THERE'S GOLD IN THOSE HILLS FOR INVESTORS WHO ARE PATIENT

By Marcus W. Robins

For investors in small- and micro-cap stocks, impatience and a day-trader's mentality are the two greatest sins. If you have an itchy trading finger, you can jettison a very successful company out of your portfolio much too early.

My great grandfather on my mother's side was one of those hapless souls who sought his fortune prospecting for gold in the Yukon. But he learned pretty fast, unlike others caught up in the Alaska Gold Rush, that the real money was not in the gold but in supplying or abetting the gold diggers. Between his dogsled supply trains, toll ferries, and bridges, the man returned to Portland with a tidy fortune.

While my colorful ancestor gave in to the natural tendency of many people to seek quick riches, he soon got practical and capitalized on what he knew and understood best. But too many of us chase the gold at the end of the rainbow—we swap jobs rather than build careers, we trade rather than invest. We tend to be impatient and all too often we suffer for it.

For investors in small- and micro-cap stocks, impatience and a day-trader's mentality are perhaps the two greatest sins. If you have an itchy trading finger, you can jettison a very successful company out of your portfolio much too early.

I admit that in my own portfolio I have suffered losses because I've held on to a position too long or didn't react fast enough to bad news. But such mistakes are insignificant compared to the enormous gains I have foregone by selling too soon.

The point is, it should take a lot more than just a wiggle in share price to cause you to pitch a small- or micro-cap stock out of your portfolio, assuming you did your homework when you bought in and were persuaded that the company offered long-term value.

THE SMALL-CAP ADVANTAGE

Before repairing willy-nilly to what you may regard as the safer confines of the S&P 500, please consider the many ways that small- and micro-cap companies can outperform their larger brethren over the long haul, and why they need to be treated differently as an investment:

Compounding: From tiny acorns, do mighty oaks grow. The single most powerful engine of growth in the value of an equity investment is compounding—particularly the internal compounding of businesses that build true value.

To illustrate, consider Measurement Specialties, Inc. (AMEX: MSS), a manufacturer of consumer, commercial, and industrial sensors found in bathroom scales, paint sprayers, road traffic counters, and underwater sonar listening devices. For the most recent six-year period (including fiscal year 2000, which ends next March, for which we're forecasting $1.15 in earnings), this firm has produced an average return on equity of 30% while building a meaningful core business as a foundation for growth. While its book value has nearly tripled to an estimated $3.10 for this fiscal year, the share price has soared over the last year from $3 to $18, with little in the way of brand-building or shareholder awareness. Its financial house is in order and it is now generating an enviable stream of earnings. But its above-average return on

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equity was a precursor of the investment opportunity its shares ultimately would embody.

The moral of the story is that if you've had the insight to invest in a small company with fast-paced internal growth—that is, a high return on equity—you should ride out any episodic downdrafts in order to gain the full benefit of the internally generated power of compounding. In contrast, these kinds of internal growth rates are not typical of large-cap stocks.

Branding: This is an immeasurable measure of financial prosperity. In all of my years in the financial services industry, nothing has made as big an impression on me as Wall Street's total disregard for the power of brand, specifically Nike's brand. Remember, Levi's in the early 1980s was a major fashion brand, but a sneaker manufacturer from Portland? "It just couldn't be any good as a long-term investment," was the thinking.

When Nike went public its primary products were court shoes, and institutional investors focused more on how many pairs of sneakers each household in the United States could buy rather than how big the potential market might be if Nike extended its brand into many sports, to other equipment, and even into fashion wear.

Of course, Wall Street, like everyone else, is handicapped by the fact that brand power really defies measurement. But the growth of brand awareness in the marketplace can propel the operating model and the value of a stock like nothing short of a booster rocket. You see its potency all around you. All Coca-Cola or Disney has to do is slap a logo on something, anything, and it will sell at a premium—that's the power of a successful brand. This facet of value is a little better understood than it once was, but, once again, the real virtue here is patience—the patience required to see a company through its early-stage efforts to build its brand.

We follow a company called Koala Corporation (Nasdaq: KARE), whose diaper-changing stations may have caught your attention in restrooms at airports, McDonald's, or any of a variety of other convenience stops. Koala's "brand equity" is something that its management is taking great pains to nurture and extend. Koala has used its ubiquitous changing stations to establish its name and make it a brand that is synonymous with family friendly environments. Now, what does that really mean? Families are more mobile than they've ever been. That means that parents are taking their "young'uns" when they shop, eat out, buy a car, discuss their finances with consultants, etc. It also means businesses that cater to families will increasingly have to offer a range of "family friendly" conveniences—play stations, toys, and the like—just to maintain their competitive edge. Koala is not only in the changing table, restaurant high chair, and booster buddy business, but it has extended its reach into child amusement centers, outdoor park play equipment, and restaurant play structures as well.

