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## SMALL CAP ROUNDTABLE

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# July 2008 Roundtable Part 4

Jennifer Schonberger | Jul 28, 2008 08:53am EDT | Comment

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*Today marks the first of two days where our panel will examine the outlook for specific sectors. Our experts share their favorite sectors to deploy capital in for the second half of the year. We'll also drill down into their thoughts on technology and energy. (This is part four of a five part series.)*

### What sectors do you favor for the second half of the year?



*Mary Lisanti is president and chief investment officer of AH Lisanti Capital Growth. Lisanti has spent 12 years as a small-cap analyst and strategist on Wall Street, holding such positions as CIO of ING Investments, senior portfolio manager for the small-Cap Growth and mid-cap growth strategies at Strong Capital Management and managing director and head of the small/mid-cap team at Bankers Trust Company.*

**Lisanti:** "If energy comes down in price, then consumers are going to go up.

"Historically, after the Fed has stopped raising rates, the stocks that tend to do the best are tech, health care and energy. The sleeper is probably healthcare. The traditional growth sectors look to me like the sectors that make the most sense right now. They tend to have high intellectual properties, high profit margins, high barriers to entry and high returns on capital. Those are the kinds of attributes you want in this environment.

"In energy, I would look at solar. Think of it as all along the energy spectrum. With [oil] at \$140 it's what we do to get more efficient. I'd put a little on the energy continuum.

"Then there's health care, which has been a really bad area. It hasn't worked for two reasons. I don't think health care outperformed until 2002, so, people have to believe that this is not going to be the quick rebound. As this plays out and after we get [a new president], it probably sets up 2009 as a much better year for health care. For the next 18 months health care will probably be a much better sector than it has been. My guess is it's been starting to work a little better this past month, and I think that'll continue.

"I think we've probably bottomed in health care. [Some] health-care stocks are at a 10-year multiple lows. The last time we had 10-year multiple lows on anything, usually it's a bottom. It was the case for retail in 2001 and 2002. Anytime you get that kind of a washout, usually it provides you with opportunities.

"I think materials and industrials will be more difficult areas as the rest of the world slows."

**Oberweis:** "Technology valuations continue to remain below average and, quite frankly, if you were a believer that the recent sell off in the first quarter was overdone, I think you have to look at technology as the place where it's most overdone. It's gone down the most because of risk aversion, not because of business fundamentals. If you have an area that's been weighed down by risk aversion and not beaten down based on business fundamentals, it's usually a good time to be buying the sector."

"Also, most people focus on how the credit crisis has led to a contraction in credit — an inability of companies to obtain financing for growth. Technology companies don't tend to be debt financed — they tend to be equity financed. You shouldn't be scared of technology companies because they usually don't take credit; they tend to do equity financing."

"If you're concerned about slowness in the United States, technology is probably your best bet if you want to be in the equity markets because they tend to have a much greater degree of international diversification than, say, consumer discretionary companies."



*Jim Oberweis is president and lead portfolio manager of Oberweis Asset Management, a growth equity investment management firm that manages approximately \$1.5 billion in micro, small, and small/mid capitalization growth strategies globally, primarily for institutional investors and its own proprietary mutual fund family. Mr. Oberweis is also president of The Oberweis Funds.*

"Another high-growth sector that would be an attractive addition but has been somewhat punished in the first quarter includes the high-growth segment of health care. [Look for] medical technology and companies that are creating new products for health-care delivery."

**O'Halloran:** "For the second half of the year, energy and industrial companies are likely to have the best earnings profiles. Industrials would include materials, producer durables and transportation companies. The reason that these should do well is that the emerging nations of China, India, Eastern Europe, the Middle East, and South America are all engaged in a multi-year infrastructure build out."

"Companies that are taking advantage of this infrastructure buildout will continue to show superior earnings growth. The sectors that will have a difficult time are consumer and financials, where the earnings estimates will continue to be cut and the growth will be negative. The one sector [that's] uncertain right now but could potentially be quite good is technology. Even though the energy and industrial companies will demonstrate better growth profiles, they have achieved unusual stock outperformance this year. If energy prices moderate, the consumer, financials, and tech companies could bounce back in terms of relative performance."

