CHAPTER 1

Start Small, Finish Big—Discover Big Profits in Small-Cap Stocks

"If I was running $1 million today, or $10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50 percent a year on $1 million. No, I know I could. I guarantee that.

The universe I can't play in has become more attractive than the universe I can play in. I have to look for elephants. It may be that the elephants are not as attractive as the mosquitoes. But that is the universe I must live in."

—Warren Buffett, 1999, discussing small-cap stocks

An old saying claims that big shots are the little shots who just keep shooting.

In the case of the stock market—in particular, the world of small-cap stocks—that maxim is decidedly true. And that is terrific news for *you*. Over the last decade, I've developed a system for consistently finding outstanding small-cap stocks that deliver big gains to early investors. Throughout this book, I'll share everything you need to know to achieve similar results in your own investment portfolio.

All great companies start out small. They are built by entrepreneurs who invest their time and money, raise capital privately, and turn their dreams into reality. Many of the world's greatest innovations come from small, entrepreneurial companies, and very few come from the behemoths. In recent decades, smaller companies have increasingly been investing in research and development, helping fuel the growth of the overall economy. To illustrate: In 1981, 71 percent of corporate research and development dollars in the United States was spent by companies with more than 25,000

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employees, while companies with fewer than 1,000 employees spent just 4 percent. By 2006, the large companies' share had dropped to 38 percent, while the small companies' share had risen to 23.7 percent; it is a trend that has continued to shift.[1]

Why? Charles Matthews, executive director of the Center for Entrepreneurship Education and Research at the University of Cincinnati, has observed that smaller firms historically employ a large percentage of computer analysts, engineers, and scientists. This drives an interest in innovation and research; today, most new jobs are generated among small companies, where the growth rate is going to be rapid in comparison to their larger competitors.

Small businesses are excellent incubators of innovation, especially technology-driven innovation. With generally flatter organizational structures, these leaner, hungrier companies can cut through the red tape, remain focused, and drive innovation with passion and efficiency.

The best of these young, innovative companies become publicly traded small-cap stocks. This allows individual investors like you to buy a piece of the action, and participate in the future growth and profits of these companies.

Small-Cap Investor: Eight-Step Process for Big Profits from Small Stocks

Throughout this book, I share with you my eight-step system for finding great small-cap stocks with big potential for financial out-performance and share price gains. I will show you exactly what you need to do to become a small-cap guru and profitable investor in small-cap stocks.

There are eight simple steps to follow in order to find, research, and analyze small-cap stocks that could put big gains in your portfolio.

Step 1: *Growth Trends:* Identify growth trends and market sectors positioned for rapid growth in the years to come.

Step 2: *Finding Potential Winners:* Screen more than 7,000 publicly traded companies to find those companies that are unknown performers positioned to grow.

Step 3: *Fundamentals Matter:* Understand the fundamentals of the potential investment, including products, services, and management's ability to run the business.

Step 4: *Financial Performance:* Review and evaluate key metrics in a company's financial statements to understand historical financial performance.

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Step 5: *Earnings Quality:* Look for red flags that indicate financial manipulation or fraud to avoid investing in a small-cap lemon.
Step 6: *Growth Outlook:* Develop an understanding of expectations for growth to make valid valuation comparisons.
Step 7: *Technical Analysis:* Understand the technical indicators of share price movements to help timing of investments, and maximize profits while limiting losses.
Step 8: *Pulling the Trigger:* Determine the optimal timing for entering new positions by using effective trading strategies.

Using my system for finding, researching, analyzing, and ultimately buying and selling small-cap stocks will make it easy for you to find those companies with huge potential upside, and determine when and how to maximize your profits.

Throughout the book, I show you exactly how to use these eight simple steps for consistently finding and profiting from great small-cap stocks before their shares take off.

Small Caps as Generators of Growth

Many of the smaller, innovative growth companies that are publicly traded fit the definition of small caps. Market capitalization is a measure of the total value of a company, calculated by multiplying shares outstanding by share price. As the term "small cap" suggests, these are the smaller companies, those with a market capitalization below $2 billion (mid caps range in size between $2 billion and $10 billion, and large caps are those with market caps exceeding $10 billion).

On my investment website, SmallCapInvestor.com, I focus on the small-cap stocks with market capitalization *below* $2 billion, and often those below $500 million. It is often the case that the smaller the better when trying to find companies poised to deliver big gains. Table 1.1 shows a list of the 10 best performing stocks and their returns for the decade ending December 31, 2007.

The returns are impressive. But look at the market capitalizations of these companies in 1998; nearly all of them are below $100 million. The smallest of the small caps tend to perform best—those unknown gems that have not yet become the darlings of Wall Street.

How many of these companies had you heard of in 1998, or even today after their significant growth? With the exception of Apple, probably not many. This is because most of the best small-cap opportunities are not well known today, and the key is to find them right before they become huge successes and their shares have risen significantly. This is the challenge.

