PETER RICCHIUTI

Professor & Founder of Burkenroad Reports at Tulane University

STOCKS UNDER ROCKS

HOW TO UNCOVER **OVERLOOKED, PROFITABLE** MARKET OPPORTUNITIES

"Smart, sensible investing isn't rocket science—it can even be fun. Professor Ricchiuti serves up down-to-earth investment advice and tales of Tulane University's highly successful student stock research program with eye-watering wit."

—Christopher C. Williams, Staff Writer, Barron's and Dow Jones & Co.

Stocks Under Rocks

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How to Uncover Overlooked,
Profitable Market Opportunities

Peter Ricchiuti

with
Annette Naake Sisco

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I dedicate this book to my wonderful wife, Laurie,
with gratitude for your love and patience,
and to my sons, Matthew and William,
who keep me laughing and have made me a proud dad.

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Aaron and Peggy Selber at the head table of the 16th Annual Burkenroad Reports Investment Conference (April, 2012).

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About the Authors

Peter Ricchiuti lives in New Orleans with his wife and two sons. He teaches courses on finance and investments at Tulane University's A.B. Freeman School of Business and also hosts the weekly business program "Out to Lunch" on the local NPR affiliate, WWNO. Peter provides surprisingly entertaining addresses to dozens of groups throughout the country each year on economics and the financial markets.

Annette Naake Sisco is a New Orleans-based writer and the features editor for *The New Orleans Advocate*.

Introduction

I wrote this book because I wanted to encourage individual investors to trust their own stock-picking abilities. Along the way, I hope to bust a few Wall Street myths and share some levity.

Why should you listen to what I have to say? Well, first of all, I have a lot of great stories to tell. Secondly, I've been in the investing business for almost 35 years, the past 27 of them teaching courses in finance at Tulane University in New Orleans, where I am founder and director of the Burkenroad Reports student stock research program. I graduated from Babson College and started my career in the Boston office of the old-line investment banking firm of Kidder Peabody & Co. After that, I served for more than five years as the assistant state treasurer and chief investment officer for the state of Louisiana, managing the state's $3 billion investment portfolio and serving on boards overseeing another $8 billion in retirement funds.

I came to teach full-time at Tulane University in New Orleans in 1993. Tulane is a highly selective research university founded in 1834. Since reopening just one semester after Hurricane Katrina hit in 2005, I've been calling Tulane University the "greatest comeback since Lazarus." Still, I'm glad that the university didn't accept my motto suggestion in 2004: "Tulane University—Higher Education Below Sea Level."

Over the past few years, we have averaged about 35,000 applications for just 1,700 freshman openings every fall. The A.B. Freeman School of Business, in the center of Tulane's leafy Uptown campus, is highly ranked (our finance department was named one of the world's ten best by *The Financial Times*), and is currently celebrating its 100th anniversary.

Besides teaching, I host a popular business program called "Out to Lunch" on the National Public Radio affiliate here in New Orleans. Post-Katrina, New Orleans is a much more vibrant business community. *Forbes* called the city "America's New Frontier for Business Opportunity," and Under 30 CEO (http://www.Under30CEO.com) recently named New Orleans the "#1 City for Young Entrepreneurs." Each week I bring two entrepreneurs to the famous Commander's Palace restaurant and interview them about their successful, often surprising, business ideas.

Over the last 30 years, I have spoken about the financial markets to more than 1,000 groups in 47 states, with audiences as diverse as nuns, water park owners, investment managers, and the New Orleans Saints. I taught these NFL players in investment workshops. (And, contrary to popular belief, I was not behind the Saints financial bounty scandal of 2012!)

In 1993, I received a generous grant from the Louisiana Education Quality Trust Fund, and later that year, I founded what has become known as the Burkenroad Reports stock research program at the A.B. Freeman School of Business (www.burkenroad.org). The program is named in honor of William B. Burkenroad Jr., an alumnus and long-time supporter of Tulane's business school.

