper can attest, buying a pair of cheap shoes isn't necessarily "value" if they break a month later. You want to buy something that's worth more than you paid for, hopefully significantly more. Same thing with value investing.

The first challenge is that most investors simply don't apply the value investing framework. Few actually engage in detailed investigations on future growth, competitive advantages, durability of profit margins, and risks, apply a reasonable multiple to arrive at an estimated value of the business, and make investment decisions accordingly. One may wonder, don't all investment managers do that on their clients' behalf? Perhaps, but some do it more than the others. In addition, many find it more convenient to cater to what the clients want at the time, even when they don't believe it's a sound investment. Sometimes it's too much work to try to persuade their clients and risk the chance of being wrong. In other words, they've elected to substitute others' judgment for their own.

Second, there is a lot of bad information everywhere you look. For all the talk about how the 24-hour news cycle and the Internet would make us more well-informed, the reality is not so straightforward. There is a lot of misinformation, both innocent and otherwise. A quick look at a Reddit chatroom makes you wonder who is really behind these discussions and tries to benefit from the chaos. And it extends well beyond Reddit. We've heard statements along these lines from reputable personalities (without naming names): Bitcoin around $50,000 is fine because it's going to $500,000! Nvidia at $800-billion market cap is fine because it could be $10 trillion! We guess in this world anything could happen (and it has), but still, these statements struck us as highly irresponsible. Partly as a result, many investors simply don't know what to believe anymore. Statements like these were sometimes made by investment managers who wanted to ride this hot momentum and bring more money under management. Or perhaps they actually believed it. We'll never know.

Finally, investment decisions are ultimately made by individuals, and as such, are heavily influenced by human psychology. You could be right about the value of a business, but in certain periods like 2021, you would be constantly made fun of and cast aside, not just for weeks or months, but potentially for *years*. It really is a lot easier to just go along. Or as the former CEO of Citigroup, Chuck Prince, had famously said in 2007 before the financial crisis, "As long as the music is playing, you've got to get up and dance. We're still dancing." It's unfortunate that Prince had in a way become the poster child for that era, because he was far from being the only one engaging in risky activities. But that quote perhaps summarizes human behaviors as well as any. In investing, ultimately though, it's better to stick with facts and numbers than music.

At First Wilshire, we hope to practice value investing as best as we can, regardless of the cacophony that may surround us. Moreover, we like to apply it primarily in the small-cap space because more price inefficiencies exist in it. When a company is small, it simply receives less attention and analysis than, say, Microsoft or Walmart, and that will always be the case. The inefficiency is more "structural" (more of a permanent feature): You don't need to wait for a year like 2021 to spot mispriced securities. There are thousands of companies to choose from at any given time. When a potential client wants to invest with us, we'd always like to make sure it's a good match because it makes for happier partnerships. If they want us to chase after fads or hot stocks promoted by TV personalities, they will likely be disappointed. But if they also believe in value investing, we can contribute by being consistent in our approach throughout all market cycles. We have been practicing value investing for over 40 years now, and we're unlikely to change in the next 40.

Thank you for your continuing trust. If you have any questions, please feel free to reach out to us. We are here to assist in any way we can, and we wish you a healthy and prosperous 2022.

Sincerely,

First Wilshire

First Wilshire Securities Management, Inc.

A Message from Client Services

Happy New Year! As we start the new year, this would be a good opportunity for our clients to inform First Wilshire of any changes that we may not be aware of. This could be items such as no longer having a land line or a fax number, beneficiary changes, trust amendments, etc. You may contact us directly at 626-796-6622 or email clientservices@firstwilshire.com.

"In the New Year, may your right hand always be stretched out in friendship and never in need."
- Anonymous

Thank you,
Client Services

First Wilshire "On the Road"

Meeting with Edward Richardson, CEO of Richardson Electronics, who showed off the company's latest, patented product: UltraGen 3000, an ultracapacitor for wind turbines. It is not only a very ecologically-friendly solution (it replaces lead-acid batteries), but also it is a no-brainer from an economic standpoint as the payback period is just 1-2 years. An ultracapacitor's life span is 10-15 years versus 2 years for a traditional lead-acid battery. This powerful combination of lower cost, a longer life span, and environmental friendliness is why the major wind turbine operators are so excited about this new product, placing $15 million in orders for this fiscal year and $25 million for the next year. The ultracapacitor is priced at ~$650 and each wind turbine needs 18 of them, so the company has significant opportunities to grow with this product. Additionally, they are working on similar lead-acid battery replacement solutions for cell towers, solar, EV and other applications. Not long ago, an investor on this company's conference call very rudely said to the CEO, "Do you know you are a loser?" Now the CEO gets the last laugh. It is a reminder that companies can be sometimes hated by investors, but they could turn out to be wonderful opportunities.

First Wilshire was happy to get on the road again. One such outing during the quarter was attending the LD Micro Conference in Los Angeles, the first in-person investment conference in almost two years. First Wilshire was a sponsor of the event. This conference has the additional distinction of previously being cancelled due to nearby fires. The organizers, despite all the setbacks, do such a good job bringing together investors and small, growing companies. Some of the meeting rooms often looked empty because the overall number of participants was still well below pre-pandemic levels and because safety measures were taken seriously. Still, nearly 150 companies presented, and for many of them their one-on-one schedules were completely booked. After such a long break, company executives and investors were happy to see each other's face (or at least each other's mask). We expect conferences to be largely in-person this year, including another First Wilshire sponsored conference, the Ideas Conference, which takes place in Chicago, Boston and Dallas. For those of you who have read this far and want to attend, let us know as we have limited tickets available for our clients.

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FIRST WILSHIRE
Detecting Value since 1977