TABLE 1.1 **Top 10 Best Performing Stocks: 1998–2007**

Company	Jan. 1, 1998 Market Cap	Dec. 31, 2007 Market Cap	Return 1998–2007
Hansen Natural (Nasdaq: HANS)	$16.5 million	$3.83 billion	21,201%
Asta Funding (Nasdaq: ASFI)	$3.1 million	$326.3 million	8,252%
Celgene (Nasdaq: CELG)	$129.0 million	$22.74 billion	6,771%
Apple (Nasdaq: AAPL)	$1.7 billion	$176.4 billion	5,959%
Comtech Telecommunications (Nasdaq: CMTL)	$11.3 million	$1.34 billion	4,246%
Daktronics (Nasdaq: DAKT)	$23.1 million	$917.4 million	3,493%
Green Mountain Coffee Roasters (Nasdaq: GMCR)	$24.7 million	$1.0 billion	3,455%
Clean Harbors (CLH)	$15.8 million	$1.23 billion	3,378%
Innodata Isogen (INOD)	$3.1 million	$128.9 million	3,135%
Immucor (BLUD)	$70.0 million	$2.39 billion	2,941%

Source: Capital IQ, www.capitaliq.com

What is most appealing about small-cap stocks? There are a number of attributes. An investment-worthy small cap is often a young company experiencing its fastest period of growth. The company introduces new products or services, launches strategic partnerships, or enters a new market while still flying under the radar of its larger competitors, remaining unnoticed by Wall Street analysts and investors. With fewer employees and lower expenses compared with larger companies, small caps have the unrestrained flexibility to pursue growth and have the ability and desire to take risks that are often avoided by the dominant industry players. This situation can catapult a small, unknown company into a roaring success, and in doing so, create millionaires out of early shareholders who stay the course.

Want proof? Let's examine a few examples of some of the best performing stocks in the history of the stock market. While I'm sure you're familiar with each of these companies, perhaps you are less aware that all started as entrepreneurial, small-cap companies that grew into well-known businesses, making big gains for early investors:

- *Cisco Systems* (Nasdaq: CSCO): An investment of $10,000 in 1990 grew to $34.5 million by 2008, a gain of over 34,000 percent. The company's IPO valued the tech company at $224 million, and 18 years later the company was valued at $180 billion. The reason that Cisco has grown in an explosive arc is due to yet another trend identified early and ridden from there on: computer networking. The brainchild of husband and wife Len Bosack and Sandy Lerner, the company got its start by developing and selling routers, but not just any other router like those already on the market. Theirs was the first to support multiple network protocols; although that technology was eventually supplanted, Cisco had its foothold. The company later branched out with careful insight, moving into Ethernet, switching, security, ATM networking, and other areas. Although Cisco was, in fact, the most valuable company in the world at the peak of the dot-com boom of the late 1990s and into the early 21st Century, it has since declined in value but remains one of the icons of the American technology community.

- *Dell* (Nasdaq: DELL): went public in June 1988 as a small-cap valued at $200 million. As of the end of 2008, market cap was more than $20 billion. An investment of $10,000 in June 1988 grew to $2.8 million in 20 years. Why the meteoric rise? The most revolutionary aspect of Dell's operation was its direct sales marketing strategy. Rather than using resellers to sell its products, Dell established a one-on-one relationship with its customers. But that meant more than just direct selling. It spelled the beginning of a highly personal form of interaction with Dell customers. For instance, in 1985 Dell began establishing customer service as the bedrock of the company's philosophy and approach, offering a risk-free return policy and next day in-home professional support. Three years later, Dell raised $30 million in its initial public offering, and the company was off and running.
- *Microsoft* (Nasdaq: MSFT): An investment of $10,000 in 1986 was worth $3.4 million by 2008, as the company's market capitalization soared from $488 million at the time of its IPO to over $200 billion. An idea whose time had come—the personal computer in every household—quickly established Microsoft as the premier provider of user-friendly software. Although the company is now synonymous with its line of Windows products, its first real commercial success derived from its DOS operating systems (remember those?). Microsoft beat out IBM because its Windows system was simply easier to use—in fact, much easier. The company debuted in the public market with a share price of $21. Thanks to these and other innovations, by December 1999 the price per share (adjusted for stock splits) topped over $17,000.
- *Wal-Mart* (NYSE: WMT): An investment of $10,000 in 1972 was worth $7.61 million by 2008. Like other small companies that blossomed, Wal-Mart captured and leveraged a revolutionary idea—in Wal-Mart's case, discount retailing. The company went public with a market capitalization of only $21 million, and it was worth $200 billion by 2008. Prior to opening his first store in Rogers, Arkansas, in 1962, Sam Walton exhaustively researched the prevailing consumer market and determined that shoppers could live better by saving on a broad variety of goods and products. For Walton, that was in large part a bottom-up proposition;

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as the company grew, Walton still tried to visit each store at least once a year, asking employees for their input and singular perspective of what consumers wanted and valued most. (This direct market research style is employed by Starbucks founder Howard Schultz and other retail executives.)