**Riley:** "There's a lot of value in retail. The way that we look at things is if you say intuitively what feels and looks really bad is the easy sale for people. Retail is an easy sale. Everybody is concerned about the domestic environment, and so the easy thing to do is to sell your exposure there, and that creates value. I think there are some long-term opportunities in retail, again, finding ones that are well-capitalized."

**Evans:** "You're going to want to be in groups that have pricing power — those are materials, energy and industrials. Within energy, natural gas is an area that is very attractive. Natural gas

trades at a fairly sizeable discount to crude oil on a BTU equivalent basis — crude oil at \$124 natural gas at \$9. On a BTU equivalent, the rough number for natural gas would be in the \$20 range. Take \$124 and divide it by six, that's \$20.67. It shows you that natural gas is trading at a sizable discount to crude oil. We're excited about what's happening with natural gas and that includes the activity in the North American oil field services. National Energy Security lies in natural gas. We're going to require a multiplicity of investment in solar, wind, nuclear and coal, but we're self-sufficient for about 90% of our needs for natural gas here in the United States. It's a continental commodity; we're not totally self-sufficient, but we have the wherewithal to drill and produce natural gas for the benefit of our economy [versus buying] expensive oil. [Natural gas is] also the most environmentally friendly hydro-carbon that we can use from a global warming perspective, so it has many positives as we talk about the energy crisis unfolding. We like secure North American natural gas assets as well as the companies that can help unlock the developers' resources. We also like the service area. It should still do pretty well even if the economy limps along.



*Tom O'Halloran is director of Small Cap Growth Investments at Lord Abbett. He is responsible for managing the firm's small cap and micro cap growth products, overseeing the investment teams, and directing the investment strategies. O'Halloran has been in the investment business for 20 years.*

"Another area that I think is intriguing is health care. It's been a terrible performer year to date (down about 14% in the Russell 2000 value). But there is an opportunity in the health-care space — like medical devices.

"We also like materials, in particular chemicals, which somewhat plays into the weaker dollar. A lot of these assets are trading below a replacement cost so there are extremely high capital barriers and environmental barriers. Industries are fairly rational from a competitive perspective, not a lot of new capacity will be coming on line, as you can imagine. Also, the weaker dollar shields the U.S. market from imports of certain chemicals and provides an export opportunity. So I would say health care, energy on the upstream, the service area and then chemicals."

**Wyatt:** "The key here is for investors to be nimble. Oil's hot right now, so if you're going to invest, then invest along those lines. However, if that's the route you have decided to take, it's imperative that you're able to quickly unwind. A few consecutive days of a slide in oil prices on the heels of a report showing an uptick in supply is a clear sell signal. Also, profits should be taken off the table in a timely manner. This isn't the market to be greedy."

#### **What are your thoughts on investing in small-cap tech stocks now?**

**Lisanti:** "People are nervous about tech, but we're entering a period where tech spending will probably improve slightly. Spending has been 3% to 5% and it's going to grow 3% to 5%. The reason is because the return on investment is very high, but increasingly investors are going to focus on companies that can deliver returns. It's going to favor the smaller companies that have unique products and unique services. Also, what do we do when times are tough? We replace people with technology. We're going to do it selectively but we're going to start that. It's a way to improve productivity."

**O'Halloran:** "Technology was out of favor for seven years after the bubble burst in 2000. During that timeframe, the industry had an opportunity to rationalize and eliminate excess capacity. There are many new

exciting products and service offerings that have had time to develop. Technology started to assume leadership in the market in 2007, but that was postponed by the bear market of 2008 because [tech] tends to be a high beta sector and tends to have a cyclical component to it.

“So, when the fears of an economic slowdown developed and the market went down, it suffered. But [tech] could be a good sector for the second half of the year.”

**Riley:** “You’re going to see consolidation that will come from foreign buyers, industry and larger-capitalized companies. There’s going to be a lot of pressure on some of the micro-caps in that space to do something, and there’s a feeling among the shareholder base that it’s time to consolidate. If you see an offer, you should respond. We’re seeing a lot of that. Microsoft legitimized it by bidding out loud for Yahoo! I think you’re going to see more and more of that, so you’ll get a lot of consolidation.”



