Guide to Small-Cap Investing

How to Invest Early in the Top Stocks of Tomorrow

By Tyler Laundon, Chief Analyst, Cabot Small-Cap Confidential
Dear Small-Cap Investor,

As the chief analyst of the limited-subscription advisory, Cabot Small-Cap Confidential, I’m delighted that you’ve chosen this advisory as your source for small-cap investing advice and ideas.

I’ve spent my entire career managing, consulting and analyzing start-up and small-cap companies. And I love the work. Small-cap stocks are my favorite area of the market, hands down. And it’s made much more enjoyable through the sharing of ideas and insights with fellow small-cap enthusiasts like you. On that note, at any time, please reach out to me with your questions, comments and stock ideas. My email address is tyler@cabotwealth.com.

Experience has led me to believe that the development of a superior business model is the biggest factor in determining a company’s long-term success. Accordingly, my research focuses on assessing the viability of management’s growth strategies, trends in addressable markets and achievement of major developmental milestones.

Fundamentals matter. Fundamental analysis tells us stories, highlights trends and opportunities, and reveals fundamental flaws. I apply this philosophy to every stock I recommend in Cabot Small-Cap Confidential.

The investment methodology I’ve developed factors in a lot of things. But at a high level, we’re looking for enough signs to suggest that the industry of a company is strong and that that particular firm is a very, very good way to play the growth potential. In other words, I’m looking for highly leveraged exposure to specific investment themes through select small-cap opportunities.

We are always looking for companies that are pioneers in their areas of business. In many cases, these companies are creating whole new micro-industries, providing essential tools for an entire industry’s growth, or doing something better or faster than in the past.

But I don’t like to discount traditional businesses. A lot of very successful small-cap investments come from very basic business models. The corner convenience store, the healthy food manufacturer, the high-volume concrete company … a lot of money can be made by keeping things simple.

So I’d say it’s fair for you to expect a mix of high-tech and fairly basic investment opportunities in Cabot Small-Cap Confidential. The common thread will always be that I see 100% or greater upside with each stock within a two-year time frame.

Because many of these stocks have little or no institutional or research coverage, Cabot Small-Cap Confidential subscribers can acquire significant positions in these companies more cheaply than if their stocks were widely followed.

Over the years, I have developed my own rules and guidelines for small-cap investing that have helped generate extraordinary returns for my clients. I typically apply some, if not all, of these rules to each stock recommended in Cabot Small-Cap Confidential.

What follows is an attempt to summarize these rules so you know what is going on “behind the scenes.” I urge you to use them to become a smarter, savvier and wealthier investor.

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10 Rules for Successful Small-Cap Investing

These are the 10 steps that I follow to insure that every small company stock I recommend has the potential to bring strong profits to Cabot Small-Cap Confidential subscribers.

1. Search for paradigm shifts that are opening up new opportunities
I search for paradigm shifts in any field of business that requires a unique, new solution that will be provided by a stand-alone company.

I then seek a niche supplier that will become an equal benefactor to that pioneering company. I call these companies “pure plays.”

A good example of such a paradigm shift was the move from the mainframe computer environment to the personal computer environment in the 1990s. All the new personal computers needed to be connected! And Cisco filled the void, supplying the industry with networking tools and its stock increased 70-fold. Another example was the move from CD to DVD format. Sonic Solutions provided the software for conversion to the new DVD format and its stock took off. In the consumer market, energy drinks burst on the scene in the late 1990s, giving the industry its first truly new product in decades. Hansen Natural stepped in to become the leader and its stock has been one of the best performers of the post-2002 bull market.

For Cabot Small-Cap Confidential, I dig deep to uncover the small company suppliers to the transition leaders—just as the top suppliers to Cisco, Sonic Solutions and Hansen became equal beneficiaries of the paradigm shifts, yet remained largely unnoticed by institutional investors until well into their industry transitions.

Because it’s institutional investors who drive up stock prices, I look for the same thing they look for, but because I’m seeking far greater returns, my approach must be different. My forensic research digs significantly deeper into the industry and company to uncover information that gives me a unique advantage over the big boys.

2. Invest only when the market opportunity is huge—and quantifiable
This is the Law of Large Numbers: Only invest in small companies that serve large, burgeoning markets because you can realize tremendous growth with even small shares of the market. The sheer size of these markets creates the potential for huge gains while helping to reduce your risk profile.

Large medical patient populations and new technology users are examples of vast markets to target. Here’s an example: By the age of 60, half of all men will have an enlarged prostate, a condition known as Benign Prostatic Hyperplasia (BPH). Research tells us that treatment for this condition will cost upward of $10 billion per year. The opportunity for a small company that captures even a fraction of this market would be enormous.

Because it’s often institutional investors who drive up stock prices, I look for the same thing they look for, but because we’re seeking far greater returns, my approach must be different. My forensic research digs significantly deeper into the industry and company to uncover information that gives us a unique advantage over the big boys.
3. **Invest in companies before the institutions notice them**
This strategy is called robbing the train before it arrives at the station. By gaining a research advantage, we can invest in companies before most big investors get on board—including mutual funds, hedge funds and pensions.

