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Small-Company Stocks

Get in on the Ground Floor

by Adam Ritt, Editor

BetterInvesting members are on a never-ending mission to discover small companies that are well-managed, growing at a high rate and reasonably priced. Though the aim is to have these stocks make up 25 percent of a portfolio, finding appropriate investments among this group (with annual revenues of, say, $500 million or less) is a common problem for both clubs and individual investors.

What's especially frustrating is that there's no shortage of small companies to consider — thousands of them, in fact. But with little or no coverage of many of these stocks on Wall Street and by the financial media, there's a lot of work involved in finding undiscovered stocks.

The long-term performance of small-company stocks relative to large-company ones, however, shows that the effort is worth it. According to the 2011 edition of Morningstar's *Ibbotson SBBI Classic Yearbook,* $1 invested in small-company stocks on Dec. 31, 1925, would have grown to $16,054.70 by year-end 2010. A dollar invested in large-company stocks (the Standard & Poor's 500 index) would have grown to $2,982.24. (By the way, the value of long-term government bonds would have been $92.94; Treasury bills, $20.55.) The total annual return for the large-company stocks was 9.9 percent, compared with 12.1 percent for small-company equities.

Lest anyone believe that all anyone should invest in are small companies, the Ibbotson yearbook indicates that large companies have outperformed small ones at times. In terms of single-year performance, small-company stocks have been the best-performing asset group 38 times through year-end 2010; the rest of the groups in the comparison are large-company equities, long-term government bonds, long-term corporate bonds, intermediate-term government bonds and Treasury bills. But large-company stocks came out on top 16 times. In terms of rolling five-year periods, small-company stocks was the No. 1 performer for 43 periods, but large-company holdings outperformed all the other classes 23 times. The numbers are similar for 10-year rolling periods.

In discussing why small-company stocks tend to do better than large-company equities, Rick Platte suggested in his excellent 2003 series for this magazine that "real world limitations on growth make it easier for small companies to grow more rapidly than large ones." To grow by 15 percent in a year, a company with annual revenues of $20 billion would need to add $3 billion in revenue. Compare that with the $75 million required for a company with $500 million in annual revenue. So if sales drives earnings, and earnings drives the stock price, it makes some sense for small-company stocks to outperform. *(In this article, we're ignoring midsize companies, but we'll cover these in a future issue.)*

Note that going small does entail enduring some severe volatility at times. We've all invested in that can't-miss small-company stock growing sales and earnings at 25 percent a year only to see its stock price tumble when the company misses analyst estimates or loses a major customer.

But in a diversified portfolio, a healthy percentage of well-chosen small-company stocks energizes returns. The problem is how to find them. One of the chief merits of small-company stocks — the fact that Wall Street tends not to follow them — is also a barrier to uncovering candidates. The following are some suggested resources.

BetterInvesting Magazine

Turning our attention to, well, us, the magazine regularly covers small-company stocks. Ken Kavula, chairman of the BetterInvesting Volunteer Advisory Committee and a small-stock connoisseur, provides several candidates roughly every other issue in his "Watch List" column. Small companies also pop up in articles by Cy Lynch ("Growth Stocks") and Nic Van Broekhoven ("International Stocks"), the Stock to Study and Undervalued Stock articles, and sometimes in the "Performance Review" article. For ideas from fellow like-minded investors, scan the portfolio in the "Repair Shop" column for candidates, as well as the Most Active and Bubbling Under lists in "Performance Perspective" and the Top 200 list published annually in the April issue. And those are just some of the places small-company stocks are mentioned. Flip through any issue of the magazine and you'll doubtless see other ideas. In addition, this month on pages 38-39 we present a list of small companies making a screen of Morningstar data.

Forbes' America's Best Small Companies

The financial publication annually offers a list of companies that meet the following criteria: publicly traded for at least a year, annual revenue of $5 million to $1 billion and a stock price of at least $5 a share. The editors rank the companies on earnings and sales growth as well as return on equity for the past 12 months and five years. Major legal problems, suspect accounting practices and having a thinly traded stock are among the reasons *Forbes* will omit companies.