Although Wal-Mart has come under fire for labor practices and other issues, its success is undeniable. By 2009, 7,390 Wal-Mart stores (and its adjunct Sam's Club operations) were open for business, employing more than two million people and making the company the largest retailer and private employer in the world.

These are all extraordinary success stories, but they're by no means exceptions to the rule, particularly when you look at the long term. While these are the big name winners that every investor aspires to duplicate with his or her investments, buying Cisco Systems in 1990 and holding it until today isn't the norm. But for every Cisco Systems or Microsoft, there are hundreds of lesser-known small-cap companies providing early investors with gains of 100, 300, 500, and even more than 1,000 percent. Even if the company doesn't become a household name, investors can bank major gains from the appreciation in share price. And the best part is that most people, active investors included, have never heard of many of these companies, even after they have posted huge returns. Table 1.2 identifies some of these lesser-known success stories over the past five years.

Small-cap stocks fit nicely into just about anyone's investment portfolio. No matter if you're in your twenties, saving for your children's college education, or currently retired, small caps have a place in a well-diversified plan, along with mid- and large-cap equities and fixed income securities. The growth that can be achieved with small-cap stocks is significant, and can help boost the returns for a diversified portfolio. For this reason alone, small caps must be on the table for every investor.

TABLE 1.2 **Top Five Best Performing Stocks: 2003 to 2008**

Company	Share Price December 31, 2003	Share Price December 31, 2008	Five-Year Gain
Terra Industries (NYSE: TRA)	$2.48	$21.12	751%
Cleveland-Cliffs (NYSE: CLF)	$3.59	$27.19	657%
ViroPharma (Nasdaq: VPHM)	$2.89	$11.31	291%
PetroQuest (NYSE: PQ)	$2.30	$ 8.53	270%
AspenBio Pharma (Nasdaq: APPY)	$1.40	$ 4.80	242%

Source: The Motley Fool, www.fool.com

An Example of Small-Cap Success

The companies highlighted in the previous section make my point that finding the great small-cap companies before they take off is a profitable venture. Figure 1.1 shows an example of another small cap that I tracked, culminating in a decision to alert my subscribers to the opportunity.

I am sure you have never heard of Almost Family Inc. (Nasdaq: AFAM). Almost Family provides in-home health care services in nine states (Florida, Kentucky, Ohio, Connecticut, Massachusetts, Alabama, Indiana, Illinois, and Missouri), bypassing nursing homes and other facilities that most elderly individuals and their families would rather not use. Almost Family has experienced extraordinary gains in share price. Have a look at how the company's stock trended from 2004 to the latter part of 2008.

This growth is attributed to several key factors, primarily structuring services to suit a carefully tailored market. From 2003 through 2007, sales rose dramatically from $59.5 million to $132.1 million, an increase of 122 percent. Over the same period, earnings per share (EPS) soared from $0.02 to $1.40. As the aging of America continues—with increasing numbers of the population living to an older age and Baby Boomers approaching their retirement years—the need for comprehensive elder care has never been so critical.

The combination is a powerful one, a growing trend met by a personal option that allows the elderly to remain in their homes and, in effect, recognition of both a nationwide pattern and the emotional appeal of this approach. As a result of this attractive marketing of services, Almost Family was named number 24 in the *Forbes* ranking of the best small companies in America in 2008.

FIGURE 1.1 Almost Family Inc.
Source: Yahoo! Inc.

Almost Family has been in business for many years. However, many great small-cap companies are young and don't have decades of financial history. It is most important to take the data available and evaluate it to determine the company's performance. The financial performance from the past few quarters or year will provide a much better understanding of the current performance and outlook for the future than financial performance from 10 years ago. After all, our investments are really a bet on the future of a company and not the past. Certainly, historical financial results must be examined when trying to predict the future, but the basis of all investments must be forward thinking, not backward looking. Almost Family's stellar financial performance even during a challenging economic period demonstrates the company's strong business model and resilience.

Ned Davis Research, an investment research firm, reported in 2008 that "small-cap stocks tend to significantly begin outperforming large-cap stocks at about the same time and typically continue leading for at least a year after the recession has ended." The same study observed that in a one-year period after the last nine recessions, small caps yielded an average of 24 percent return, versus less than 18 percent from the S&P 500.[2]

It is helpful to consider the long-term performance of small caps over time to understand how this class of equities can benefit long-term investors. To illustrate that point, look at Figure 1.2, comparing returns of five asset classes: U.S. Treasury bills, long-term government bonds, corporate bonds, equity returns from larger stocks on the New York and American stock exchanges, and small stocks. Figure 1.2 assumes that $1 was invested in December 1925 and that all proceeds were reinvested.