*Bryant Riley is founder and managing member of Riley Investment Management, an investment advisor which provides investment management services. He also is founder and chairman of brokerage firm B. Riley & Co.*

**Evans:** “I’m cautious on technology because all the research we see indicates that investors are heavily overweight technology. It’s not a contrarian investment. You have to be very selective.

“If you look at that area right now, though, one area that looks attractive to me is semiconductors. Again, on a very selective basis. The analog and radio frequency semi-conductor area are two areas that I think are attractive.”

**Wyatt:** “Avoid them. There is no institutional money pouring into that space. Tech spending is extremely elastic, and so bears the full force of any economic downturn. Small-cap techs tend to have concentrated revenue streams — one hiccup could lead to a huge earnings miss.”

#### **How does investing in tech now compare with the state of the tech sector in 2001?**

**Lisanti:** “It’s an easier sector to invest in than it has been since 1998. After the wake of the Internet boom, there were over 5,000 companies that were small cap and there are still 5,000 companies that are small cap today. But 1,500 of those used to be mid-cap companies and about 1,500 went out of business. Most of them are public domain companies, so we cleaned out the weaker companies and were left with better-quality companies. You’re left with companies that have found ways to be value-added and different.”

**Riley:** “In our world, it’s a total and complete opposite. In 2001, we were being driven by metrics such as multiples of revenues and revenues per click that were idiotic. All these things have nothing to do with running a business, and that was a very real world to invest in, but it created an environment in which an amazing amount of money was raised for the wrong reasons. Now you’re seeing companies that have much better operating structures, stronger balance sheets and are focused more on the right things such as making money.”

**Wyatt:** “It’s different — in 2001, we had a tech-fueled recession. People went from hoarding everything tech in the years before to avoiding any contact because of factors outside of fundamental ones — namely fear of

getting burned again. This time the concern is a fundamental one: tech is not the place to be because tech spending is going to be down in a sputtering economy.”

**What about energy? Do you think the rally’s getting long in the tooth? Have we seen, or will we soon see, a topping there?**

**Lisanti:** “Yes I do because in my opinion the Fed will win, as the whole world needs lower energy prices. The rest of the world will slow and the price of energy will enter a trading range for a long time — and may even come down. That means you’re going to have to be a lot more selective. Small companies where reserves are growing 100% a year will still do fine.

“Energy is a funny thing. There will there be a top in energy and I can’t call it over the next month or so, but I think a year from now we’ll look back and say, ‘this was the time.’ I don’t know what the right price for oil is, but my guess is somewhere between \$80 and \$100.



*Brad Evans is a portfolio manager of the Heartland Value Plus Fund and the Heartland Value Fund for Heartland Advisors. Evans is a Chartered Financial Analyst and has more than 11 years of investment industry experience.*

“When we got to this price in 1975, it was the peak. We’re back at 1975 peak prices right now. The question becomes ‘Do we do a short-term fix, or do we do a long-term fix?’ We didn’t do a long-term fix in ‘75; I think we’ll do a long-term fix now.

“We have a lot of alternatives we haven’t explored. We’re going to start looking at so many other ways of doing things that it’s going to spark a whole wave of innovation and creativity. McCain is proposing to build tons of nuclear plants. They’ve had nuclear power in France forever and it’s worked.

“I think [alternative energy] is going to see the real excitement in small caps over the next five years. It’s a little like biotech when it got moving ... we started the biotech revolution and now it’s so woven into the fabric of our health-care system that it’s a given we’re going to get genetic testing and designer drugs. That’s happened in less than a generation — it’s been in the last 20 years. I think the same thing is going to happen with energy.

“As we pass through September, when we finally know the subsidies for the solar guys (from Spain, Italy and Greece, among others), [they are] going to do really well. There’s no question that some of these companies are starting to get very close to group parity. When that happens, it becomes viable and could develop into a fertile area over the next five years.”

**Oberweis:** “I suspect you will probably see a short-term top here. There’s an imbalance between actual demand and price right now, meaning the demand is not likely to support the kind of prices that we have. If you’re a believer of a prolonged uncertain economic environment, what tends to happen historically is that during slower economic times, demand for energy goes down. In addition, I think when you have prices as high as they are right now, it tends to spur alternative energy ideas and alternative technologies that will consume less energy.