What makes the list so interesting is that it traditionally has a number of companies already discovered by the BetterInvesting community. This year, for example, Quality Systems (ticker: QSII), The Buckle (BKE), II-VI (IIVI), Strayer Education (STRA), Capella Education (CPLA), True Religion (TRLG), Bio-Reference Labs (BRLI), Buffalo Wild Wings (BWLD), Dolby Labs (DLB) and FactSet Research (FDS) are just a few of the companies that members already have been investing in for at least a few years. It's likely quite a few more on the list are worth studying. (*Companies are mentioned only for educational purposes. No investment recommendations are intended*.)

In fact, simply reading about companies in publications such as *The Wall Street Journal, Barron's, Kiplinger's, SmartMoney, BusinessWeek* and other financial publications will often yield stocks worth studying. Just make sure to run any candidates through the Stock Selection Guide to ensure these are quality companies. Journalists are paid to write interesting stories, not to analyze stocks for their investment potential. The *Investor Advisory Service*, featuring commentary and stocks selected by the authors of "Repair Shop" and "Performance Review," also includes many small-stock ideas.

Small-Capitalization Mutual Funds

Well-managed mutual funds — in BetterInvesting's perspective, ones that have turnover of 20 percent or less, long management tenure, reasonable costs and outperform their benchmarks over the long term — specializing in small companies can offer interesting investment ideas. Scour fund filings and read commentary from the professionals overseeing the stock selection for small-cap funds to learn of recent investments and perspective on holdings. You'll want to take their comments with a grain of salt because it's in their interest to make positive remarks about the stocks they've acquired, but it's a starting point for further research.

For example, the Baron Small Cap Fund (BSCFX), which invests mainly in small growth companies, provides quarterly commentary at its website. The site also details the funds' entire portfolio. Understand that the fund holdings might be a few months out of date. But in the Baron fund's case, the information is relatively recent. The top holdings as of Oct. 31 included TransDigm Group (TDG), which provides highly engineered aircraft parts; Clean Harbors (CLH), which provides environmental and hazardous-waste management services; and Equinix (EQIX), an operator of data centers.

Learning about any new companies added by a fund manager can be quite a task, but it might yield some interesting ideas. To do this, you'd likely need to access the funds' filings with the Securities and Exchange Commission and compare the list of holdings from quarter to quarter looking for any new stocks.

Company	Ticker	Industry	TTM revenue ($ millions)	3-yr revenue growth (%)	3-yr EPS growth (%)
AboveNet	ABVT	Telecom Services	459	17.3	67.4
Almost Family	AFAM	Medical Care	335	36.6	32.8
Bio-Reference Labs	BRLI	Diagnostics & Research	534	22.3	23.0
Cardinal Financial	CFNL	Banks-Regional-U.S.	108	17.3	51.0
Cavium	CAVM	Semiconductors	263	56.2	122.4
Changyou.com	CYOU	Electronic Gaming & Multimedia	413	98.1	201.8
China Automotive Systems	CAAS	Auto Parts	349	37.3	43.8
China Ceramics	CCCL	Conglomerates	190	524.2	259.4
China Information Technology	CNIT	Information Technology Services	145	75.4	26.0
Chindex International	CHDX	Medical Distribution	174	17.4	26.0
Diamond Foods	DMND	Packaged Foods	966	22.0	34.6
Digital Generation	DGIT	Business Services	297	36.3	32.8
Duff & Phelps	DUF	Asset Management	378	60.5	146.6
Ebix	EBIX	Software-Application	160	45.6	55.7
Emergent BioSolutions	EBS	Biotechnology	269	16.1	27.3
EZCorp	EZPW	Specialty Retail	833	25.4	30.6
First Cash Financial Services	FCFS	Credit Services	510	15.4	23.5
Grand Canyon Education	LOPE	Education & Training Services	404	57.2	217.5
Gulf Resources	GURE	Specialty Chemicals	179	42.9	41.7
Home Inns & Hotels Management	HMIN	Lodging	478	46.3	108.0
InterDigital	IDCC	Telecom Services	320	19.0	104.7
Investors Bancorp	ISBC	Savings & Cooperative Banks	333	47.2	69.2
IPG Photonics	IPGP	Semiconductors	452	16.6	20.2
Ixia	XXIA	Scientific & Technical Instruments	302	16.7	19.4
KMG Chemicals	KMGB	Specialty Chemicals	266	19.9	19.8
Masimo	MASI	Medical Devices	432	16.5	26.3
Medifast	MED	Specialty Retail	292	45.4	68.9
QuinStreet	QNST	Advertising Agencies	401	28.0	28.4
Rovi	ROVI	Software-Application	691	51.5	36.7
Spreadtrum Communications	SPRD	Semiconductors	520	33.5	39.0
Summer Infant	SUMR	Household & Personal Products	220	41.9	20.3
Synaptics	SYNA	Computer Systems	579	18.4	31.6
United Financial Bancorp	UBNK	Banks-Regional-U.S.	62	20.9	35.7
United Therapeutics	UTHR	Biotechnology	723	41.9	59.3