This research from Duke University indicates that over the long-term, small-cap stocks outperform all other investment classes. From December 1925 to June 1995, small caps led the way: $1 invested in small caps grew to $3,425 during this period. $1 invested in the next best performing investment—the S&P Total Return, representing large-cap stocks—grew to just $973.

Figure 1.3 is the annual chart showing the cumulative returns (for $1 invested, and with dividends reinvested) of large caps and small caps from 1926 to 2004.

Figure 1.3 reveals two significant facts:

1. Small caps have outperformed large caps by a 5-to-1 ratio since 1926, especially over the last 40 years. This "size effect" is significant; not all of the excess returns can be explained by the higher risk in buying shares of small-cap companies.
2. From 1926 to 1957, small caps underperformed large caps on a consistent basis. Throughout the 1920s, many U.S. investors were willing to buy shares of small- and mid-sized companies believing that they

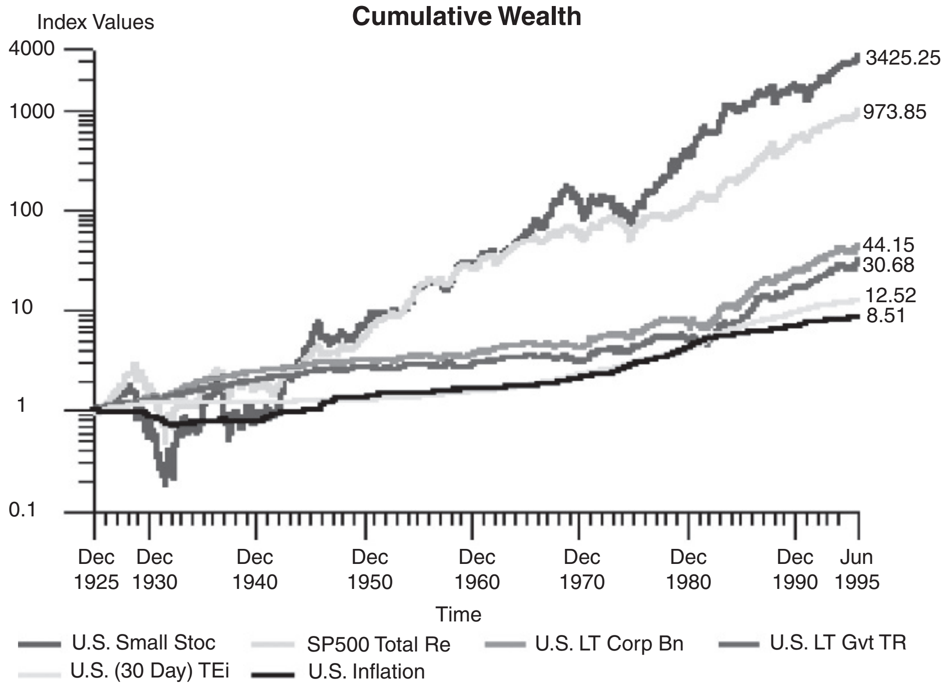

FIGURE 1.2 Cumulative Wealth 1925 to 1995: U.S. Small-Cap Stocks Outperform Other Asset Classes

Source: Duke University

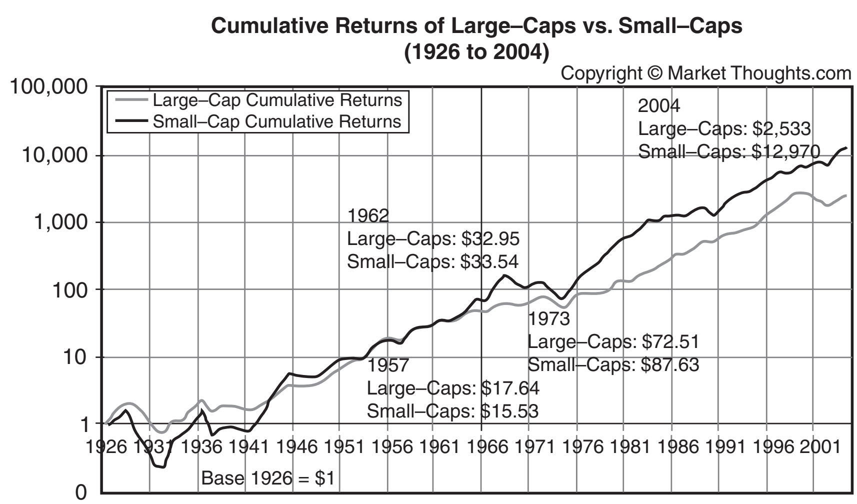

FIGURE 1.3 Cumulative Returns of Large Caps vs. Small Caps (1926 to 2004)

Source: Copyright © 2009 MarketThoughts LLC could sustain themselves as well as large-sized companies during economic recessions. The huge bear market and subsequent Depression from September 1929 to July 1932 dispelled that belief, and for the next 30 years, investors refused to buy shares of small caps unless they were trading at deep discounts to shares of large-cap companies. More stringent reporting requirements by the SEC after the 1929–1932 crash did much to improve the quality of smaller companies listed on the NYSE, and provided investors with the information needed in order for them to determine whether the stocks were sound.

