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SMALL CAP ROUNDTABLE

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July 2008 Roundtable Part 5

Jennifer Schonberger | Jul 29, 2008 09:14am EDT | Comment

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Today concludes SmallCapInvestor.com's Roundtable. In this final installment, our experts examine the alternative energy sector, compare the tech bubble burst with the current implosion of financials and take the temperature of the current state of the credit market. Taking a look at the international investing landscape, our experts still perceive the emerging nations, particularly China, to be the hottest destination for investment. And lastly our experts on average forecast the small-cap index Russell 2000 will end the year higher than it is today. (This is part five of a five part series.)



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.

What do you think about alternative energy? Do you think that energy prices need to remain inflated for the alternative energy space to remain profitable?

Oberweis: "No, the key for alternative energy is the subsidies, quite frankly. The real danger to buying solar stocks right now is there's some momentum in the Spanish and German markets, which are the two of the large consumers and drivers of the adoption of solar energy, to reduce or remove the subsidies that are making the technologies economical and affordable. That's probably a much bigger and more important driver of the success of solar companies than the actual price of oil."

O'Halloran: "Alternative energy is an industry where we have very strong forces helping the companies. We have three holdings in solar energy: **SunPower Corp.** (Nasdaq:SPWR), **Energy Conversion Devices, Inc.** (Nasdaq:ENER) and **JA Solar Holdings Co., Ltd.** (Nasdaq:JASO). This year we have more wind energy companies in the portfolio because wind energy is just starting to ramp up aggressively like solar did over the past couple of years.

"American Superconductor (Nasdaq:AMSC) and **Woodward Governor Company** (Nasdaq:WGOV) — whose equipment is used to adjust turbine-generated power for conveyance to electrical grids — are a couple. There are also companies such as **RBC Bearings Inc.** (Nasdaq:ROLL) and **Kaydon Corp.** (NYSE:KDN), which make bearings for the wind turbines. Another is **ITC Holdings Corp.** (NYSE:ITC), which is in the process of rebuilding electrical transmission lines as part of a federal government initiative. These upgrade lines will help take energy from [wind farms], put it on to the electrical grid

and get it into homes. Fuel cells and their technology and ethanol are either too early or not profitable enough for us to be involved with yet.”

Focusing on the energy space, do you think we’re experiencing the equivalent of the tech bubble in 2001, but for energy?

Wyatt: “No, I don’t see a retreat in oil of the same magnitude of the retreat in tech in 2001 because fundamentally, oil needed to advance. Whether it needed to advance to this degree remains to be seen.”

What do you think about financials now?

Lisanti: “This idea that the banks will come back anytime soon is fallacious. It’s the same argument we made for technology. People are slow to realize that things have changed. Leaving aside all the problems that the banks have, this is not a good environment for banks. Rates are going up, not down, and the economy’s slowing. This does not lead to earnings growth, even if they make pristine loans.



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.

“The banks were unfortunately a major source of economic expansion. This is also part of the reason why we’re in for a very, very long period of zero to 2% GDP. We go through economic and product cycles, invest in the economy and express them in the public market. These companies end up having much better-than-expected earnings growth for a long period of time. We build in expectations that ultimately they cannot achieve. We did that with energy in the late ‘70s, pharmaceutical stocks and big box retailers in the ‘80s and technology and banks in the ‘90s.

“In 1991, your average regional bank was selling at about book value, maybe even less. Now they’re selling about two to three times book value. Their earnings growth has been 20%-plus for the past 10 or 15 years and they probably won’t see that for a long time. It’s a recipe for stocks not going up.”

Oberweis: “It’s a difficult area to predict. From our perspective it’s hard to innovate or create something new in financials where one company is likely to be able to out-innovate other companies within that sector. That said, it goes back to making a guess in the overall economic environment as to when things will change because it’s much harder to buck the trend in an area like financials.

“There are a couple of companies that are interesting and unique. I like a company called **Life Partners Holdings, Inc.** (Nasdaq:LPHI), which is not a traditional financial company. It essentially brokers life settlements on insurance companies. Say an individual buys a life insurance policy, has terminal cancer and could also be broke. Eventually they will receive a settlement giving them the ability to sell their settlement to a third party. Quite frankly, this area has been a less than ethical area across the board, however Life Partners is one of the first companies to bring a certain degree of

legitimacy to the area. It benefited from taking market share from its largest competitor in the past year. If

we do have uncertain economic times, my guess is that business for Life Partners would actually increase, not decrease, as people demand cash today as opposed to waiting for more cash tomorrow.”

O’Halloran: “In small caps, our strategy is to own multi-year growth companies. Banks or brokerages are usually not a big part of the portfolio. We currently believe that the time for not owning them at all has passed, but we don’t think it’s time to own them in a large way.



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.