In many cases, we’ll invest in companies that have less than 50% institutional ownership. The idea here is that subsequent investments by institutions will drive up the value of the stock.

4. **Measure the company, not the stock price**
While some investors perceive low stock prices as bargains, the reality is that stock price should be low on the hierarchy of importance. The stock price is just a factor of market cap and share count. A $40 stock can be “cheaper” than a $2 stock on a price-to-earnings basis.

This is why fundamental analysis matters. It tells you what the real deal is, not just what the share price is.

5. **Invest in stocks that offer both growth and value**
Big, growth-oriented ideas are awesome, but it’s also important to consider valuation and buying when valuation as compared to peers is reasonable. A good candidate may be a young company that has demonstrated significant growth in sales, yet is undervalued based on the company’s market potential versus its total market capitalization.

I also want to see a balance sheet with cash and little, if any, debt. Cash is important because it can carry a company through unexpected events. For example, should the much-anticipated launch of a product be delayed, I want the company to have enough cash available to see the product to market.
6. Validate market acceptance of the product

Market acceptance of a company’s product must be validated, never judged solely from my own viewpoint. The best way to do that is by looking at customer relationships, specifically OEM (Original Equipment Manufacture) deals.

OEM firms integrate a component product into a larger final product (think of semiconductors into personal computers). If an established OEM has a supply deal with our company, it provides tremendous recognition and product endorsement, as well as an inside view of the customer’s product plans. Like annuities, these supply deals provide predictable, stable flows of revenue over time. An OEM contract also offers the ability to raise prices to meet demand and can therefore contribute to even higher revenue rates.

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The Law of Large Numbers

You only have to have a few great stocks to win big in the stock market. So how do I increase my odds of selecting winners?

I apply the Law of Large Numbers: Invest only in companies that offer critical products in very large growing markets. The sheer size of these markets will stage my investment for huge potential gains.

For the past two decades, this investment philosophy has led me to first uncover a paradigm shift offering a huge market opportunity, and then apply extraordinary research to evaluate the industry and select the company that will offer the most potential gains.

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7. Research what the top institutions are holding

Mutual funds spend significant amounts of money researching companies and industries for stocks to include in their portfolios. By studying the individual stocks in the 13-F HR reports that mutual funds must file with the SEC, we can gain a sense of what industries and products they’re following—and what could become interesting to additional institutions in the future. I know this is the opposite of rule #3 above; but in the context of a diversified small-cap portfolio there is room for both approaches.

8. Invest at the right time in the product cycle

The point at which you invest in a stock is critical to your success. There is a direct correlation between the time of investment and the degree of risk and rate of return you can expect.

Generally, I consider the time period after venture capital investors come aboard to be the most promising point of investment. The most likely point to sell is after institutions have begun to invest en masse, and the general public is jumping in hand over fist. At this point, we often see a very big jump in share price and it can be wise to lock in at least partial profits.
9. Concentrate on the very best ideas
Here’s an ideal scenario: An industry has hit a roadblock and needs new technologies or products to keep growing. My targeted company offers a new and fresh solution that will be adopted, in time, by the industry leaders.

When we take positions in stocks, we buy large amounts because few stocks meet my high standards for quality as investment candidates.

I’m not alone in my investment perspective; Warren Buffet buys approximately 12 stocks a year and only acquires large stakes, often controlling positions in his companies. Taking size in any stock is predicated on research. The more I know about the company, the markets served and the competitive landscape, the more shares I can add to my holdings.

*Good stock picking is analogous to good poker skills. Face cards mitigate risk. Company revenue, top-line sales, thematic investment idea, barriers of entry, and so on are all face cards. My objective is to collect as many face cards as possible to win. A company that reports losses is missing an important face card.*

10. Keep research current
All the preparatory research work I’ve elaborated is dynamic leading up to the stock purchase. As my companies do not operate in a vacuum, my research efforts must continue to confirm our company’s superiority.

Here are three ways I stay ahead of my investments:

I keep an open dialog with the officers of the company on a quarterly basis and look for clues indicating the pulse of the company. I pay close attention to tone of voice and level of enthusiasm as the officers respond to questions. If their answers are upbeat instead of reserved, it’s a good indication business is picking up. If, on the other hand, they’re very zealous in their forecasts and spend enormous amounts of time on the phone, then perhaps there isn’t enough business to keep them busy.

Assess ongoing business conditions by viewing the company’s operating statements. Sales are the first indication of the wellness of the company. I compare the company’s revenues over the past quarter to the prior quarter to determine if they are growing sequentially. Make sure there’s parity between the growth rate of sales and receivables, as the two benchmarks should track each other in terms of percentage growth. If the sales are genuine, I move on to margins to ensure current gross margins are stable-to-rising versus the immediate past quarter.

