LESSONS FROM THE PAST: OPPORTUNITIES IN SMALL-CAP STOCKS

By Marcus W. Robins

The experience we have all endured during the past year is no different than that endured by the railroads over 150 years ago, or the automobile industry about 100 years ago. The difference is that the economic tragedy happened to us rather than to those long dead.

You think the last year has been a challenge?

If you are old enough to remember, or are familiar with ancient history, the period since the market top in March has been nearly a cakewalk.

Sure, life isn't turning up roses, particularly with $800 million—or is it $800 billion?—of venture capital having evaporated with the demise of the dot-coms. Gasps of alarm are sounding over unemployment as it pokes its wee head above the 4% level. Corporate profitability has clearly been damaged.

Now, roll back in time to the era when a Republican president last promoted tax cuts, beefed-up defense expenditures, and even talked about fixing Social Security. Corporate profits weren't down, they were out. Inflation was a problem, not an apparition. And unemployment was a multiple of current levels.

For those of us not graced with this much gray hair or a corpulent midriff bulge, 30 months ago was no real picnic either. The "Asian Contagion" was greatly magnified by the Federal Reserve's vehement fight against inflation. The increase in interest rates was enough to slow economic activity here, while the softness across the Pacific threw technology issues into a tailspin. Junk bonds—with the fiery flameout of the hedge fund Long-Term Capital Management—became "investment non grata." High-yield instruments and foreign debt sold for pennies on the dollar, if any one was courageous enough to bid for issues. The financial markets became very unstable and thin, and only equity and debt of the highest caliber traded with reasonable liquidity. Technology valuations collapsed, business was in a funk, and Wall Street shuddered with layoffs and losses.

In fact, the experience we have all endured—me included—is no different than that endured by the railroads over 150 years ago or the automobile industry about 100 years ago. The difference is that the economic tragedy happened to us rather than to those long dead.

THE GOOD NEWS

I believe there is a gilded lining to this cloud—it's turned back into a "thinking man's" game, centered around old-fashioned security analysis, where growing industries, revenues, and margins count, and all the other fundamental indicators of value have to be considered for capital appreciation. The old habits of buying "stocks on the go" or "industry de jour" investment ideas have not been this tarnished for years, and it is time for a different approach.

What do I mean? It's time for Wall Street—professional managers and retail investors alike—to reconsider their investment style after passing through the conditions that have just been dealt out. Think about the past 18 years and the different investment themes that have run their course—LBO-mania and forays into foreign equities and momentum plays, for instance. All have gone up, and then down. There's little left intact as a viable alternative except

Marcus Robins is CEO and editor in chief of The Red Chip Review, a newsletter that focuses on smaller capitalization firms; 1099 SW Columbia St., Suite 350, Portland, Oregon 97201; 503/241-1265, 888/733-2447 or visit the Web site at www.redchip.com.

small-cap, special-situation investing, which has not only survived the market, but posted pretty good results in an 18-year bear market for small caps.

Why now, after all the hallowed emerging and small-cap brokerage houses have been acquired by the major banks?

My first answer would be: "Because the opposite is almost exactly what happens after Wall Street positions itself for something else."

But without being sarcastic, let me summarize conditions with five salient points:

