

WEALTH & INVESTING



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Bobbing for multibaggers in the small-cap market

In addition to steering clear of losers – avoiding mistakes – small-cap investors have to demonstrate the ‘positive art’ of finding winners

IN AGATHA Christie’s mystery novel *Hallowe’en Party*, a young guest who may have witnessed a murder drowns in an apple-bobbing basket. In the wrong place at the wrong time, the unfortunate partygoer’s fate is a metaphor for that of the unlucky investor who bites into a losing stock and tastes the consequences.

Taking a page from Benjamin Graham and David Dodd, Howard Marks, co-chair and co-founder of Oaktree Capital Management, describes fixed-income investing as “a negative art”: Success depends not on finding winners but on avoiding losers, on not buying those companies likely to default on loans and drag down returns.

In *Winning the Loser’s Game*, Charles D Ellis draws a similar parallel between professional money management and tennis and golf. In tennis and golf, the winner tends to be the player who makes the fewest errors, not necessarily the

one who makes the best shots.

Small-cap investing is a similarly “negative art”. But in addition to steering clear of losers – avoiding mistakes – small-cap investors have to demonstrate the “positive art” of finding winners. By achieving that equilibrium and, importantly, selecting a smaller subset of very big winners, small-cap investors stand the best chance of harvesting alpha.

Investing in smaller, early-stage companies has specific pitfalls that make risk control paramount. Many such firms have unproven business models and inexperienced management teams. They often lack sufficient financial resources, which could lead to significant dilution as they seek to raise funds for operations.

In some cases, the value of the enterprise could go to zero and investors could experience total capital loss. That’s why prudent investors

In golf, the winner tends to be the player who makes the fewest errors, not necessarily the one who makes the best shots. Small-cap investing is a similarly “negative art”. PHOTO: REUTERS

should avoid these types of companies just as they would invitations to Christie’s Halloween party.

By ignoring the “bad apples”, investors can focus on that subset of companies that are likely to do well, potentially so well that they become the drivers of great long-term returns. Indeed, research demonstrates that almost 40 per cent of stocks lose money, while only 20 per cent account for most returns.

So, is there a recipe for finding such a stellar investment, say, a stock that returns \$100 for every \$1 invested and joins the so-called “100-Bagger Club”? Yes, there is, and while it may be simple, it is far from easy.

The 100-Bagger recipe

Multiple Growth + Earnings/Intrinsic Value + (Earnings Growth of 25x) x (Multiple Expansion 4x) = 100x Return

But there are other important attributes to screen for. So, remember:

- Smaller is better. Why? Because smaller companies tend to adapt more quickly to changing market conditions and often have faster growth rates;
- Prioritise companies with differentiated products and services;
- Don’t underrate the value of a long runway and a large addressable market;
- Favour a proven, long-term-focused management team whose incentives are aligned with investors; and
- Focus on under-followed firms. Avoid crowded trades to obtain greater value than what you pay.

When an investor finds a subset of these companies, history has shown it pays to hold on for as long as earnings are increasing. Taking profits is standard operating procedure for investors because no one wants to experience the regret of seeing significant paper gains dissipate.

Yet, as Marks pointed out in his memo, the investor who held onto Apple stock from its split-adjusted cost of US\$0.37 in 2003 would have enjoyed a 500-fold return by 2023.

When bobbing for tasty investments, we have to focus just as much on avoiding the sour ones as we do on snagging the winners. Over time, the winners will take care of themselves.

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