It may be reasonable to believe that an intelligent investor can simply put money in small-cap index funds and forget about their investment until retirement. But this strategy may not be wise, as small cap out-performance has also been mired in bull and bear markets since 1926. For example, large caps outperformed small caps from 1926 to 1931. They beat small caps again from 1946 to 1948, and again (with the exception of 1954) from 1951 to 1957. Just as stocks have outperformed bonds on a long-term basis but underperformed for significant periods of time, it is not a given that small caps will outperform large caps every year. Table 1.3 is an illustration of historical periods where small caps have outperformed large caps consistently.

Indices are designed to yield average returns. If you buy the Dow Jones Industrial Average index, and the stock market moves higher, it's a safe bet that the Dow will move in-line with the overall move of the stock market. However, investing in indices isn't a good option for investors looking to beat the market. For investors seeking above average returns, individual stocks are the way to go.

TABLE 1.3 **Periods of Small Cap Outperformance in the U.S.**

Periods	Duration (Years)	Outperformance (%)
1932 to 1934	3	105
1938 to 1945	8	224
1949 to 1950	2	6
1958 to 1959	2	20
1963 to 1968	6	152
1974 to 1983	10	344
1991 to 1994	4	42
1999 to 2004	6	135
Average	5.13	129

Source: Ibbotson (SSBI Yearbook)

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The Russell Investment Group manages several well-known indices, including the Russell 2000 and Russell MicroCap, which serve as barometers for small-cap stocks. Russell has claimed that large caps outperformed small caps from 2005 through 2007. If this is the case, then the 1999 to 2004 period of small caps out-performance ended. Small caps continued to lead the market for several years through the dot-com crash and decline of the market in 2001. As with all investments, no one class of equities can outperform forever. While small caps underperformed compared with large caps from 2005 through 2007, evidence shows that the smaller companies will lead the market coming out of a recession, and that these companies bounce back faster. After the crash of 2008, small caps will lead the way. Regardless of the overall performance of small caps, there are always opportunities for individual investors to find great, profitable, high-growth companies trading at very attractive valuations. And through this book, I provide you with the strategies required to find and profit from these opportunities in good markets and bad.[3]

Small-Cap Value Stocks Outperform Large-Cap Growth Stocks

Between 1926 and 2004, large-cap growth stocks had an average annual return of about 9.26 percent. Accordingly, $10,000 invested in large-cap growth stocks in 1926 would have grown to about $10 million by 2004. That's not too shabby. But this pales when compared to the impressive 15.9 percent *annual return* of small-cap value stocks in the same time period. So $10,000 invested in small-cap value stocks in 1926 would have grown to about $1 billion by 2004.

Figure 1.4 shows a summary of these returns from the *New York Times* in 2008.

The difference between the highest and lowest returns is dramatic. If only we had all bought $10,000 worth of small caps in 1926! Unfortunately, most of us weren't alive at that time, and if we were, we likely didn't have $10,000 and the conviction to buy small caps.

Profitable Small Caps Don't Always Make Gains on Day One

We have seen how small caps historically outperform other investments over the long haul. But buying and holding a small-cap index may not be the best way to generate big returns in your portfolio today. However, investing in a selective group of individual stocks poised for rapid growth and trading at attractive valuations can deliver big gains and improve the total return for your investment portfolio.

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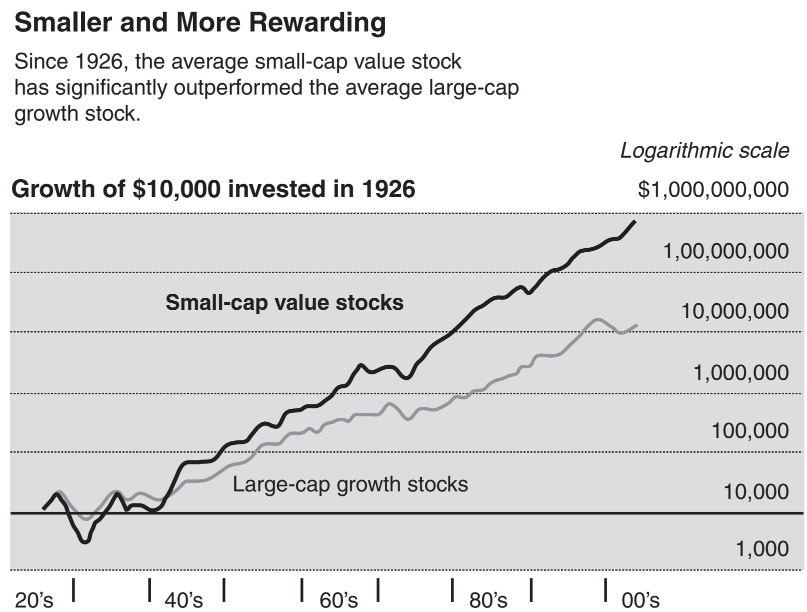

FIGURE 1.4 **Smaller and More Rewarding**

Source: The New York Times

Let's go back to an individual stock example. Small-cap success is not exclusively the story of companies starting out small and getting bigger. Many equally appealing examples involve turning around a bad situation and creating a new direction.