For Burkenroad Reports, my smart young army of student analysts combs six Southern states to get the "skinny" on underfollowed public companies. This is the first student stock research program in the country where students actually meet with top management, visit company sites, develop financial models, and publish investment research reports on little-known companies with outstanding potential. These are the stocks under rocks—dozens of companies that Wall Street has more or less ignored to its own peril.

Since the beginning, each student has been required to sign an agreement not to purchase stock in any of the individual companies followed by Burkenroad Reports until after they've graduated. It's also our policy to prohibit my staff and myself from making such purchases. We actually implemented these rules years before Wall Street put into place similar restrictions on its analysts forbidding them from buying shares in the companies they follow. To us here at Burkenroad, this seemed like a Sunday-school-simple example of avoiding a conflict of interest.

Our research impressed Hancock Bank of Mississippi so much, it started a mutual fund built around the program. These student-produced research reports help power this fund that began on December 31, 2001 and has outperformed about 99 percent of all stock mutual funds over nearly a dozen years. Since its inception, the Hancock Horizon Burkenroad Small Cap Fund (Ticker Symbols: HYBUX & HHBUX) has chalked up a 271% total rate of return, double that of the small cap Russell 2000 (+132%) and more than three times the S&P 500's +77% return. The fund has more than $400 million in assets and is managed by David Lundgren at Hancock Bank.

Burkenroad Fund (HYBUX) vs. S&P 500 Index vs. Russell 2000 Index

Range 12/31/2001 - 06/28/2013 Period Monthly No. of Period 138 Month(s)

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1.	SPX Index	USD	39.91%	77.25%	-193.33%	5.10%
2.	HYBUX US Equity	USD	221.33%	270.59%		12.07%
3.	RTY Index	USD	100.10%	132.13%	-138.46%	7.60%

The Burkenroad Reports Course

Each year, I take 200 students, break them up into teams of five, and assign each team to research one of 40 small to mid-sized, under-followed public companies headquartered in Louisiana, Texas, Mississippi, Alabama, Georgia, and Florida. (I know, pretty much the financial center of the country—NOT.)

We don't just track these businesses on paper.We strap on hard hats or pull on rubber boots, tour the plants, and meet the CEOs, CFOs, and other company decision makers. We have the best field trips in the free world. We've flown out to and visited offshore oil rigs, toured steel mills, and walked through chicken processing plants. If you've never been to a chicken processing plant, do take the family!

I got the itch for visiting companies when I was at Kidder Peabody & Co. in the early 1980s and we were doing a secondary offering on a company that bred hairless rats for medical research. Our bosses thought we could do a better job talking to clients about the deal if we actually visited with the company and saw what they did. They put us on a bus, and when we arrived, we were told to put on germ-free smocks, pants, booties, and gloves. (I asked why and was told that a group of previous visitors had brought germs, and, well, the rats died.) I was fascinated. And so were all my colleagues on the trip. It was a big-boy Mister Rogers episode come to life!

You may have heard of Burkenroad Reports, since the program has been featured in *The Wall Street Journal*, *The New York Times*, *CNBC*, *CNN*, and *PBS's Nightly Business Report,* among other places

Here's another reason you should take the time to read this book. This is a great time for individuals to research and invest in stocks, particularly under-followed stocks. Yet frankly, I've never seen people more confused about economics and the financial markets. I saw a study that said half of all Americans believed that the Federal Reserve was an Indian reservation, while the other half thought it was a brand of whiskey. (Just kidding.)

But, this story is true. Last year I was giving a talk in the Midwest, and a guy came up to me at the end and told me that he enjoyed my presentation and all the jokes—but that the material didn't pertain to him personally because it was about stocks and bonds and all his money was in mutual funds. Yikes! I didn't have the heart to tell him that stocks and bonds are what generally comprise mutual funds. He seemed so happy. I guess he thought mutual funds were made of cheese!

Individual investors today are either terrified and doing nothing, making unimpressive returns by mirroring the crowd, or driving themselves to distraction through adrenalin-driven gambling on the stock market. Here's a closer look at the three generally "wallet-thinning" camps.