My final health check is for any emerging technology coming that could leapfrog the company’s proprietary position in the marketplace. I gain a sense of what technologies are present or in the works by reading trade journals that are specific to my sector and going to the websites of venture capital firms to see what new technologies they’re investing in.
I only buy a stock when the following checklist is complete:

✓ What important need does my product serve in the marketplace that will create an insatiable demand for its use?
✓ What is this market potential in dollars?
✓ Have I validated the technology or science via journals, writings and conversations with experts in this field?
✓ What evidence indicates that the market is accepting this approach?
✓ How is my company’s leadership distinguished versus the competition?

How to Manage Your Small-Cap Stock Portfolio

To start investing in the stocks recommended in Cabot Small-Cap Confidential, I recommend that you prioritize stocks that coincide with your risk profile. For instance, my personal risk tolerance has guided me toward a higher allocation of relatively stable, high growth small-cap companies. Then I add event-driven and more speculative investments. In this way, I try to create a small cap portfolio that will endure through both up and down markets. But do what seems right to you.

Not every stock in Cabot Small-Cap Confidential will match your investment objectives, nor will every high-potential stock become a home run. Please read each new stock profile carefully, including the segment on risks, and decide if the stock will work for you, and how much to invest.

Here are a few tips for getting the most from your small-cap portfolio.

**Average Out Your Cost Basis**

You don’t need to buy all the stock you want all at once. In fact, it’s probably wise to average into a new position. For example: One might buy an initial position of 50 shares of a certain stock at $40.00 per share today, for a total investment of $2,000. Three months from now, make a second purchase of 55 shares at $36.39 for approximately $2,000. The two purchases represent a total investment of $4,000 for 105 shares, at an average cost of $38.10. The strategy helps to reduce the risk of buying a full position in a stock at a poor time (it happens), or an unlucky time.

**Take Partial Profits**

If averaging into a position seems to make sense to you then the opposite probably does as well. I’ll typically recommend that investors sell up to half of their position once the stock doubles. That way the rest of the investment is essentially all profit, and the original capital can be allocated to a lower-risk investment (or left in, if the existing investment remains relatively
low-risk). Of course, you don’t have to wait for a double—the same can be done when a stock is up enough to warrant taking some profits, say once the gain is 30% or more. This strategy helps to avoid the heartache of having a nice profit that evaporates due to some unforeseen negative event.

Follow Advice in the Weekly Updates
Please take advantage of all the work that goes into the weekly updates. The idea with these is to give a running commentary of the potential, and the risks, of each position over time. If you follow along you’re likely to be far more comfortable with your allocation to each position, and you’ll have fewer surprises. You’ll know which stocks make sense to take some profits on, and which ones look like good values, every week.

Allocate More Funds to Your Strongest Stocks
There’s nothing wrong with buying more of a stock that is going up. Stocks are often momentum vehicles—they tend to continue on their general trajectory for longer than investors expect. One of the best ways to increase your profit potential is to simply buy more of what’s working.

Limit Your Losses
On the flip side, when a stock is going down, it’s more likely to keep going down. There are exceptions of course, especially in the small-cap world, where market overreactions are quite frequent. Understanding the fundamentals and market opportunities for a particular company helps to increase your chances of knowing whether a decline is likely to be short-term or long-term. In either event, there is a point at which one has to just step aside to remove the potential for a big mistake. I typically put a stock on red alert when it’s down 25% from the entry point, and once it’s down 30% it’s very likely to be sold.

Cabot Small-Cap Confidential Stop-Loss Guidelines

Since 1925, small-cap stocks have posted greater gains than any other asset class—2% to 5% a year more than mid-caps and large caps. And between September 2011 and September 2015, small caps rallied by 20% more than large caps, posting a total return of 97%.

That long-term outperformance helps to make a strong case for owning small-cap stocks. But investors do need to understand that the larger moves to the upside are typically mirrored on the downside during bear markets and market corrections.

As a general rule, small caps are more volatile than large caps, but less volatile than emerging market stocks. This isn’t reason to steer clear, it just means that you should expect larger swings in their prices, and you should use stop losses to avoid really big losses.

Many advisors advocate a 10% to 15% stop loss for large caps. For small caps, I like to widen this to 25% to 30%. The reason is that we often see quality small caps drop 20% or so during market corrections. And often, these are the times to buy, not to sell. We don’t want to get chased out of a quality stock because of market volatility.
If a small-cap stock falls by 25% from my entry point, I start to watch very, very closely. The critical thing to do at this point is determine if the decline is due to some fundamentally negative event, or trend, that undermines the company’s longer-term potential, or if it is simply the result of market turbulence.

If it is the prior, then the stock is more than likely a candidate to sell. While turnaround stories do happen, the bottom line is that investors need to cut losses short on bad stocks that continue to fall.

If it is the latter, it may make sense to give the stock a little more wiggle room, and see if it hits that 30% stop loss level. If it does, than at that point it really is a matter of watching extremely closely for a good exit point.

The idea here is to avoid catastrophic losses. A couple of 30% or so losses a year is not a big deal. But allowing those losses to get bigger really does curb the overall profit potential of your portfolio.

Ultimately, you’ll need to decide what stop loss level works for you, and what will make sure you sleep well every single night.