

**Today's Notes:**

- 1. A Short Discovery Tutorial**
- 2. Lakes of Lithium Brines**

## **1. DISCOVERY INVESTING: A CREATIVE WAY TO THE FUTURE**

About a decade ago I realized that there was a big hole in current investing theory and practice. At the time I didn't realize that my ideas would morph into a new approach I called Discovery Investing (D.I.). This investing discipline is different and, more important; it is more powerful in many ways than traditional investing strategies we have from academics and practitioners.

First, though, we must define the technique. Discovery Investing is a discipline that seeks significant value creation through market recognition of a world class discovery. For example the discovery of a cure or effective treatment for cancer would be worth billions of dollars. The recent sale of Imclone and its cancer treatment Erbitux, a \$7 billion take-out, attests to this fact. In 2002, I recommended Western Silver as a micro cap (Incubator) Discovery company. After 4 years of silver exploration in Zacatecas, Mexico the company had discovered millions ounces of gold and hundreds of million ounces of silver. Goldcorp (GG) ended up owning Western's discovery for a premium of \$2 billion.

Practitioners of the discipline seek companies that offer these mega-wealth creating opportunities in many different fields. They may be found in the natural resource sector, bio tech sector, high tech sector or, today, in the infrastructure space here in the US. The reformation of the Utility sector (the development of the electrical grid) is a good example of how the Discovery Space tends to expand and change over time. A major discovery always pays a significant wealth dividend. The recent focus on health care and alternative energy discoveries has spawned dozens of new discovery opportunities.

D.I. is virtually an untouched investment space. At the beginning of their life cycle the discovery companies are usually small, illiquid micro caps. We categorize them as "Incubator" companies. Nobody cares about them. They fly "under the radar screen." I developed a factor model to rank the best of these opportunities, the Discovery Investing Factor Model. Consisting of just 10 rules or Discovery Factors, it is easy to use. A quick examination of the grid's analytical framework below provides a useful description of the discipline. For each company, each discovery factor is rated by its potential between 1 and 10 (10 points being the optimal rating).

- 1. Discovery Potential is real. Does this discovery have "world class" value-creation potential?**
- 2. Ownership share: does the company own control of the asset 100%?**
- 3. Is the potential discovery a game changer? Is it revolutionary, useful today and progressing towards realization?**
- 4. Is there diversification of discovery risk, multiple opportunities? Are there opportunities for serendipity?**
- 5. Management and the Board: track record, ownership and insider transactions, option strategy.**
- 6. Identify a Dominant Cycle (e.g. the Global Quality of Life Cycle) and Catalyst (e.g. the discovery).**
- 7. Is this a Contrarian discovery play? Are you buying into this for pennies?**
- 8. Financial strength: balance sheet & income statement management; sustainability of operations, dilution strategy.**
- 9. Does management communicate with employees, shareholders and customers? Is it honest and timely?**
- 10. Can you exhibit self control, patience, courage, sustain loss, and continue to invest in this opportunity?**

## The Practice of Discovery Investing

This last element is critical. You must always realize that the discovery process is long term, costly and risky. Is this an investment that **you** believe will sustain itself and create value in strong and weak economies? One most important question is this: Are you willing to stay the course? In order to become a Discovery Investor you must practice the discipline. Analyzing any of the companies mentioned in this short report is your opportunity. A score above 70 (when you add the ten factors) is a very good score.

So then to answer the question posed in the title. Is Discovery Investing a more creative approach? Perhaps the appropriate answer is that it is a different and more powerful way of looking at the same old problem – how to invest in your equity portfolio to create wealth. What we do know is this. While D.I. is risky, the risk reward ratio for most discovery opportunities is usually very appealing. Since we base this investing discipline on the proposition that great discoveries will create great wealth, D.I. should work in all seasons including recessions. In our experiences, over the past 7 years, we have found this to be true. Since investors in this discipline tend to focus initially more on the discovery itself, the core of the investment issue, there is less immediate focus on the company itself. That's an excellent starting point for analysis. We think this is an advantage for investors. But in the end analysis Discovery Investing is simply adjunct to the investing tools that have developed over the course of the past few decades.

A few recent examples of Incubator, Mature or Legacy discovery companies:

- 1) Quaterra Resources (Mature, QMM NYSE AMEX),
- 2) MegaWest Energy (Mature, MGWSF),
- 3) Avalon Rare Metals Inc. (Incubator, AVL TSXV AVARF),
- 4) Houston Lake Mining (Incubator, HLM TSXV) and,
- 5) Senesco Technologies (Incubator, SNT NYSE AMEX).
- 6) Goldbrook Ventures (Mature, GBK TSXV).

These are companies of interest to me that you might follow in the 2010 timeframe. You might even evaluate them using the Discovery Factor Model outlined above.