The Mattress Investor

These are the ones who put their money under a mattress—or let it sit in a no/low interest bank CD or money market fund, which amounts to the same thing. The folks who do this are terrified; they usually can't shut off the cable news and financial networks spewing dire economic spin. "It's bad, you know. This just in: Today, in the heartland, people began eating their young!"

Here is a good indicator. As I write this, the stock market is hitting record highs. Yet people are scared. Fear mongers blame this on an uncertain economy. Well, when the heck did we ever have a "certain economy"? It's capitalism, and capitalist economies are cyclical. It's been that way since the earth cooled.

Before you even start thinking about investing in the stock market, you need to have a few things checked on your financial to-do list. You need to pay off your credit card debt. You are paying 15 percent, 20 percent, maybe even 30 percent on those debts, and that level of return is going to be very difficult, if not impossible, to consistently earn in the stock market—even with the help of this book! In fact, paying those loans off is the equivalent of having that money earn the usurious rate you were previously paying the credit card folks.

Secondly, make sure you and your family have adequate health insurance. Far and away, the number-one cause of personal bankruptcy is the crushing burden of unpaid medical bills. Don't let that happen to you! It doesn't help to have a portfolio of exciting small-cap stocks when the bill collectors are coming to take your home and your golf clubs.

I'm not saying that individual investors should put all their money into smaller, under-followed stocks. Far from it! Your investments should be viewed as a pyramid. On the bottom, or base, are treasury bonds, CDs, high-quality corporate bonds. The middle portion of this pyramid might contain blue chip stocks (an index fund is probably best) or real estate. But on the tip of the pyramid, you have room for higher-risk, higher-return investments.

One handy measure for saving for your retirement is to subtract your age from 100: The remainder is the percent that goes into stocks. So, if you're just 30, you can take the long view on 70 percent of your portfolio, whereas if you're 75, it might not feel safe to put more than 25 percent into stocks. The reason for this is that over long periods of time, stocks have handily outperformed bonds, but stocks come with much more volatility. The longer your time horizon is, the more attractive stocks become. Generally, it's better to be an owner (stocks) than a renter (bonds).

Yes, the market has its ups and downs. Yes, the media does its level best to scare small investors into hiding with 24/7 updates from around the globe that are, I can assure you, largely irrelevant to the vast majority of companies.

But if you just let your money sit, in a bank or under your Sealy Posturepedic, its real value will decline due to inflation. Doing nothing erodes your purchasing power. Put that money to work.

The Handoff

Some investors just don't want to know. They simply hand over their money to the investment experts. This tends to lead to predictable and uninspiring results. Most of the "experts" are focusing on the same large, "picked-over" investment ideas as their counterparts.

One of the saddest, but most common, things I see is when an investor shows me his or her "diversified" portfolio of mutual funds. When you look up their skirts (OK, let's rephrase that: when you check the fund's largest holdings), you find that they all tend to own basically the same 20 or so stocks. The investor here is getting a lot of different financial documents but is not really getting much diversification.

Over the past 90 years or so, the S&P 500 has produced annualized total returns of about 10 percent. That is pretty good. Here's the bad news. For the past five years, almost 70 percent of mutual funds have underperformed their benchmarks, and the average mutual fund investor does even worse. The investment industry usually quotes "relative returns" (i.e., "You lost money BUT did better than most investors."). This is like being named "the tallest jockey."

Most investors get bullish and bearish at precisely the wrong times, in effect buying high and selling low. It seems to me that "timing the market" is an exercise in futility and usually leads to questions of your financial adviser like, "Excuse me, but what are these parentheses in my account?"

The Trader

Hunched over his or her computer screen and gulping down energy drinks, this "gambler" believes his ASD (attention surplus disorder) will allow him to capture a series of small profits.

This lifestyle has a certain Kenny Rogers appeal (...you gotta know when to hold 'em...), but in all my years of investing, I've never seen anyone consistently earn superior returns investing this way. On the other hand, they have done a great job at keeping the antacid industry solvent.