During its assault on comfort stops, Koala has racked up a 24.4% compounded rate of growth in earnings from $0.65 in 1995 to an estimated $1.55 for the current fiscal year based on the success of its growing brand and the additional growth it is leveraging through the acquisition of other equipment manufacturers. More impressive, however, is the appreciation of its share price. Without the benefit of "bulge bracket," Wall Street investment banks flushing out investors and drumming up attention for Koala, the share has risen from $6 back in 1995 to nearly $28 this summer for a 47.0% compounded rate of price appreciation. It's difficult to separate out how much of that is attributable to organic growth and how much is due to development of brand equity and growing awareness of the stock given the rise in the shares. But there is little doubt that brand development has been a pivotal element in Koala's success.

Discovery: You'll get one of the fastest rides to the top of the market you'll ever enjoy when you latch on to a company that is in the process of being "discovered." There really are no boundaries on how fast or how high a "discovery run" can carry you. But it works. Hitching such a ride sounds easier than it really is, but however difficult the search may be, the vehicles can be identified early.

A variety of influences can make under-recognized and inefficiently priced stocks advance.

The most frequent engine of a "discovery run" is the development of a brokerage/institutional investor sponsorship over time as management re-establishes its credibility and builds a growing base of earnings. A surge of interest on the part of individual investors is another engine that is growing in importance. I was introduced to Newell Corporation, for example, before it had bought Rubbermaid, not at an analyst society luncheon but at an investment club convention in Chico, California. I discovered that Newell was a favorite with the investment clubs long before it became a household name on Wall Street because of its steady ramp in earnings and regular efforts to build interest among investment club members.

RECOGNIZING THE STAGES

As the "constituency" for a stock becomes established, there seems to be certain ranges, or levels, that mark off the different interest groups that participate not only in the company's operational development, but also in its price development or market capitalization. The levels often develop sequentially with resting pauses that tend to demarcate the beginning and end of each successive elevation. Recognizing these stages can help you develop more patience to ride out the inevitable blips and hang on until the final stage of appreciation bliss.

The base level is the "doldrums" price range—hardly a stage but more of a saucer-shaped plateau, or price level purgatory, that stays nearly flat and uninteresting for at least a year, and possibly several years. The reason for this state of suspended market indifference is that the company in question has disappointed shareholders and its price has more or less found its natural, fundamental value.

Typically, how long a company is caught in the doldrums relates to a combination of how much it will take to pull earnings out of a slump, the turnover of shareholders from those who are throwing in the towel after repeated disappointments to those who believe in the upside potential, and finally, how long the drought of uplifting news that will spark interest lasts.

The next level is reached when old-fashioned, stock-picking, value brokers, small-cap money managers looking for "road kill," and, more recently, the opportunistic hedge-fund mavens, discover a company in their quest for either fundamental asset value or cash flow. Think of these investors as the "trapper-gatherers," or "second-hand rose" specialists of the financial markets who are looking for stocks that represent far more value than the current market price suggests. This recognition usually ties into an opportunity for the business to turn around operationally and once again become a stock worthy of respect.

Interestingly, this bounce from the doldrums to the next level often is quite protracted and most often represents the greatest risk to the money manager or broker, because the opportunity cost of missing some other rising stock is great or the performance of indexes embarrass the managed returns. Conversely, the transformation from a lousy, no-good, waste-of-time company to a reasonable operation most frequently provides investors the greatest reward since it is a transformation from a point where the "steak" is seen as nothing more than chopped liver with negative investor sentiment to the level of pâté, with all the flourish of a real operation.

The third tier comes after the transformation from a plague-ridden value stock to a company with apparent operational viability and income growth visibility. At this level, the investment bankers are sniffing around because they know that fast-growing concerns usually need growth capital.

To avoid any unintended disparagement, I'm really talking here about two distinct classes of beast. The first of the investment banker species usually is the regional or major boutique brokerage that can help secure equity financing needs between $20 million and $50 million. They often back their deal-making abilities with research coverage. To be fair, these investment bankers also are the ones that assume the most risk since the businesses they serve are not the most developed. By definition, the market cap is usually only in the range of $70 million to $250 million—they still are teetering on the fence and in danger at any moment of falling back into their old value range.

The second class of beast, the larger, bulge-bracket investment banks, generally writes research on the most actively traded companies, performs this duty whether serving as guaranteed investment banker or not (although the lineup between covered company and client seems to be even more stratified), and deals with far more established firms, nearly all of them household names.

The point is that when the investment bankers get interested in a company, they often do so to sell an offering in the immediate future or to maintain lively trading volume. Both of these activities are performed with their institutional clients or more substantial retail clients, who pay for the proprietary information or the opportunity to buy large blocks of shares. At this point, the firms being researched and touted by the brokerage industry are companies with established growth paths, established brands, sound balance sheets, and a risk-reward profile that has seemingly shifted to the extent that institutional investors are not as afraid to own the shares and therefore jeopardize their fiduciary responsibility.