Stock Screens

Screening tools offered by financial information sites can help investors spot companies that have fallen between the cracks on Wall Street. The problem is finding them. Value Line and Morningstar have robust screening tools, but these are reserved for paying customers. ICLUBcentral's Stock Prospector software program uses data from Morningstar.

Most of the free screeners are basic, but there are at least two good options on the Internet. The first is Yahoo! Finance's advanced screening tool. When you get to the stock screener page, click Launch Yahoo! Finance Stock Screener. You'll need to make sure your computer meets the operating system requirements, and the screener itself takes time to load and isn't intuitive. But it has enough functionality to provide good results. There's also FinViz, which allows users to screen based on more than 60 fundamental and technical variables.

Finding small companies worth investing in can be difficult, time-consuming work. But these are often among the most rewarding uses of your time, and with the tools and resources mentioned above, you should be well on your way to riding a high-quality small company's growth up to the top.

Websites of Interest

***Forbes*' America's Best Small Companies**
www.forbes.com/best-small-companies

Investor Advisory Service
www.investoradvisoryservice.com

Baron Funds
www.baronfunds.com

Yahoo! Finance screening tool
http://screener.finance.yahoo.com/newscreener.html

FinViz.com screener
http://finviz.com/screener.ashx

ICLUBcentral Stock Prospector
www.iclub.com/products/stock_prospector.asp

5-yr EPS growth est. (%)	Current P/E	Avg P/E	LT debt/ capital (%)	PTP in most recent year (%)	ROE in most recent year	Financial Strength	Earnings Predictability	Ticker
18.5	22.6	21.9	8.1	25.4	12.4	B++	30	**ABVT**
16.0	6.6	14.0	0.6	15.3	16.6	B+	75	**AFAM**
18.6	13.2	23.2	4.8	10.3	17.2	A	90	**BRLI**
18.0	12.8	N.A.	64.9	31.9	8.0	B	35	**CFNL**
20.3	38.3	N.A.	0.3	4.7	15.2	B++	N.A.	**CAVM**
16.4	5.3	10.7	0.4	62.1	41.4	N.A.	N.A.	**CYOU**
15.0	7.0	24.2	12.2	20.6	26.6	B+	55	**CAAS**
20.0	0.6	N.A.	2.2	28.5	30.8	N.A.	N.A.	**CCCL**
23.0	1.5	24.4	0.0	26.4	16.6	B	N.A.	**CNIT**
23.0	23.8	N.A.	14.5	8.4	7.1	B	30	**CHDX**
16.8	16.9	25.1	49.7	8.9	10.7	B+	60	**DMND**
26.0	9.5	64.0	48.7	30.0	8.4	B+	30	**DGIT**
17.5	23.6	N.A.	29.2	8.9	7.5	B+	N.A.	**DUF**
20.0	9.8	12.7	6.1	45.1	23.5	B+	85	**EBIX**
27.5	29.3	15.9	11.2	25.6	15.1	B+	60	**EBS**
15.0	12.0	11.7	2.6	21.7	19.4	B++	90	**EZPW**
18.0	18.8	15.8	0.3	19.6	18.3	B++	95	**FCFS**
17.6	16.4	44.9	12.3	18.9	32.1	B++	N.A.	**LOPE**
19.0	1.7	25.4	1.2	43.8	26.7	B	N.A.	**GURE**
23.1	25.8	N.A.	23.8	17.0	12.3	N.A.	N.A.	**HMIN**
15.0	19.8	27.0	29.8	60.4	43.7	B++	25	**IDCC**
15.0	19.3	N.A.	70.2	33.3	7.0	B+	10	**ISBC**
24.4	20.1	53.9	3.7	26.5	16.8	B++	35	**IPGP**
19.4	37.4	77.4	37.6	6.7	3.9	B+	25	**XXIA**
15.0	17.1	19.4	27.8	5.7	10.1	B	50	**KMGB**
19.1	20.4	40.7	0.0	26.5	31.3	A	N.A.	**MASI**
21.3	10.5	25.2	5.2	12.3	29.0	B+	50	**MED**
14.3	16.9	31.9	19.0	11.2	7.3	N.A.	N.A.	**QNST**
18.0	41.7	36.0	36.7	16.1	12.6	B++	25	**ROVI**
17.1	6.3	18.5	1.4	23.0	31.4	N.A.	N.A.	**SPRD**
26.3	30.8	29.9	40.3	4.4	8.1	C++	N.A.	**SUMR**
14.4	19.4	23.6	0.7	12.3	17.7	B++	50	**SYNA**
15.0	22.2	36.2	36.7	28.0	4.7	N.A.	65	**UBNK**
30.3	14.4	64.0	4.9	24.5	11.6	B++	40	**UTHR**