- Long-term U.S. demographics still point to a continuing inflow of funds into the market unparalleled by past experience. Will it be the deluge we've enjoyed in the past? I don't think so. Many novice investors have been burned and have learned caution, but there will still be an inflow of substantial portions.
- Tax cuts, and particularly those affecting capital gains, have always had a positive effect on equity prices, and particularly on small-cap total returns, since their returns are generated by appreciation and not dividend flow.
- Relative valuations support money flowing into the smaller market-cap arena. Interestingly, small-cap price-to-sales ratios are at a 30-year low relative to the large caps, and strategic merger and acquisition activity is at a two-decade high. This last figure does not include transaction activity by financial buyers, which also should be on the rise.
- We have witnessed the high-water mark of what Satya Pradhuman of Merrill Lynch calls the "domino effect." This was marked by Microsoft reaching its high of $120. He believes that money flows in the market like tides, and for 18 years funds have flowed into the large-cap marketplace, leaving small caps high and dry. Now it's time for the reverse: Money flowing out of the large caps and back into the small caps, similar to the time between 1974 and 1982. Already, for two-and-a-half years we have seen interest and valuations begin to rise in the secondary and tertiary market places. If Pradhuman is right and it does describe the beginning of a change in course, what follows is typically a very long and meaningful secular period when small-cap stocks outperform large-cap stocks.
- There has indeed been a reversal of the money flow in small-cap mutual funds. Money is flowing into small-cap value funds after a three-year outflow. I think this is a nascent indication that pension consultants are realigning their thinking toward small- and micro-cap stocks, and this should bring a greater share of pension assets to our world.

UNCOVERING OPPORTUNITIES

Of course, it is important to define what a small-cap rally is—it's been so long since we really have enjoyed an experience like this, that most may have forgotten. During the 70 years between 1926 and 1996, we had five distinct periods when small caps outperformed large caps. The average duration of the outperformance was 5.5 years, with the longest being 8.3 years. Usually, the outperformance was 2:1.

Now that you know what you should expect, how do you maximize the opportunity? It's been so long since we have truly enjoyed a small-cap rally that many may have forgotten how to best benefit from times like these.

We always search for companies that should appreciate in value. But we always keep a special eye out for those undervalued companies that can grow their operations and expand their market value beyond the "10-bagger" hurdle that we all want to enjoy—we call these opportunities "special situations." Of course, those companies are few and far apart, but as we have searched about, we have stumbled upon very interesting companies that Wall Street doesn't have time for.

What can we relay to others that we've learned from our past experience?

First, you must understand that "special situations" are individual companies that outshine their peers and perform well beyond the averages. You are not going to pick tomorrow's blue chips today just by choosing the right industry group. You have to find the right combination of traits all in one place.

WHAT TO LOOK FOR

Real "special situations" include five key ingredients.

The first ingredient is vision. These are not companies parroting the industry mantra. The vision has to be distinctive, it has to be expansive, it has to be accepted by the associate team, and it has to be recognized and embraced by the company's customer base. For example, the company mantra is not "We're going to make billions and billions of chips!"

A very good example of a poor vision versus the right vision comes from the experience of Electro Scientific Industries back in 1992. Originally, the firm's belief was that it "brings lasers to technology." It was an engineering firm that liked to play with lasers. They were successful with a couple of leading-edge applications, but that only worked for so long. When the stock was $4, they brought in new CEO Don VanLuvanee, and he made the new mantra, "the toolmaker to technology leaders." It worked. The scope was broad enough, the message specific enough, and the magic powerful enough to reverse the declining trends. It was also clear that the right management was in place. The stock is touching $65 several years later.

That brings us to the second ingredient necessary for success:

management. There are four aspects that are imperative for management of special situations:

- Passion: Without a love and drive for achieving the opportunistic goal, you don't have management, you have caretakers.
- Experience: Enthusiasm is no substitute for experience. In our recent quest to name a winner for the RedChip CEO Award for 2001, it was quite apparent that the contenders with proven financial and market prowess were typically in their 50s, and their successful ventures were their second or third careers. The recent dot-com situation also illustrates the value of experienced management. Enthusiasm is no substitute for experience; on the other hand, nothing is better than enthusiastic experience.
- Focus: Without focus, passion has a habit of expanding an operation's boundaries well beyond the scope of safety, and that often mires companies in details that can kill it. I've witnessed a lot of special situations that have narrowly focused on one successful enterprise. I've witnessed no conglomerates that have become a special situation.
- Bench depth: Good management understands that today's market requires substantial team depth and varying talents, but also different managers with different skills to be called upon to handle varying demands.