In other words, small-cap successes are not limited to companies that started small and took off from the day they went public. There are plenty of successful turnarounds as well—companies that fell on hard times, only to recover under the leadership of a new team or with a different business direction or strategy. Bankrate Inc. (Nasdaq: RATE) is one example. Bankrate.com is a leading website for consumers seeking information about loans, including home and auto loans, and credit cards. Bankrate went public in May 1999 at $12 per share.

Along with other Internet stocks that dropped like rocks with the dot-com crash of 2000, by the end of 2001, shares had lost 95 percent of their value, plummeting to 65 cents a share. Former Bloomberg L.P. executive Elisabeth DeMarse was brought in to turn the company around in 2000, but the stock languished for two more years. It was during this time that I discovered BankRate. The company was cash flow positive, had a market

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cap of $15 million, $8 million in cash in the bank, no debt, and growing revenues and earnings. I presented the stock to subscribers of my small-cap newsletter service when shares were trading at $1.05 in July 2002.

The company then started reporting a long string of positive financial results; having lost nearly $17 million in 2000, the company reported a net profit of nearly $7 million just two years later. The stock made astounding gains. Shares increased over 5,000 percent between 2002 and 2008. By 2008, Bankrate's market cap had grown to $700 million. The stock ultimately went as high as $55 in 2008, an increase of 5,138 percent in six years.

Even though Bankrate struggled for a time, it hit on a formula that promised long-term success: personalized financing information, which paralleled an increase in loan requests as a result of the housing and refinancing boom and increased Internet advertising in the financial services sector. Rather than having to call banks and complete multiple loan applications, Bankrate became a one-stop shopping destination on the Web for individuals seeking home loans, car loans, or refinancing. In this case, the key to success was tapping into multiple growth trends—increased consumer borrowing coupled with growing online advertising spending.

Small-cap companies are up for grabs, and individual investors doing their homework often will find excellent investments not yet widely recognized by the smart money crowd on Wall Street. Small caps are where Main Street investors like you and me can enjoy extraordinary returns.

Bigger Gains from Low-Priced Stocks

It is important to differentiate between small-cap stocks and low-priced or penny stocks. Market capitalization is simply a calculation of the current market value of a company, and it uses share price to calculate one half of the equation. Stocks with low share prices typically have smaller market cap, but this isn't always the case. For example, consider Citigroup (NYSE: C), market cap $17 billion, share price early in 2009 of $3; Taiwan Demiconductor (NYSE: TSM), market cap $43 billion, share price $7. The SEC defines *penny stocks* as those companies with share prices below $5. Most of these are small-cap or micro-cap stocks.

Because small-cap stocks are often thinly traded (meaning fewer shares traded every day), even modest buying can move a company's share price quickly. And, because share price is often quite low, a $1 increase in the price of a small-cap stock often represents a much higher percentage gain than a similar shift in its larger brethren. When investing in stocks, it's all about banking big percentage gains and limiting losses. For example, a $1 price increase in a stock trading at $6 per share is a gain of almost 17 percent. The same price increase for a $50 stock is a gain of only 2 percent.

The surprising thing is that it's easier to find these stocks than you might think. Young companies are much more likely to create or take advantage of new trends in the marketplace and are more opportunistic. Just by looking at changing trends in recent years, such as the Internet, the iPod craze, and the soaring demand for alternative energy sources like solar power, investors can find great companies that will benefit from these developments. Small-cap stocks targeting these trends will financially reward those astute investors who pony up their chips while others continue to seek investments with certainty in an uncertain world.

Innovations are part of the reason small-cap companies are exciting; changing technology is another. At the beginning of the 20th Century, many people anticipated automobile or air travel advances, adding to a field of amazing new ideas, all creating new industries. Now, 100 years later, the world is a rapidly changing one. Old industries are going obsolete (when was the last time you needed to shoe your horse or, for that matter, drop off a roll of film to be developed?).

So what's the potential downside of small caps? The world economy was in flux from 2007 to 2009. The latter part of that period saw the largest prolonged drop in the stock market since The Great Depression, and no one could anticipate the next rise or fall, its extent, or its duration. Economic cycles are inevitable, but their timing and severity can never be known in advance. This is the elephant in the room that is too often ignored. Why? Because the market tends to be euphoric in good times and suicidal in bad times. It is like an ill-adjusted person, subject to extreme moods and rarely level-headed.