“A name such as **SVB Financial Group** (Nasdaq:[SIVB](#)) (formerly called Silicon Valley Bank), which has a secure source of deposits and a conservative lending strategy, is a growth bank. A name such as **MSCI Inc.** (NYSE:[MXB](#)), which was spun off Morgan Stanley and provides software for analyzing indices and risk in a portfolio, is a good name. It’s an example of a financial service firm we think is more attractive than a financial lender.

“Our brokerage holdings are very insignificant at this point if at all. We’re underweight financials and if we do own them, we prefer to own financial service names such as MSCI, **Morningstar, Inc.** (Nasdaq:[MORN](#)), or names like that.”

Evans: “Unfortunately, I am bearish on financials. I think the financial area is full of land mines. I abhor dilution. A large number of the banks, small regional banks, probably need to raise capital and most bank managers have been in denial to that fact. If they didn’t anticipate the credit cycle that’s unfolding and the stock market did, it has brutalized banks. The fact of the matter is these banks are still going to have to raise capital. At these current prices, the cost of capital is almost prohibitively high, but it’s either go out of business or raise capital.

“I’m not recommending this stock, but take this example: **BankUnited Financial Corp.** (Nasdaq:[BKUNA](#)). Here’s a company who has 335 million shares outstanding, and it is trading at, say, \$1.33 versus a year ago when it was trading in the high teens. Two years ago the stock was trading at around \$30. [BankUnited] has gone to its shareholders and asked them to allow the company to issue an upward of 500 million shares. It’s going to have to raise capital. I don’t know how much, but can you sense the type of dilution we’re starring here?”

Wyatt: “I don’t think financials have bottomed. There’s bad news yet to come, much more than has been priced in. Shorting financials for the last few months has proven to be a great way to make money. However, I do think that the bottom for financials will come sooner rather than later.”

Is there a parallel between the bursting of the tech bubble and the current financial crisis? Why do you think financials will act or not act like technology did from 2001 to 2007 or 2008?

Evans: “People seem to be hoping that financials will be our savior this year; there will be a V-shape recovery and we’ll be off on the races led by financials. There is a fundamental shift going on that could last a decade or more where you’re going to see hard assets outperform financial assets. I think there’s a direct parallel

between what happened with the technology bubble. Everybody is pointing to the energy bubble, the oil bubble. The real bubble that's imploding in front of our eyes is a financial bubble and housing bubble. They're both interrelated. People point fingers at the energy situation, not recognizing the fact that there could be a multi-year cycle of out-performance of hard assets. So the investing thesis of materials, industrials, and energy outperforming other sectors within stocks, bonds and financial assets should hold.



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.

"I would say the same thing about tech about financials. You've to be very careful and very valuation-focused. We are extremely valuation disciplined, [using] P/E, price-to-cash flow, price-to-book value, discounted cash flow analysis, private market equity value and peer group analysis. You have to be extremely religious in terms of your valuation work. Tech and financials have many similarities in that if you pick a stock that is attractively valued and has good end markets, the upside can be very attractive. [However, in financials], you're risking the possibility of significant value traps."

Where are we in the credit cycle?

Lisanti: "We're about one-third of the way through. We're through the shock and awe, but we're not through the nitty-gritty kind of stuff and now we have to go house to house. The banks have to work their way out of the loans that they now know are bad and fix the ones that are going to go bad. The net result is going to be tight credit for a very long time until they fix this. They don't even know what's on their books right now. Until they know and how to fix that, I don't think it will be resolved. With a consumer-focused slowdown and a service economy, it will take about four years to work through. At some point we'll get to a stage where it will be overmarked and stop. We're not there yet."

Evans: "The baseline is that the credit cycle has not peaked. It's going to get worse. Unfortunately the financial crisis that's gripping both investment banks and, most recently, regional banks is in its very early stages, in a 3rd or 4th inning. That's why you need to avoid financials at this point."

Wyatt: "The Fed's latest action makes me think they believe that we are at the trough of the credit cycle, reason being a lowering of rates at this point could lead to hyperinflation as we move on to an upward phase of the cycle. Rates were cut earlier to stimulate lending. The Fed probably had signs that the earlier cuts were taking effect, and has now frozen rates to keep inflation from getting worse."

Are you at all concerned about the effect of tightened credit on small-cap companies?

Lisanti: "Only if it pushes us into a recession. If it does, then small caps will have a very tough time — they always do. If it doesn't push us into a recession, and the state where we are now persists, it won't have much impact."

Evans: "We are extremely focused on strong balance sheets here at Heartland that's one of the tenants of our process. We are valuation disciplined: low P/E, low price-to-cash, low price-to-book and low price-to-sales."

"So does the credit crisis impact them? Yes. Find companies with good balance sheets and good cash flows that are not relying upon the markets for capital. Every investor should be focused on balance sheets and cash flow statements in this environment."