BRAND NAMES

After vision and management, the third major ingredient is "brand." It is one of the secret elements of success that time and again has proven to be the underlying strength of an operation. When markets are tough, competition keen, or inevitable missteps occur, brand has often stepped in to save the day, preserve market awareness, and energize the recovery when conditions have been righted.

When investors think of brand, they immediately think of either retail trade names or product categories. A good example is Nike. Back in the early 1980s, the professional investment community that didn't live in Portland couldn't understand how a sneaker company could ever grow beyond the upper limit of putting three pairs of $89 shoes in each closet. Yet, Nike evolved from just a single-line, court-shoe supplier to a multifaceted sports shoe, apparel, and equipment behemoth. Brand was the obvious magic element in this success story.

But brand doesn't have to be just what a company sells at the counter. There is Union Pacific and the "We can handle it" logo; Medicis' "The dermatology company"; and how about On Assignment with just "On Assignment." Brand is an extension of the vision and works to convey the vision as the company develops in the market. However, brand without vision does not work. Look at Xerox and consider how hollow that company has become.

This last point is a good introduction to element number four—technology or, more specifically, a lack of dependence on it as the primary business. If you were to survey the special situations that really developed beyond the small-cap threshold, I'd wager that the great majority were not technology concerns. Some successful technology operations have broken beyond the glass ceiling, but when it really comes down to it, technology winners would stand in the minority. Why? People in the technology field depend too much on their scientific or engineering breakthroughs and forget all the other elements of a successful operation. Indeed technology is only good for so long before someone else invents a more powerful chip, a stronger drug, or a more elegant process. The annals of business are filled with success stories that ended up in the scrap heap because they had the latest and the greatest, and then they didn't.

Why is Tektronix still a billion-dollar firm even though it had, and still has, some of the most advanced electronic measurement equipment on earth? At the same time, Hewlett-Packard now dwarfs its once formidable competitor. The latter grew its markets, its distribution channels, and its management prowess, while the former clung to its technological lead.

Lastly, special situations have to have a strong operating model—operating margins or license fees or some unique distribution capability that permits strong profits.

It is possible to be a special situation without egregious profit margins. Look at Advanced Marketing—its margins are 10%, which is all the warehouse clubs would allow. But today with its market presence (it handles one in four best-selling books sold in the country), large scale, and distribution capability, it is working its gross to 15% and still watching its bottom line expand well in excess of 25%.

Of course, leverage can take many forms. There is the normal approach of gaining operating leverage by improving volume. There is balance sheet leverage like that enjoyed by financial institutions. But there are other opportunities for leverage. For instance, there is creative leverage—at RedChip, we write it once and publish it many, many times. There is also people leverage, like that experienced at UCBH Holdings, where that bank's very close ties to the Chinese community of San Francisco makes for people leverage. Leverage is always necessary for success, but there are really all kinds of leverage that can be tapped beyond the textbook examples.

THE SMALL-CAP REVIVAL

In summary, I think the market is primed for a turnaround in the next couple of months. The case for a small-cap stock revival similar to the one enjoyed between 1974 and 1982 is strong and it is approaching.

And if you want to hunt for special situations, the kind that always have performed, and the kind that particularly will perform in the next several years, look to the stocks of companies led by managements with vision, but also managements that express passion for what they are doing, and that have experience, focus, and bench depth. They are companies that are succeeding in a niche, and because of that success they are developing decisive brand equity in the market. And they include operations that benefit from one distinctive form of operating or balance sheet leverage. ✥

AAII.com

American Association of Individual Investors

- Learn how to screen for small-cap stocks in the **Stock Screens** area.
- Get current statistics on small-cap stocks you are investigating:
  - —Use the **Quotes & Research** function under Tools
  - —Read the **S&P Reports** under Tools
- Use the **Search** tool to:
  - —Access other articles written by Marcus Robins
  - —Read more about small-cap investing
- Post your opinions on this article and read the opinions of others on the **Stocks Message Board** under Community.