34 Small-Company Ideas (Companies With Annual Revenues of Less Than $1 Billion)

The above list is of companies that passed the following conditions using Morningstar's premium stock screening tool: trailing-12-month revenues of less than $1 billion (to provide enough companies for a sizable list); three-year sales and earnings growth of at least 15 percent (three years was the most allowed by the tool); forecasted five-year annual earnings growth of 15 percent; a debt-to-equity ratio of less than 50 percent (we left in a couple of financial services companies with ratios above that because these firms are structured differently); and a price-earnings ratio of less than 50.

We've also provided average P/Es (ones exceeding 100 were omitted) as well as pre-tax profit margins and return on equity for the most recent fiscal year using BetterInvesting's stock data service. The ratio of long-term debt to capital in the table is also from the stock data service. Finally, from Value Line we pulled the company's Financial Strength and Earnings Predictability grades. The long-term earnings estimates in the table are from Yahoo! Finance. No investment recommendations are intended. Especially with this screen, you'll want to make sure any company of interest looks suitable on a Stock Selection Guide and to use your own judgments.

Experts Say Company Size Does Matter in Economic Cycles

Small-Caps Lift Off Higher as Economy Recovers

by Natasha Gural

Large-capitalization companies are typically more stable than small-caps, because they boast more and larger customers as well as steady, predictable earnings. But there are always exceptions, as we've learned from major market disasters such as the dot-com bust and the collapse of behemoths Bear Stearns and Lehman Brothers. That's why it's essential to diversify your holdings between small-, mid- and large-cap stocks. Although large caps have been slightly outperforming small caps over the last five years, that could change very soon with the start of another five-year cycle.

The stock market historically goes through slow, vast cycles between large-caps and small-caps that generally last about five years. A recent study published in *The North American Journal of Economics and Finance*, however, reveals a small-cap premium of roughly 200 basis points over large-caps in the U.S. since 1926. Lorne N. Switzer, a professor at the John Molson School of Business, Concordia University, in Montreal, Quebec, examined the relative performance of small-cap versus large-cap stocks from the mid-1920s through 2010 and found that large-caps tend to outperform when an economic expansion has matured, but small-caps take off right as it's forming.

Over the last five years through Oct. 14, large-caps have had a "slight edge" over small-caps, according to Jon Eggins, a portfolio manager at Russell Investments.