Remember, though, that even the most sobering time is also a time of extraordinary opportunity. Stocks—and, in particular, small-cap stocks—are at bargain prices when markets drop, especially to the extremes of 2008 and early 2009. Given that I'm an unabashed fan of small-cap stocks—and have enjoyed significant success in the recommendations I've shared with my subscribers—I have total confidence that small caps are most likely to lead the way to recovery after a bear market. This has been the case with corrections following a bear market in the past, and I believe the same will be true in the future.

However, since small-cap stocks are intrinsically more volatile, you also need to exercise extra care in examining their fundamentals. Small caps'

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higher relative volatility stems from their relatively low liquidity. This means there are fewer shares available to buy or sell on the open market compared to larger companies, so small caps can move fast, even on relatively small pieces of information or news. For the savvy and well-researched investor, this can mean quick and sizable gains; for those who fail to do adequate legwork, steep losses can just as easily be the result.

With less coverage from analysts, institutional investors, and the financial media, many small caps fly under the radar. This can be good for small-cap investors, as it provides opportunities. But it also means that most small caps go unchecked, without the coverage and exposure that exposes potential problems for investors. For this reason, thorough research is an absolute requirement for successful small-cap investing.

Many low-quality companies trade on the "pink sheets," an electronic exchange that is largely unregulated and considered the Wild Wild West for investing. Stocks listed there are often of suspect quality, as these companies may not be required to report financial results to the Securities and Exchange Commission (SEC). That can make it virtually impossible for investors to determine the value of the firm or its underlying stock. And even the OTC Bulletin Board (OTC BB), which requires companies to file timely financial statements with the SEC, can be littered with shell companies and "pump and dump" stock shams. While there are some great opportunities with OTC BB companies, avoiding pink sheet stocks is a wise decision for those looking to invest, rather than gamble, in the stock market.

Pump and Dump

"Pump and dump" is an illegal activity and a common form of stock manipulation. Here's how it takes place: Someone with a position in a stock promotes the company's value (pumps), often in an investment chat room or message board. If this succeeds and many more people buy the stock, the original investor then sells shares (dumps) at a profit. This works well with small caps because the number of shares is relatively limited, meaning even a small change in volume can make a big difference in the share price.

You also need to be diligent even with companies required to report their financials. Since small, fast-growing companies are often under pressure to maintain earnings growth, they can be prone to manipulate financial

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statements to make financial conditions look better than they actually are. Ultimately, not even the most adept financial chicanery can hide the truth; when word gets out that a company's financials are not up to snuff, its stock value can plummet. And when they crash, they crash hard.

The good news is that there are almost always telltale signs that point out either corporate malfeasance or merely bad bookkeeping. Later in this book, I'll go into detail about what to look for in a company's financials, arming you with the skills and knowledge necessary to separate potential winners from other small caps that are more likely to stumble.

Financials are a critical element in small-cap stock analysis. I encourage you to not overlook this aspect of small-cap research. The financials let you see just how well a small cap is performing and how likely it is that it will maintain that sort of performance. The numbers by themselves are only a single entry, but the trend reveals all. Understanding financial statements is key to successful investing, and I will delve into this in detail in a later chapter. First, however, I need to talk about some important theories about how the market works. A variety of different approaches have found their way into the market culture, and we all need to make sure that the method we use for trying to anticipate the direction of the next trend is in fact an *accurate* method. One of the most misleading among the popular theories about the market is the so-called efficient market theory.

The Inefficient Market Theory: The Small-Cap Advantage

The efficient market theory is preferred among academic market experts because it makes the whole thing nice and tidy and easy to predict, even though in the real world far more chaos prevails. The efficient market theory states that all information available publicly is already factored into the price of a stock.

What is wrong with this idea? In reality, chaos dominates the market. Price movement tends to consist of many overreactions in the short term, so that a single day's price movement is going to be corrected the following day (or the following hour). Buyers overreact when the news is good, scooping up shares at inflated prices; sellers overreact on the other side, dumping bargain-priced shares to avoid further losses. At the top of the price trend, greed dominates; at the bottom, the predominant emotion is panic. Among the hundreds of maxims about the market, the one that most accurately dispels the myth of the efficient market theory is this: "Bulls can make money, and bears can make money. But pigs and chickens get slaughtered."

The constant struggle between buyers and sellers, with trades made in the middle of a vast array of information, news, and rumor, demonstrates that in fact the market really operates on the *inefficient* market theory.

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Under this more realistic idea, the current price of a stock is the culmination of all known information, *true and false*, and that the overall mood has exaggerated the latest price movement (too far up on good news and too far down on bad news).

The efficient market theory raises many questions, and properly so. Most people can spot a flawed theory right away because their common sense tells them it cannot be so simple. The efficient approach is no exception. Consider these questions:

- Do all investors access the Internet at the same moment?
- Does everyone refer to the same websites for information?
- Do all investors talk to their family, friends, and people in the investment community in absolute lockstep?
- Is it not more likely that two people buying or selling the same stock are naturally going to make those decisions based on differing reasons?
- Can anyone reasonably argue that, if you both decide to buy a particular small-cap stock, you came to that choice based on an identical path of reasoning and information?

