THE SMALL-CAP INVESTOR

Secrets *to* Winning Big *with* Small-Cap Stocks

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To Gram and Grandpa Cheney
who got me started with investing

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INTRODUCTION

The Story of a Small-Cap Investor

There is nothing quite as exciting, intoxicating, or rewarding as investing in promising *small-cap* stocks—those on the path to growth, profits, and big returns for their shareholders. I love investing in small-cap stocks, those publicly traded companies with market capitalizations of less than $2 billion. My favorite and best-performing investments of all time have tended to be the smallest of the small caps, with market capitalization of less than $500 million; these are often called *micro* caps. I like to discover the unknown stock with great promise and strong fundamentals when nobody else has recognized the potential. And I try to buy growth at value prices.

Many great small-cap stocks go unnoticed by other investors, not only by individuals, but by big institutional investors as well. This book tells you why these stocks are usually overlooked, and shows you how to find the small companies with significant potential for growth and profits. It also shows you how to evaluate these stocks from both a fundamental and a technical perspective so you can determine whether you should buy the stock to begin with, and also when you should buy and sell. Small caps are different than mid- or large-cap stocks in many ways, and can yield significant gains that are impossible to find in larger stocks. Unfortunately, until now there hasn't been a lot of information about how to successfully invest in these smaller, less known companies. In this book, I share with you my simple system for successfully finding great small-cap stocks for maximum profits.

Contrary to what most people think, small caps as an asset class are relatively safe investments. Over the long term, small caps have outperformed every other class of investments, as I'll show you in a later chapter. And the fact that these investments outperform over the long term makes them a no-brainer for every portfolio. For investors seeking big long-term gains, small caps should be thought of as the home run hitter, the investments that can really help improve overall portfolio returns from average to extraordinary. While the volatility of an individual small-cap stock can be significant, a diversified portfolio of individual stocks, index funds, or mutual funds is recommended for most investors. I believe small caps have a place in every equity investment portfolio, regardless of your investing time horizon.

Throughout this book, I share my investment process and the systems that are involved, and clearly outline the easy steps you need to take to begin uncovering great small-cap gems today. If you seek growth in your portfolio, small caps offer an effective solution. This book shows you how to not only find the winners, but also how to avoid the losers. This is particularly important for investors who experienced significant losses in the stock market crash of 2008 and are looking to aggressively grow their investment portfolio to make up for early losses.

Many investors are skeptical of investment advice from someone who isn't a hedge fund or mutual fund manager. But after the recent collapse of many hedge funds, and under-performance of most mutual funds, being a "money manager" doesn't hold the same prestige that it once did. I often get asked, "If you're such a great investor, why are you selling your information, strategies, and stock picks to individual investors like me?" This is a valid question.

I have never worked for anyone else, but instead have always chosen to do my own thing and taken the path less traveled. This started with my own freelance web design at age 15; the money I earned was invested in the stock market. I started the web site BizFN.com in 1998 while in high school and built it into a leading investment site with content from dozens of investment experts and financial advisors. I attended college for a year before moving on to pursue my entrepreneurial interests. In 2001, I started my Internet publishing company, Business Financial Publishing, which grew to more than $7 million in annual sales within six years, placing my company at number 185 on the *Inc. Magazine* 2008 Inc. 500 list of the fastest-growing private companies in the United States. Prominent accounting firm Deloitte and Touche also selected my company as one of its fastest-growth companies, rating Business Financial Publishing number 66 on its Fast 500 list of high growth private companies in 2008. Today more than one million individual investors receive my updates and insights into the stock market every day through my various investment publications and services including SmallCapInvestor.com.

I've never been a suit-and-tie type of guy and never wanted to have a boss. While my job may not be as prestigious as that of an investment banker or mutual fund manager, it is perfect for me, giving me complete flexibility to spend my time as I choose. Being the boss and owner of my company also allows me to personally invest in great small-cap stocks, educating individual investors, and sharing my top stock picks with others. In a big investment firm, I simply wouldn't have the same flexibility. Running my own company satisfies my passion for small-cap stocks and my desire to share my investing strategies that have worked so well for me. I enjoy helping investors successfully buy great companies at bargain prices before Wall Street and Main Street catch on to these success stories.

Let me tell you how I got started investing at a young age. In 1982, when I was two years old, my grandfather gave each of his grandchildren $1,000 of Exxon stock and signed each of us up for the company's dividend reinvestment plan. Within nine years the shares had appreciated more than 500 percent to $7.50 per share from a split-adjusted $1.20. By age 11, I was sitting on an investment portfolio worth more than $10,000, all in Exxon stock, thanks to my generous grandparents.