“If I were going to bet up or down, I would bet down over the next six months. That said, energy prices could go down a lot, but we could still have terrific gains out of many E&P companies because they haven’t gone up

as much as they probably should have. "Anything north of \$100 a barrel will lead to very good numbers for companies such as **EXCO Resources, Inc.** (NYSE:XCO). EXCO's an exploration production company with significant acreage in Louisiana. [Just] remember that most U.S. energy companies aren't oil players, they are natural gas players.

"There are certainly good opportunities within the energy arena. You have to have companies that are not necessarily banking their business on current energy prices, as those are a short-term variable and will drop down."

**O'Halloran:** "People have been predicting the collapse of energy prices since \$50 a barrel. Cambridge Energy Research Associates may tell you that the marginal cost to produce is \$70, and that's where the price ought to be. Perhaps there is speculation or geopolitical manipulation that may be bringing about these high prices. Demand has been outstripping supply, and supply will not be ramped up quickly enough. As long as prices stay at elevated levels, it means that the energy company earnings are going to look a lot better than those of other companies. We don't think the era of high energy prices are over. That being said, demand destruction is beginning to occur, and energy prices are likely to moderate in the second half of 2008."



*Ian Wyatt is Chief Investment Strategist for SmallCapInvestor.com. As a well regarded small cap stock expert, Ian also serves as the Editor-in-Chief of two independent investment newsletters, Growth Report and Rising Star Stocks.*

**Riley:** "If you go through Wall Street recommendations on a daily basis, [some] 75% of those upgrades and recommendations are energy and energy-related. Over the long term, when you get to those kinds of levels, if you were to measure when your [success rate], you're probably less successful when the whole world is buying [energy stocks] or recommending them. There aren't a lot of places to put your money right now if you're a growth investor, and some of the commodity-related companies have pricing power and growth. You're starting to see it, but I think that's reflected in the prices, and I would be more cautious on those."

**Evans:** "In the upstream ones — the exploration and production stocks — our work indicates that roughly \$80 oil and \$8.50 natural gas is discounted into these stocks on a discounted cash-flow basis. So, the 12-month strip per oil is \$135-plus and the 12-month strip for natural gas is over \$13. Those represent discounts of 40% or 50% from the strip. The market is not discounting anywhere close to the 12-month strip in these companies. Many are trading at four- or four-and-a-half times cash flow, 12 to 13 times earnings.

"Granted commodity prices are high, so multiple expansion may be unlikely. But the independent exploration and production companies are taking a leadership role from the Exxon's and the Chevron's and other integrateds because those companies are having a great deal of difficulty growing production. The independent E&P companies have the wherewithal and are exhibiting production growth in an energy-starved world. We have a failed energy policy: we have not invested over the last decade.

"If you look at consumption here in the United States on an annual basis, we consume roughly 64 billion cubic feet (BCF) of natural gas per day. In the United States, we supply 53 to 54 BCF a day and we import from

Canada, [but our] production-decline rate every year is 30%-plus. If you're producing, let's say 54 BCF a day, and don't drill another well, a year from now your production would be about 35 BCF a day. But demand is growing.

"Picture a treadmill, it gets faster and faster and the capital intensity of the industry is increasing. That's why commodity prices are as high as they are. There is a short-term cyclical aspect to crude and natural gas prices and prices could see a 10% to 20% pullback. There are secular trends underway, though, that strongly support higher commodity prices into the future, and I think that every investor should have exposure to energy stocks."

**Wyatt:** "I think volatility can sometimes provide a clear picture of what's going on, offering a separation of the fundamental from the speculative. A large part of this energy boom is indeed fundamental, but at this point, volatility is fairly extreme as oil prices fluctuate widely on the slightest of news. I think that's a sign that everyone is riding this boom. The everyman investor is almost always late to the party. Yet, here's the thing: whether we're near the top or not, the idea is to make money while you can, pocket some gains and move on when there are clear signs of weakness. Right now, I would continue to go long energy, hope to make some money and exit at the first sign of a broad-based sell off."



**About the Author**

Reporter Jennifer Schonberger is based in SmallCapInvestor.com's Washington, D.C. bureau.