Interview with Mary Lisanti

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We are small-cap growth investors, so when I talk about small-cap stocks I am really focusing on small-cap growt stocks. [This year] seems to me to have a lot of similarities to 1990; that was a year where small stocks declined in the first half of the year over concerns regarding the bank crisis and the economy, and then recovered as it became clear that the bank crisis, while difficult, was being handled, and the economy had entered a short (two quarter) and relatively mild recession. I believe, given the recent actions by the Fed and the regulators, that the financial issues tha currently confront us today will also turn out to be manageable — by that I mean they will not plunge us into a depression or a severe recession — and while it appears we are in a recession, I believe it will be reasonably short anc mild. However, also like the 1990s, the effects of the financial crisis will cause economic growth to be quite mild for many years forward; this will cause the market, I believe, to put a premium on those companies that can deliver earnings growth.

Smaller companies tend to be less liquid as trading vehicles than larger companies and mid-sized companies, as they have fewer shares outstanding. They also can be more volatile over short-time horizons, for the same reason. However, in part because of their smaller size and fewer shares outstanding, they have the potential to grow earnings at a faster rate than larger companies. I would also say that, in my experience, management has a bigger impact, either positive or negative, on smaller companies.

There are over 5,000 companies that meet our definition of small cap (companies under $2 billion in capitalization) thus it is really hard to make generalizations [concerning the corporate earnings outlook]. We are still finding companies that have bright prospects for earnings growth in 2008 and beyond, because they have strong product cycles, really differentiated products, have made an acquisition that is strategically significant, or some other event. I believe that in all but the most severe recessions, the future of a small company rests much more with its internal ability to execute than it does with outside macroeconomic events.

What matters most to us is the ability of the company to grow its earnings at an above-average rate for some period of time — usually three to five years. The process by which we determine that is fairly intensive: we do a lot of research, interview management, talk to customers, look at research reports and at 10Ks, 10Qs, etc. The majority of companies in which we invest tend to have a product or service we believe is unique and different; they tend to have management teams that we think highly of, and have strong balance sheets — no debt and several dollars per share i cash.

I think individual stock selection is more important than sector allocation if you are a stock picker, and being a good small-cap growth investor is all about being a stock picker. Having said that, there are certain sectors in which we do not spend much effort, such as telecommunication services or consumer staples, as most of the companies in those sectors do not grow earnings quickly enough to meet our hurdle (we look for 15% earnings growth annually). I also think it might be a bit too early to look at the financial sector.

Given the decline in the small-cap market year to date, there are a lot of companies we like. Three of our favorites:

• **BioMarin Pharmaceutical Inc.** (Nasdaq:BMRN): this is a biotechnology company that specializes in smaller metabolic diseases where there is not a lot of competition. Most of their drugs end up with "orphan drug" status, and they tend to solve problems or issues that previously did not have a solution.

• **Carrizo Oil & Gas, Inc.** (Nasdaq:CRZO): this is a smaller oil and gas exploration and production company with a lo of acreage in the Barnett Shale, which is one of the bigger gas fields in the United States. The company is just hitting its stride in terms of drilling wells successfully, and thus its production is growing very quickly, which is leading to very strong earnings growth.

• **Rubicon Technology, Inc.** (Nasdaq:RBCN): this is a technology company that is one of five manufacturers of crystals used in the LED (light emitting diode) market. LEDs are more energy efficient and provide a brighter, whiter light than traditional lighting sources, and thus are being used in anything from cell phones to automobile headlights. This industry is experiencing very fast growth because it is very early in its development. *(For more on Rubicon, read our Spotlight column on the company.)*

We believe small-cap growth stock prices are driven generally by two things: the rate at which they grow earnings, and the valuation that investors are willing to put on that earnings growth. When the Federal Reserve is raising rates, it tends to cap the valuation levels that investors want to pay, particularly for fast growing companies. When the Federal Reserve is lowering rates, it tends to raise the valuation levels investors want to pay, but in times like this, when investors are worried about a recession, they tend to worry about the ability to grow earnings. The best of all worlds for small-growth stocks is one in which GDP is growing slowly, inflation is modest and rates are low — like the early 1990s.

I'm not in the business of calling market bottoms. I think if you look at periods of time when we have experienced brief, mild recessions combined with financial crises, such as 1990, the Russell 2000 Growth index declined 25% to 30% from peak to trough. I think if this market follows that pattern, we are closer to a bottom than a top. I think if one is investing in small-cap growth stocks, given their volatility, it is best to take a longer-term view and focus on the individual company's prospects, as opposed to trying to time the overall market. I am a personal fan of dollar-cost averaging in small caps, and diversification among a number of stocks to lessen the risk inherent in any one individual issue. When I look at the stocks we own in our portfolio, I am fairly confident that, if they deliver on the earnings growth we are looking for in 2008, the stocks will be higher in a year than they are now, barring any unforeseen catastrophes.

Mary Lisanti was interviewed via email by SmallCapInvestor.com reporter Jennifer Schonberger.