On family trips, my parents reminded me that I owned a small piece of every Exxon gas station we passed. While on a family vacation when I was 12, I bought my siblings and cousins ice cream using proceeds from a recent dividend check. No work, and I was able to spend money from the earnings of my investment. This ownership concept sparked my interest in stocks and investments. Before my 12th birthday, my parents helped me set up a discount brokerage account at Charles Schwab.

After liquidating half of my Exxon position, I started having some fun buying more stocks. Some of my first purchases were unknown small caps, including a Midwestern radio media company, a maker of stereo speakers, and a chemicals company. I also bought better-known companies whose brands I was familiar with, like the baseball card company Topps and the candy company Tootsie Roll.

One of my best purchases was a company named Fastenal (Nasdaq: FAST), based in Winona, Minnesota. As an aspiring entrepreneur whose business pursuits included a paper route, I was lucky to deliver the daily newspaper and become friends with Bob, a financial advisor at Robert W. Baird, a Milwaukee-based full-service brokerage firm and the first broker to cover Fastenal. Bob turned me on to this unknown small-cap gem, and together we rode the stock for years and enjoyed lavish gains and consistent profits.

Fastenal was a leading seller of industrial and construction materials, including screws, nuts, and bolts. In the mid-1990s, the company was reporting consistent growth. This was far from a sexy business or a company that was of interest to kids in America; it wasn't Six Flags, Disney, Coke, or Wrigley's.

But Fastenal was a cash machine. And the stock price soared as the company expanded across the country. I began buying the stock in 1993 around a split-adjusted price of $2.50. In 1992, the company's sales were $81.3 million and earnings were $8.8 million. A decade later, the stock price was around $17, and the company was a booming success, with sales of $905 million and earnings of $75 million. Who knew the boring business of nuts and bolts could be so profitable? By the time I cashed out of Fastenal in the late 1990s, my gains were more than 500 percent.

Shares were trading at $36 by the beginning of 2008. Had I continued to hold shares of Fastenal in my portfolio, I would have been sitting on even more impressive gains of 1,340 percent! It is difficult to time the peak price of a stock, and almost impossible to sell at the market top (or buy at the market bottom, for that matter). The key point is that only by selling a stock will you be able to lock in profits. Many investments rise and fall in price, and the prudent investors who make money are those that are willing to sell winners and lock in profits, even though the investment may continue an upward trajectory. But selling out too early can be a common mistake of individual investors. It is important to actively monitor and review every investment in a portfolio, and it is okay to continue to hold winners so long as the investment thesis and fundamentals hold up. At the same time, locking in profits along the way is a good approach to take, even if that means selling only a portion of an investment.

After my Fastenal experience, I was hooked on small caps. Nowhere else could I find stocks capable of such impressive movements in a short period of time. Large-cap stocks just couldn't make such big moves so quickly. How many large caps can gain 500 percent in a few short years? I realized that with small-cap stocks, with a lot of research and a little luck, I could find great undiscovered stocks that were being overlooked by big institutional investors and analysts.

During the 1990s, as a kid growing up in Beloit, Wisconsin, I bought and sold positions in several stocks, some winners and some losers. I began reading the *Wall Street Journal* book series on investing, talking with family friends about their investments, and reading *Barron's Weekly*. I was hooked on investing, utilizing funds from my paper route and other entrepreneurial pursuits to feed my investing habit. I even spent a summer internship working at the Baird branch office in Beloit and at market-making firm Rock Island Securities on the Chicago Stock Exchange to learn more about the stock market from professional asset managers and traders.

I had become an investing junkie by age 15. I spent much of my free time reading books about the investing greats like Warren Buffett and Peter Lynch, digesting investment magazines, reading annual reports from public companies, and digging through press releases and financial information on my dial-up Internet connection at home. I also began reading and participating in online message boards, sharing my opinions with other investors.

I've been an active investor for nearly two-thirds of my life, and as of 2009 I hadn't yet hit age 30. I've been through the dot-com boom of the late 1990s, and the subsequent bust of 2000. I've seen oil soar from $23 a barrel in 2001 to $147 in July 2008, before collapsing to $35 a barrel by the end of the same year. I've seen housing prices (and the share prices of home builders and mortgage companies) jump in the first half of this decade, only to plunge as bad subprime mortgages and poor lending practices tore