Some investors think they get an edge by quickly reacting to news. Forget it. The market receives, interprets, and factors in new information in no time! Even complicated news is quickly assessed. One of the successful companies we follow is Gulf Island Fabrication (GIFI), an oilfield marine construction company in Houma, Louisiana. The company's founder is Alden "Doc" Laborde. "Doc" is a business folk hero in this area and also created two other public companies: ODECO (since bought out by Diamond Offshore Drilling) and Tidewater (TDW), the largest owner and operator of oilfield service vessels in the world. There was even a 1953 movie about his heroics called “Thunder Bay” starring Jimmy Stewart.

S&P 500 Index vs. Gulf Island Fabrication

Range 08/29/1997 - 06/28/2013 Period Monthly No. of Period 190 Month(s)

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1.	SPX Index	USD	78.58%	137.99%	132.30%	5.63%
2.	GIFI UW Equity	USD	-5.43%	5.69%		.35%
3.						

In late 1998, Gulf Island completed a $50 million deck fabrication to be installed onto the Petronius oil platform in 2,000 feet of water about 210 miles southeast of New Orleans in the Gulf of Mexico. Petronius was a Roman satirical writer in Nero’s time (and you thought those liberal arts courses were wasted). An offshore installation contractor barged the huge structure out to the rig. While workers were installing it, the cable snapped, and this valuable hunk of iron sank to the ocean floor. Every event has winners and losers. After breathing a sigh of relief that there were no fatalities, investors quickly went to work evaluating the situation. Within minutes:

- Shares of the offshore contractor fell in value (it was their error).
- The oil company’s stock price remained stable (business insurance was in place).
- Gulf Island’s stock went up sharply (they were going to get to build it all over again).

It's official. Wall Street is filled with quick thinkers.

A recent study by Professors Terrance Odean and Brad Barber at the University of California at Berkeley shows that those investors who trade the least outperform those who trade the most by 6.8 percent annually. I think I've always suspected this was true.

So instead, I want to show investors how to find and evaluate overlooked companies, show a little patience—and then reap the rewards by picking stocks.

You might be saying, "Hey, this guy teaches at a university. Doesn't he know that the markets are efficient and that stocks are perfectly priced based on all available information?"

The "Efficient Market Hypothesis" is an assumption that everything we are talking about here is already priced into the stock. It also assumes that what we're talking about in this book is a waste of time. There are academics wearing black socks and Birkenstock sandals walking around campuses all over America teaching that.

There are some who say that the market prices every stock at exactly what it's worth. A company's stock price is affected by many factors: projected earnings per share, strength of its balance sheet, prospects for growth, past performance, and so on. Everything is in the price. As the ads used to say about Ragu spaghetti sauce, "It's in there."

I will grant them that—but only for well-monitored companies whose fortunes attract analysts by the bushel. I'm really not having a face-off against academic finance. I'm just saying, I think academic finance is partially right. The market for blue chips is pretty darn efficient. Small companies often aren't so scrutinized. And that's where many of the opportunities lie.

Many of these gems might be right in your hometown. Or perhaps they're companies you have come across in your work, or through a friend or neighbor. In any economy, good or not, there are solid companies run by smart individuals that are going to prosper.

I wanted to show investors how to find and evaluate these overlooked companies—and then reap the rewards by investing in these stocks. Small companies are one of the best places in the market to generate “alpha”—return over and above what you’d expect to earn for the risk you have assumed by purchasing a particular stock.

Let me tell you a story about how I fell in love with the stock market. Gather ‘round.

In the early 1980s, I was a young man working at Kidder Peabody & Co. investment firm in Boston (since bought out by General Electric). I lived downtown, in the North End, and every morning I would put on my suit and walk to work. The market back then opened at 10:00 a.m., and we generally had to be there by 8 a.m. But one morning, our boss told us to be in the office at 7 a.m. He wanted us to hear from an analyst who was coming in from out of town.

