Kramer, Hilary - The Little Book of Big Profits from Small Stocks

John Wiley & Sons, 2012, [Equity Investing] Grade ★★★

Hilary Kramer, editor of two investment letters and previous hedge fund manager and equity analyst at Morgan Stanley and Lehman here shares her hard earned insights from 25 years of small cap investing. Her starting point is that of a contrarian searching for beaten down and unloved stocks that have potential for spectacular returns to glory. The limited market value of smaller stocks gives significant stock market profits if large institutions start to buy the shares. After an introduction Kramer kicks off with three chapters covering the three categories of small cap stocks she favors. They are the fallen angels, the undiscovered growth companies and companies in the bargain bin. They all have in common that they are low priced, undervalued and have catalysts that give them potential for higher stock prices.

Fallen angels are previously well-regarded companies that have fallen from grace and have seen tumbling share prices as a result. Prospects could for example be found among the stocks with the largest declines over a period of time. When a list of prospects has been identified the real work starts. According to the author there are two questions to be asked: "*what went wrong?*" and "*can it be fixed?*". Without knowing the answers there is no way of distinguishing the potential comeback kid from the structurally impaired that should be avoided at all costs. Kramer correctly warns that the list will turn out "*more demons than angels*" – so be very picky. Undiscovered growth stocks are longer-term holdings where you just make money by sitting still as long as the company is doing structurally fine. These are not the highflying darling stocks of Wall Street. Instead look for stocks in mundane and boring below-the-radar-sectors that have produced high and stable sales and profit growth over the previous economic cycle. Kramer puts her growth threshold to 15 percent CAGR and also requires a debt-to-equity ratio of 50 percent. Finally the author searches for treasures in the bargain bin by looking for companies that combine a price-to-tangible book below one, a minimum debt-to-equity ratio of 30 percent, a share price below USD 10 and that is profitable. The purpose is to find companies that have net assets that are undervalued by the stock market. Often opportunities will present themselves when stocks in cyclical companies get sold down during business cycle downturns. The net asset value is only a safety backstop for the stock if those assets can be realized at full value should worst come to worst. The investor thus needs to take a critical look at the probable value of the assets should they be sold.

After a chapter on international investing and one on biotechnology companies (with a more general point of always taking into consideration if the company have the prospects of being bought up), Kramer finishes off with further thoughts on analysis of small cap stocks. To find the 'breakout' stocks she's searching for one has to look for signs of improvement. It's change in company fundamentals, not absolute levels, which will drive positive or negative change in stock prices. As a general rule Kramer however wants her companies to be profitable and to have low debt levels to provide security should the investment backfire. She also wants to understand reinvestment needs and the operating leverage of companies as measured by the proportion of fixed and variable costs. Further she looks for accounting red flags and management insider trading to gain insights. The selling process is trickiest when it comes to loosing positions. The question deciding the course of action is "*are you wrong or just early?*", i.e. have you missed a negative factor in the analysis, have things changed to the worse and or is fundamentals improving and the case is thus still intact?

This book gives solid advice and it does its job for the novice, but there is very little detail. As a matter of fact this review probably covers most of the book's content.

Mats Larsson, March 26, 2014