Remember, the efficient market theory doesn't claim to be instantly accurate all the time it says that investors have to allow sufficient time for the parity that the hypothesis embraces to level out. That's reasonable, but some stocks that have tumbled take years to recover while others bounce back within a quarter, if not sooner. Where's the parity in that? It's like putting a bag of popcorn in the microwave oven expecting to see every kernel pop in the exact same instance, or at least within a reasonable amount of time. The truth is that some kernels pop sooner, while others pop later. Still others never pop at all.

The Market as an Emotional Being

Another ingredient is the powerful effect of emotion. The stock market in 2008 and 2009 was in the heart of the maelstrom resulting from debate over the bailout of several major financial institutions, ongoing credit problems stemming from subprime mortgage write-offs, and growing unemployment indicating a recession. Here's one headline that topped the business section of a prominent daily newspaper of the time: "Persistent Anxiety over Tight Credit Sends Stocks Plunging." The bedrock of that headline was the word "anxiety." Variations of this theme could be found daily in the fourth quarter of 2008 and beyond.

Investor emotion—particularly with regard to the herd mentality of the market—can move mountains. Of course, that emotion can derive from

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empirical data, but that's not to suggest that every investor's and institution's gut reaction to the same bit of information is going to be identical. In a sense, that's asking for a far more robotic pattern than humans can ever be expected to follow.

In the interest of being as balanced as possible, there is more truth to the efficient market theory today than when it was first posited some 40 years ago, if only due to the speed and broad access of the Internet. The trouble is, it really has little to do with the hypothesis itself. The explosion of the Internet and the proliferation of computers and portable devices that display information have contributed to the fastest sharing and dissemination of investment news and analysis ever, so in that sense we enjoy the efficient communication theory. Beyond this, we have no more efficiency today than in the past. Markets have always been chaotic and always will be.

Bottom line: In an economy based on perfect information, all participants consistently act in a completely rational fashion.

Go to your favorite Internet financial site. What are the basic elements? Perhaps the Dow Jones Average is careening up or down. Maybe it's news about some giant company announcing layoffs or meeting (or failing to meet) earnings expectations or the financial and economic forecast for an entire nation or region.

Traditional news outlets have only so many resources and space with which to report what they deem to be of significance. When multibillion-dollar behemoths announce important developments, news that is every bit as important to small-cap stocks tends to go by the wayside—or, at the very least, becomes buried in the back pages. The media focus on the most popular companies with the largest followings. These typically are larger companies, given their well-known brands, large market capitalization, and extensive number of shareholders. In the media business, the larger the audience the better, since media companies generate most of their revenues from advertising. For example, Pfizer has 12 analysts following it; by contrast, there are dozens of promising small-cap pharmaceutical firms out there that have little or no analyst coverage. Think of just how quickly media outlets would spread Pfizer-related news versus that of a smaller player. Even today, someone, like myself, who's built a career around investing in small caps still has to proactively seek information on small caps. When it comes to larger firms, the news somehow always finds me.

And this is where you can profit. Do your research, look for news, and buy when the fundamentals and valuation tell you the stock is a winner. If you're an early and immediate buyer, you'll be likely to see a steady increase in your investment value as the news becomes well known by other investors.

While salient investing information is much more accessible than it was even a decade or so ago, accessibility doesn't by definition mean that every

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individual investor or every institution is going to access it—or, for that matter, treat it and react to it in an identical fashion.

While technology has made information increasingly accessible, the fact remains that it is still human beings who are pushing all those buttons. We see things differently. We react differently. We prioritize information in different ways and with different results. And, we all make mistakes.

As a diligent investor, you want to avoid the mistakes that other investors make, mistakes borne of focusing just on the big news at the expense of less visible data that, when interpreted properly, can result in remarkable investing profit. Taken in concert with the flaws of the efficient market theory, you need to investigate sources of information that point you to those small-cap stocks flying under the radar.

The Bottom Line

- The lion's share of innovation and development now derives from smaller companies.
- Small caps consistently outperform larger companies over the long-term.
- Big stock market winners such as Cisco, Dell, Microsoft, and Wal-Mart all started as entrepreneurial small caps and grew to become huge successes.
- As a small-cap stock investor, you seek the small, fast-growing companies that have yet to be recognized by the mainstream investing community.
- Many of the biggest small-cap winners share the attribute of recognizing a trend or market before others do and building their success on that innovation.
- Even a small increase in the price of a low-priced stock can mean a significant percentage gain.
- Successful investing in small-cap stocks requires thorough research.
- The market for small caps is inefficient, allowing individual investors to gain an edge over large institutional investors.
- Watch for signs among small-cap stocks that suggest positive upcoming news. You have an advantage because small caps are often overlooked by 99 percent of investors.