The stock market was flat-out awful. I remember complaining about the stock market to an older colleague. He also had money in the equally dreadful real estate market and quipped, “Yeah, but at least you don’t have to paint them!” (fair enough).

Stock prices kept declining. I was ready to hear what this Wall Street guru had to say, so I got myself to work early, and...well, it was practically a religious experience for me (clouds parting, rays of brilliant light, etc.).

Just picture it. Interest rates were 18 percent, and nobody could buy a home (the interest rates made that impossible). If you had a home, you were going to stay in it because you needed to stick with your current low interest mortgage.

The analyst said, “All over America, wives are saying to their husbands, ‘Honey, I know we can’t move, but you are going to do something about this place. It’s outdated; it looks awful. At least paint the den! If you don’t, I’m moving out, and here’s the best part...I’m leaving the kids with you!’”

“So,” the speaker continued, “I’m recommending Sherwin Williams (SHW).” This was the Cleveland-based paint company, about as unsexy a stock as you imagine. And guess what? He was right. Homeowners did start fixing up their homes, and in less than a year, the stock was up 250 percent (four times better than the overall stock market).

That's what I mean. As they say in the South, "Every pancake's got two sides." There is no scenario that's bad for EVERYONE. In 1980, despite a challenging stock market, it was a bull market for companies that catered to do-it-yourselfers who splurged on paint to fix up their homes. No matter the scenario, somebody is going to benefit from it.

You just have to figure out who that is.

1

Hit 'Em Where They Ain't

"Wee" Willie Keeler was so good at hitting a baseball that he was inducted into the Hall of Fame in 1939. At only 5 foot 4 inches tall and 140 pounds, he credited not brawn but his brains for his success on the diamond. He said his strategy was simple: "I hit 'em where they ain't!"

In his case, "they" referred to fielders. At Tulane University's Burkenroad Reports, our student stock researchers are employing that same strategy, but the "they" we are avoiding are money managers and securities analysts.

I will grant you that some stocks are ignored for good reason. But it still amazes me how many solid and attractively priced stocks have almost nobody following them. Most people assume that companies "orphaned" by analysts have horrible balance sheets, uninspiring growth outlooks, or are so small that investors would label them "penny stocks." These characteristics would have me running the other way, too. But in many cases, they've slipped through the cracks because:

- They operate in more than one business or industry.
- They are based "out where the buses don't run," far from Wall Street.
- They don't have many shares traded on a daily basis and aren't in need of corporate finance work. They don't make very attractive clients for investment firms.

- They lack an easily identifiable "peer group." Most analysts compare relative valuations to determine a stock's attractiveness. And for this, you need a peer group of like public companies. This is similar to the way real estate agents price homes by square footage, based on the sales of comparable nearby homes.

This is an especially important concept, so let me give an example. There's a Morgan City, Louisiana, marine fabricator called Conrad Industries (CNRD). The vessels that Conrad makes are too big to compare the company to the public companies that manufacture pleasure boats, and too small to compare to those who build tankers or Navy ships. Only Burkenroad follows the stock. Such a "peerless" company often becomes an orphan stock, because analysts don't have any valuation benchmarks.

You're more likely to uncover these gems than any Wall Street professional.

Smaller companies tend to be overlooked by the big analysts, and my observation has been that the number of analysts following the stock seems to be inversely correlated to its potential performance. Apple (AAPL) has 65 analysts following it. Every time they drop a pencil, the analysts jump on it. If a horde of analysts are following a company, then the stock is probably priced efficiently and not a bargain. I look for companies where five or fewer analysts are following the stock.

Bayou Steel, a company that Burkenroad Reports followed, was profiled by *The Wall Street Journal*. They asked the CFO whether he liked having the Tulane students come over and write their reports. "Yes!" he replied. "Would we prefer to have analysts from Morgan Stanley follow us, sure, but they ain't coming!"