What countries or regions outside the United States and Canada do you find attractive for investment purposes?

Oberweis: "Most of our international funds are focused on companies that are in some way benefiting from the growth of Asia. Over the next 20 or 30 years, we're likely to continue to see a long-term capital shift from the United States, Europe in Asia. The other play would be to buy Chinese equities and then surrounding countries that are benefiting from that growth."



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.

"The other opportunity would be to buy companies that are making the picks and axes for infrastructure development in China and places such as India. The first approach is probably the riskier and the highest return opportunity, whereas the second approach provides the benefits of both worlds by buying, let's say, U.K. companies that provide infrastructure equipment to companies in India and China. You're benefiting from change in those economies, but you're also investing in a developed market with western-style management and transparency."

"Given the recent decline in China, valuations there are more compelling than they were at the beginning of the year. If you asked me internationally where I would be putting money, it's probably in China."

O'Halloran: "All of our international exposure is in international emerging nations, not developed nations. We have had a healthy presence in Chinese Internet stocks such as **SINA Corp.** (Nasdaq:[SINA](#)), **Sohu.com Inc.** (Nasdaq:[SOHU](#)), **Ctrip.com International, Ltd.** (Nasdaq:[CTRP](#)), **Shanda Interactive Entertainment Ltd.** (Nasdaq:[SNDA](#)) and in education company **New Oriental Education & Tech. Group Inc.** (NYSE:[EDU](#)).

"China is going to achieve healthy growth for an extended period of time, and right now is a good buying opportunity. Chinese stocks have now corrected down going into the Olympics [on fears] that growth would slow. I feel that's discounted and when the Olympics goes well and it becomes apparent that the Chinese economy is going to continue growing for an extended period of time, it'll probably encourage people to come back into those stocks. I think this correction is a good buying opportunity for China."

"South America has healthy growth in Brazil, Argentina and other developing nations. In Eastern Europe, we own **Central European Distribution** (Nasdaq:[CEDC](#)), which owns vodka brands and is a distributor of vodka in Poland. It's expanded into Hungary and it's now making a big push into Russia."

"The big growth engine of the U.S. consumer fed by the financial complex is slowing and is being replaced by the emergence of emerging nations. There are two things going on there. The first, is [emerging nations are] building out their infrastructure like we did after World War II through houses, roads and airports, among

other things. Also, their consumers are getting wealthier. For example, they're buying more expensive vodka brands in Russia now, Central European Distribution is growing at a 35% top line growth rate."

Wyatt: "China remains my favorite place outside of the United States. Right now Chinese firms look outright cheap for their expected growth."

What are your thoughts on India? Indian shares are off 30% year-to-date, so well into bear market territory. Do you think we're going to see reversal in the second half as some had purported earlier this year? Or will the downward trend continue?



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.

Oberweis: "You'll probably begin to see some stabilization. The way to play India is it's all about infrastructure. The government is going to continue to spend ... you have a better forecast there and end-user demand. However, trying to guess the consumer is really tough. You never know when the spicket is going to be on or off. Trying to guess government spending is an easier proposition. India and Peru really need infrastructure at this point and I suspect that the infrastructure projects that are in place so far are not going to change."

O'Halloran: "We like shipping companies — Safe Bulkers (SB) is one that has good exposure to India. Brazil, Russia, India and China are the biggest emerging nations, but the regions of Eastern Europe, South America and Asia have other smaller emerging nations. There will be a lot of volatility, but these companies will grow at a much faster rate than developed economies for quite some time."

Wyatt: "Indian shares are off 30% this year as of Monday well into bear-market territory. India is much like China — there are many stocks that are cheap for the expected growth; however, without a U.S. recovery there won't be an Indian recovery."

Where do you think the Russell 2000 will end the year?

Lisanti: "Thirty percent of the index is financials and REITs, so they have to weigh on it. I think it will end the year somewhere between 770 and 800, up 5% to 9%. (I'm using March 1990 to March 1991 as a guide.) At the end of March in 1990 when the world was still a decent place, the Russell was 168. At the end of March in 1991, it was about 171. That was the period through the short two-quarter recession, when it went from 171 to about 201 the next year. We'll make it part of the way back, but not fully. The way we get there is if the growth sector moves 10% to 20% and the value sector stays flat. I would expect most of it to come in the fourth quarter and further toward next year."

"A lot of it depends on what people think is going to happen with this year and next year. In other words, if people buy the argument that we're in slow motion but not in a recession, then we're fine. If people want to buy that we're in a recession again, then I would say 750 is probably about the best we can do."

O'Halloran: "Higher than it is today."

Evans: "It will end up in the range of 740 to 750."

Wyatt: "I expect it to move laterally, basically trading in the 600 to 700 range. But the Russell moves quickly, so investors need to be quick on their feet to adapt."



About the Author

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