Shares in companies that have become ordained as quality holdings seem to rise to the penultimate level of opportunity. Companies in this realm are now covered regularly by both brokerage and buy-side research departments. Institutional ownership rises well beyond the 50% level. The sad fact is that these stocks become far less "inefficient," which means they are better understood by the Street and the investing public and, therefore, the opportunity for "surprise" returns and for outsized capital appreciation is reduced.

The final tier of holdings are exalted names like Microsoft, Disney, Coca-Cola, General Electric, IBM, and Ford, which are featured nearly every day in the financial media or investment magazine publications. They are the mainstay holdings of the national indexes, and references to them don't need to include the usually short explanatory statement as to what they do.

When companies grow so large and are so well known that their names are as much the argot of Main Street as of Wall Street, much of the opportunity for appreciation is already well understood by investors or is already baked into the price of the stock.

SOME EXAMPLES

Here are some examples of

companies that are sitting at the different "market heft" tiers that I have been discussing.

At the bottom of the continuum, a disappointing value stock, one might consider Simula, Inc. (NYSE: SMU—$6). The top line continues to grow as this company achieves success in the side-impact airbag market, the military safety arena, and, unfortunately, the commercial aircraft seating business. It will generate close to $120 million in revenues this year. But the ramp and learning curve problems related to its commercial aircraft seating business has just about derailed this company and certainly sullied its credibility. Fortunately, prospects appear to have turned the corner. The stock has dropped from the $20 range to the mid-single digit area where it has languished for what seems like forever. It should turn in a profitable year (with earnings per share of maybe $0.30 to $0.40), the first in almost forever.

Next, Excel Technology, Inc. (Nasdaq: XLTC—$14 3/8), an "operating discovery" stock waiting to be discovered, is an unloved, underfollowed company that manufactures laser systems, but with strong financial returns for the past four years, including 1999, it produces some of the highest profit margin ratios in the industry, incredible cash flow, a strong balance sheet, and yet it sells at just 14.5 times current earnings. This company is one of the most profitable producers of industrial lasers used in marking, cutting, and shaping material in general production and manufacturing settings. Operating performance was marred a little last year when sequential earnings per share slipped from $0.73 in 1997 to $0.68 in 1998, but it appears that the business is well back on track to record an all-time high in profitability of nearly $0.95 for this calendar year. Right now, there is no real coverage by Wall Street, since there is no need to bolster the balance sheet with financial underwritings, and the acquisitions the company has made are essentially funded out of cash and cash flow.

Celgene, Inc. (Nasdaq: CELG—$25) is an example of the "investment bank" lamb for the slaughter. This is the company that sought and received FDA approval for thalidomide. The current fundamentals are nowhere near as glamorous as the two previous examples, but the hype surrounding the curative properties of CELG's *Thalomid* in the treatment of a myriad of cancers, Crohn's disease, and wasting found in AIDS and cancer patients, has lured a bevy of investment bankers to produce research reports on the stock. The growth potential of this company is large but uncertain. This year, revenues will reach $25 million but with a truly substantial loss per share. However, initial projections show that next year the company may actually see $50 million in revenues and turn the corner on profitability by mid-year. In the last year, the shares have moved from the mid-single-digit levels to as high as $25. Certainly, part of the rebound has been due to the resurgence of the market from last year's lows, but also the drug approval trial data and investment research coverage has helped to lift the valuation.

ABM Industries, Inc. (NYSE: ABM—$22) is the last example and one of the "pre-exalted" institutional working names that is large enough to be a favorite but not large enough to frolic among the greatest. This company is the old American Building Maintenance janitorial operation that is pretty well known in most of the major cities in the country. Revenues exceeding $1.6 billion this year and per share profits reaching toward $1.70, up from 1998's $1.44, have helped lift this well-run, pedestrian operation to a well-known, fairly covered holding in the ranks of institutional investors. Indeed, nearly two-thirds of the shares are held by money managers, even though Wall Street research coverage is still sparse. The shortage of minimum wage labor in this economy and the Fed's attempt to slow the pace of economic growth has greatly attenuated the enthusiasm the market previously had for the shares.

THE VIRTUE OF PATIENCE

Investors who want to follow a buy-and-hold strategy must run a gauntlet of influences that sway too many of us into premature action, from commission brokers (not discounters, who are salaried) whose compensation structure may encourage them to encourage you to trade, to the current tax structure that inserts murky tax considerations into the process and often results in less-than-optimal investment decisions.

But one of the biggest hurdles is human nature—either because of something innate or something learned in the deep aboriginal past, people want to reap the rewards of their efforts now rather than waiting patiently for a financial asset to compound.

Recognizing the various stages that companies go through as they mature may help you develop the patience you need to take maximum advantage of the profits available from small- and micro-cap investing. Uncovering the real gold takes time, but your patience will be well-rewarded. ✦