The point is, people far from Wall Street run across business opportunities analysts would never know about. For my money, two of the greatest investors in history are Warren Buffet of Omaha and John Templeton, who spent his time in the Bahamas. If they had been operating out of big money centers like Boston or New York, they may have suffered from "group-think" and owned the same stocks as everybody else. Be grateful for "group-think"—it leaves a lot of opportunities for the rest of us!

When I was first thinking about starting Burkenroad Reports, I went to New York and was talking to a money manager, this big, gruff guy, and I was telling him what I planned to do—going to visit and write about these public companies headquartered in the South. And he said, "Peter, that's a terrific idea. You know why?" He snorted. "Up here, they don't know anything. You know what they know? They know Starbucks! They know delicatessens!"

It was actually an important message. You're more likely to find a great company in your hometown or through the company a friend works for than the Wall Street in-crowd ever would be.

Individual investors can also have a lot more patience. Unlike professional analysts, individuals don't need to report impressive short-term results at the end of each quarter to keep their jobs. This situation always reminds me of something my investor friend Fred Speece likes to say: "Genius is just a greater aptitude for patience."

There are several reasons I think this is a great time for individuals to pick their own stocks.

The one big advantage that individual investors have nowadays is the Internet (quick, Batman, to The Google). In the past, investment information was the province of the big firms that dominated Wall Street. Investors had to depend on brokers or dig through newsletters and stock guides to figure out how much companies were worth and what their earnings potential might be. I actually remember taking a friend from another firm to lunch so that he could slip me his firm's research report on a company I was interested in.

These kinds of archaic stories, like tales of writing "order tickets" and having the order takers type them up and send them to the floor, drive my Tulane students crazy. ("How old ARE you, Professor Ricchiuti?") In truth, a lot has changed in a relatively short period of time. Working with young people is great and invigorating, but sometimes it does make you feel old. I know I'm getting old. I'm now approaching that age when the term "pulling an all-nighter" pretty much means sleeping through the night without having to get up to go to the bathroom!

And change is hard. I had a tough time getting over the stock market's 2001 move from fractions to decimal pricing. I was really good with fractions...and where can I use that skill set now? Recipes? (1/2 cup of sugar!) Racetracks? (He's coming around the 3/8ths pole!) Math is tough for a lot of people. They say that a waitress once asked Yogi Berra if he wanted his pizza cut into six or eight slices. "Six," said Yogi, "I'm not hungry enough to eat eight!"

Nowadays, investors can pull up company websites and find financial analyses, annual reports, investor slide shows, and even listen to archived conference calls. And whereas in the past, investors had to pay brokers hundreds of dollars in commission, these days ordinary people can make their own trades online for just a few dollars.

So, why aren't people taking advantage of this wealth of great information? They just aren't interested. Stock-picking is a lost art. I think it goes back to the mood of the investor. They're terrified and don't want to make a move. Or, they've been convinced that they need to let someone else manage all their investments, to go with the crowd.

Small Caps

I once noticed a solid, well-run company in Houston that made gloves, safety goggles, and other products that protected people who worked with dangerous chemicals. It was doing well, and I thought it would fit well in Burkenroad Reports. So, I called the company and got through to the CFO's secretary, and asked to speak to the guy. I told her who I was, and how we followed small public companies.

The secretary read me the riot act. She said, indignantly, "We are NOT a small company! We are a large, multinational corporation!" It was funny to me, because she was using the term differently than I was using it. The company had a market capitalization of about $700 million. That is what Wall Street calls a small-cap company, and believe me, there's nothing "belittling" about that description. Almost all of our best investments are small-cap companies!

The general public thinks of a large company as one that has a lot of employees, maybe, or has a lot of stores or big earnings. Investors, on the other hand, look strictly at what we call market capitalization. It's easy to figure: It's simply the number of shares outstanding in the company times the stock price.

For instance, a terrific, well-managed small-cap company we follow is AFC Enterprises (AFCE), better known as the fast-food chain Popeyes Chicken & Biscuits. AFC has a market capitalization of about $750 million and is currently a small-cap stock.