"This has been dramatically influenced by the market turmoil in (the third quarter), where investor risk aversion in response to the unfolding situation in Europe saw the Russell 2000 fall 21.9 percent," Eggins tells *BetterInvesting Magazine*. "If we roll back to August, small-caps were ahead of large-caps over one year, flat over three years and above for five years."

This period isn't really unusual, given the nature of the markets. "In times of high uncertainty, small-cap stocks typically underperform large-caps," Eggins says. "This has again been the case recently, with small-cap underperforming large by 7.2 percent in (the third quarter). The large-cap advantage is even greater over the past 12 months."

The small-cap underperformance is likely to be temporary, as the returns of these equities relative to large-cap stocks are cyclical.

The Standard & Poor's Capital IQ consensus earnings growth estimates are higher for the S&P SmallCap 600 than for the S&P 500, according to Sam Stovall, chief investment strategist for Standard & Poor's Equity Research Services.

Eggins says: "Small-cap is a higher beta asset class than large-cap, and the relative performance usually reflects this *(we'll discuss beta next month)*. The recent underperformance is therefore not surprising. Macro events have depressed small-cap stocks recently, and any further bad news out of Europe could create short-term headwinds. There are, however, a number of potentially positive forces underpinning the U.S. small-cap market."

The valuation gap between small-cap and large-cap has narrowed since the third-quarter selloff, Eggins says. Earlier this year many investors also were claiming smaller stocks were overvalued.

U.S. small-cap companies typically are domestically focused and therefore not as directly exposed to Europe or potentially slowing emerging markets, Eggins notes. Meanwhile, the larger-cap companies have significant cash reserves that they could use on acquisitions.

"If this sparks more M&A activity, this could be a boon for smaller-company stock prices," Eggins says.

BetterInvesting advocates holding 25 percent in small companies, 50 percent in midsize companies and 25 percent in large companies. Understanding how market cycles work and how investors react to macroeconomic changes is key. Performance must be measured over time, as dramatic events can always alter the course of any economic or financial cycle.

Websites of Interest

"The Behavior of Small-Cap vs. Large-Cap Stocks in Recessions and Recoveries: Empirical Evidence for the United States and Canada," by professor Lorne N. Switzer
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1937396

Timeless Wisdom

Bankruptcy's Impact on Shareholders

from Ask Mr. NAIC, by Kenneth S. Janke, Sr.

Editor's note: As a tribute to the late Ken Janke, who authored "Ask Mr. NAIC" and helped millions of investors understand investment club operations, the Stock Selection Guide and sound investing principles, we're reprinting some of his wisdom.

One of the companies in which we own stock has gone bankrupt. Should we charge-off the stock?

A Unfortunately, hearing the word "bankruptcy" makes an investor think about total loss. However, this may not always be the case. Bankruptcy proceedings are initiated when the company acts as a debtor, filing a petition for involuntary bankruptcy or when certain creditors file the petition in the bankruptcy court.

The result of the bankruptcy may not mean just liquidation of a company's assets for the benefit of the creditors. It could also end up in a reorganization, which would allow the continuation of the company as a going concern. The interests of shareowners are not necessarily terminated when a company goes into bankruptcy. Sometimes, the operations of the "new" company will not look much like the old, as witnessed by Penn Central.

The court is asked, in a reorganization proceeding, to appoint a creditors' committee, consisting of unsecured creditors. The court can also appoint a committee of equity security holders if it feels such a committee is necessary to assure adequate representation. The court may also appoint a disinterested party to serve as an agent of the court. The primary goal of a reorganization proceeding is the development of a plan of reorganization acceptable to creditors and shareowners.

The Securities and Exchange Commission is also likely to participate in those proceedings, which involve a significant number of public investors. Before the reorganization plan is accepted or rejected, all creditors and security holders must receive the plan or a summary of the plan, a disclosure statement approved by the court, a notice of the date, if any, for the hearing or confirmation and any other information directed by the court.

In straight bankruptcy proceedings, the company is usually found to be insolvent and the stock deemed worthless. At that time, the shareowners should contact the Internal Revenue Service in their area for information about treating the securities as a tax loss.