**Quaterra** is a diversified metals company with top management and silver, copper and molybdenum properties in North America. QMM has developed an extensive pipeline of highly prospective properties. Freeport McMoran and Goldcorp, two mining industry giants, have recently made significant investments in the QMM business model. **MegaWest Energy** is producing ~200 barrels each day of heavy oil in the US (Missouri) on 5% of its U.S. land position of 130,000 acres. MGWSF expects production of 500 bpd by June 2010. MegaWest is classified as a Mature Discovery company with production and cash flow. **Senesco** is an Incubator bio tech company with a promising genetic cancer technology. Senesco management expects to enter human cancer 1A/2B trials in 2010 at the Mayo Clinic. Their chances for positive multiple myeloma results are excellent. **Avalon** has developed a large rare earth ore body near Yellowknife in Canada's Northwest Territories. AVL is an example of a rapidly maturing discovery investment. Its deposit contains both light and heavy rare earth elements. **Houston Lake Mining** continues to make excellent progress on their gold property near Kenora in Northern Ontario.

**Goldbrook Ventures** is perhaps the cheapest and best positioned discovery company. The company now controls almost 1 million acres in the rapidly developing Raglan nickel, copper, cobalt camp in Northern Quebec – and – China's Jilin Jien is spending all the development money for 75% of the rich nickel / copper sulphides.

As always, a word of caution is in order. Discovery Investing, especially in the Incubator space, is risky. To counter the high risk, the risk / reward ratio must be extremely favorable. Not all of discoveries will come to fruition. In the Discovery investing discipline if you bat just .200 you will likely be richly rewarded. That is why we developed and utilize the Discovery Factor Model. We revise our factor values and weightings frequently, diversify thoroughly and follow a rigorous sell discipline.

## 2. LAKES OF LITHIUM

We last wrote on Salares Lithium January 11<sup>th</sup>. The shares had soared at the time. But since then there had been significant selling, we think, from the investors in the old shell company. On Friday the stock regained its January 11<sup>th</sup> price based. A research report was released Friday at the close.

This AM Salares Lithium reported a potential, promising brine volume from the northern section (about 65% of the area) on 1 of its 7 salars or brine lakes (Salar de la Isla) in Chile. The company completed the first phase of its tests using a technique called transient electromagnetic survey ("TEM").



The majority of the world's lithium production comes from salars, or salt lakes, where prospective lithium mineralization is generally hosted in brine "horizons." The TEM survey was designed to define the size and extent of the brine pool within LIT's largest salar.

Salar de la Isla, encompasses a total of 16,500 hectares. It is 15 kilometers long and 6 km wide on average. Using the results obtained from the 38.5 line km survey Geodatos, the geophysical company, constructed a 3 dimensional model of the distribution of the brine horizon. The company reported a possible volume of 5.393 billion kiloliters using a resistivity cut-off of 2 ohm/metres (interpreted as possible brines) and 2.459 billion kiloliters using a cutoff of 1 ohm/meter. Be aware that these volume estimates are based on 65% of only 1 of 5 possible salars.

This lower volume is significant. It puts the company in good shape from a volume perspective compared to the leaders in the lithium exploration space (for example Orocobre). Toyota recently invested \$4.5 million in Orocobre, guaranteed a \$80-\$100 million dollar plant and an off-take agreement of 25% of the lithium produced. Salares Lithium must now determine grade and porosity of the brine.

Here's another interesting issue. The TEM study was unable to "see" the bottom of the brine lake. This means that the salar must be deeper than 200 meters. We are told by the management of LIT that the "grade" of the lithium may increase at depth. To date we do not have measurements on the ratio of magnesium to lithium (a key parameter for economic feasibility) but we feel increasingly confident that with this volume announced the first salar has enough size to be developed if the grade that matches the historic sampling is accurate. There is potential for additional brine bearing horizons beyond where the TEM was able to penetrate.

Salares Lithium's CEO Todd Hilditch said,

***"We are excited about the volume calculation identified by Geodatos and the fact that it only accounts for the northern portion of one of the Company's seven salars. The experience Geodatos represents regarding the TEM survey and the relationship of the correlation of 1 ohm/metre as definite brine with potential of brine up to 2 ohm/metre, is encouraging. The Company will now be required to drill/sample the extensive interpreted brine horizons before a porosity value and a resource calculation can be established."***

The Company will now move quickly on 4 of the remaining six salars. LIT has instructed Geodatos (the company that initiated the TEM tests) to double the size of the geophysical crew.

The next step will be gravity testing and sampling of the brines. LIT's shares have been held back by investor selling from owners of the former shell company. We think these sellers are, for the most part, gone. If so this stock could have significant upside as more results from gravity tests and sampling of the brines are realized.

Key to the success of Salares Lithium is their ownership of 100% of the 5 lakes. They will control their destiny if the lithium grades are sufficient.

LIT's Salares 7 Project is located over 1,000 kms north of the epicenter of Saturday's 8.8 magnitude earthquake. The project has not been affected by the earthquake.

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