RPC, Inc. (RES) is an oilfield service provider we write about and has a market cap of about $3.5 billion. It is considered a mid-cap stock.

At Burkenroad Reports, we don't follow any large-cap stocks, but a good example might be Microsoft (MSFT). It has a market cap of over $235 billion and is definitely a large-cap stock...and out of our league. We also tend to avoid high-tech stocks. Plenty of investors have made money in technology stocks, but we've been successful focusing mainly on low-tech companies, and we'll continue to "dance with who brung us."

Here's a current rough gauge on market capitalization:

Large Cap = Above $10 billion

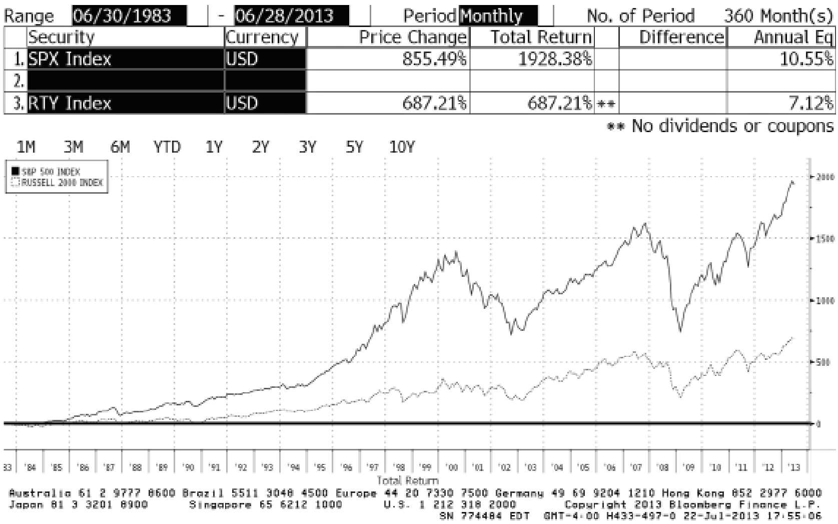
Mid Cap = $2 to $10 billion

Small Cap = $100 million to $2 billion

Micro Cap = Up to $100 million

Over long periods of time, small-cap companies have significantly outperformed their large-cap brethren. Over the last 30 years, the small cap Russell 2000 (RTY) has outperformed the large cap S&P 500 (SPX) by nearly 3-1.

S&P 500 Index vs. Russell 2000 Index



I can hear you wondering right now: If small-cap companies tend to be overlooked by Wall Street, how do investors eventually make money off them? What makes their share prices go up? Can't they just linger forever as dreaded "perma-cheaps"?

Stock Catalysts

One big reason small caps tend to beat large caps is simply based on scale. If Microsoft, which has $78 billion in annual sales, invents a new widget and sales go up by $100 million, the stock might barely register it. But if egg distributor Cal-Maine (CALM), with $1.3 billion in annual sales, picks up a new customer and grows *its* sales by $100 million, the stock would likely see a re-evaluation and a jump in its share price.

Share Buybacks

Likewise, if a company starts buying up its own shares, the amount of available stock—denominator—gets smaller A relatively small change in the fortunes of a company can have a big impact on the stock if there aren't many shares outstanding. With each share packing more worth, earnings per share gets a boost from fewer shares as well.

Growth Brings Attention

Although a company might be too small for Wall Street to notice right now, at some point, a successful small cap is likely to get to a size where the analysts sit up and take notice. As it gets bigger, it will get followed.

This is one of the great oddities in the world. As a company's shares get more expensive, they become more attractive to Wall Street. A company that is invisible to analysts at $10 per share and a $100 million market cap suddenly becomes an investment community darling at $100 per share with a $1 billion market cap.

The world outside of Wall Street doesn't work this way. People don't generally ignore a sweater at $10 and then fight with other shoppers at the chance to pay $100 for the same garment.

I am originally from Boston, so I saw aggressive bargain hunting first hand at the original (now bankrupt) Filene's Basement store downtown. Filene's had a system for dropping prices on items for each week they remained in the store. It was such an institution that my Dad was taught percentages Filene's style as a child in Boston's public schools (Show your work! A men's shirt arrives at Filene's Basement on March 1 and is priced at $5. The shirt's price is halved every seven days. What is its price on March 15?). I loved this place and the surly sales staff. I am color-blind and once asked a salesman the color of a particular (highly discounted) suit I had found. He answered, "What color do you want it to be?" You just don't get that kind of customer service anymore!

As a little boy, I was brought to Filene's all the time by my Mom. I will never forget watching women disrobe in the aisles to try on much sought-after items. You can imagine this made a lasting impact on me.

The Liquidity Discount

Big institutional investors need to move millions of dollars quickly in and out of a stock, and they tend to avoid companies that don't have a high number of shares outstanding, big average daily volume, or a large float of tradable shares. This lowers the valuation of "less liquid" stocks and leaves a nice opening for Mr. or Ms. Small Investor. You're in the proverbial catbird's seat. The individual investor doesn't need to be scared away by a stock's limited liquidity. You're probably not going to be buying or selling enough shares to really affect the market.

I once sent my students' research to a money manager at a big Chicago-based investment firm. He thanked me for the reports and complimented my students' work. But, when I asked him if he had purchased stock in any of these ideas, he said, "I have for my own account, but not in the fund. These stocks don't have the liquidity I need. It's tough to sell a lot of shares in these kinds of companies without knocking down the price. For institutional investors, these are called 'Hotel California' stocks. You can check in anytime you want—but you can never leave."

Because the big institutional investors shy away from these stocks, they tend to sell at more attractive valuations. We call this "the liquidity discount."

Skin in the Game

Another reason I like small caps: In many cases, a big portion of the management team's personal assets are invested in the company's stock, even though their financial planners probably say they need to be more diversified. If the stock rises, they'll be in "high cotton," but if things go south, the company managers and their families could be suddenly "downwardly mobile." I feel good when management is in the same boat as I am. Will they work hard to grow the company and get the stock price up? Is the Popemobile Catholic?

Quicker Thinking

Small caps are more flexible as economic winds shift. Managers can make decisions based on their thorough knowledge of the business and see the impact quickly—not, as with some huge companies, weeks later after layers of executives are consulted and endless meetings are held. If they need to close down a lagging product line or move personnel, it happens right away, with less costly waste.

Better Balance Sheets

Even if accounting was not your forte as a student, and all you remember from that class was that the "debits are closest to the windows," you need to think about this. Generally, smaller, unknown companies operating in seemingly "un-sexy" industries have cleaner balance sheets. There is a reason for this. They just don't have the easy access to capital as do their Silicon Valley or large-cap counterparts. This makes these managements very good "stewards of capital."

Buyout Potential

Furthermore, small caps are more likely to be bought out. Since Burkenroad Reports started in 1993, we've had 24 companies bought out. And when they do get bought out, you're more likely to have a fatter takeover premium. That is, whoever's buying the company is likely to pay quite a bit above the asking price for a small-cap company. If a big company is taken over, the premium might be 20 percent. For small companies, we've seen premiums of 50, 60, and even 100 percent.

In August 2012, one of the companies we followed, The Shaw Group (SHAW), out of Baton Rouge, was bought out by CB&I Corporation (CBI), another engineering and construction firm. Shaw was trading at $28 a share; CB&I offered $48 a share: a 72 percent premium. A few months later, New Orleans-based McMoRan Exploration (MMR) was bought out by its former parent company, Freeport McMoRan (FCX), at almost double its pre-buyout announcement price.

These small-cap "Stocks Under Rocks" aren't always in favor, and even good stocks will decline in value when the market takes a tumble. (As they say here in New Orleans, "When they raid the brothel, even the piano player goes to jail!") But, eventually human nature and economics will win out, and these kinds of stocks have a lot going for them.

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