Goldman SMALL CAP RESEARCH

The Goldman Guide

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KEY TAKEAWAYS

- ⇒ *January Effect has begun*
- ⇒ *This phenomenon has occurred 30 of the past 36 years*
- ⇒ *This year's big losers could be next year's big winners*
- ⇒ *Small cap stocks offer greater value and upside than big cap stocks*
- ⇒ *This stock got a big contract renewed, will grow EPS by 40% but trades at a 8x P/E*

THE MAJOR INDICES

Index	Close	2015
DJIA	17552	-1.5%
S&P 500	2061	0.01%
NASDAQ	5048	6.6%
Russell 2000	1155	-2.5%

(figures are rounded)

The January Effect

Judging by the performance of stocks last week, The January Effect has just begun. After all, small caps rose 3% in the holiday-shortened week.

There are multiple definitions associated with the *January Effect* and its related Santa Claus rally moniker. In a nutshell, the *January Effect* is an historical Wall Street moniker for the belief that small cap stocks outperform large caps from January through June, with the trigger based upon catalysts mentioned above. In fact, this event has occurred for 30 of the past 36 years, which is an 83% accuracy rate!

I have known some money managers and big-time traders that bought stocks in beginning in mid-late December during what is called the Santa Claus Rally, rode gains into the first half of the first quarter, sat on cash for a few months, and then started all over again.

The drivers of this phenomenon are easily understood. Now that we are in the last week of December, all of the year-end selling has passed. As a result, many small cap stocks are temporarily low prompting investors to begin buying stocks with an objective of a 2-6 month holding period, based upon the risk/reward associated with current prospects and valuation of these stocks. Therefore, investors and traders should start making their list and checking it twice.

In the meantime, as you begin to build your list of potential buys, be sure to fill it with the big losers of 2015 that appear to be primed for a turnaround sometime next year. We will provide our top picks for 2016 next week but have found one that looks great today!

The Stock Market Today

U.S. Stock Market Index Performance as 12/24/15								
Index	Close	52-Wk Hi	52-Wk Low	Hi Date	Low Date	% off High	% from Low	% Above 200-DMA
DJIA	17,552	18,351	15,370	5/19/15	8/24/15	4.4%	14.2%	0.1%
S&P 500	2,061	2,135	1,867	5/20/15	10/17/14	3.5%	10.4%	0.0%
NASDAQ	5,048	5,232	4,242	7/20/15	10/17/14	3.5%	19.0%	1.4%
Russell 2000	1,155	1,296	1,079	6/23/15	10/20/14	10.9%	7.0%	-4.3%
Average						5.6%	12.7%	0.0%
Source: www.BarChart.com, Goldman Small Cap Research								

After enduring what is shaping up to be two consecutive down years for the Russell 2000 Index, it appears that small caps offer the greatest value and upside versus large cap and midcap stocks. The current 12-month forward P/E ratio on the Russell 2000 is 17.9x, a fraction above the 17.5x P/E afforded the S&P 500 Index, despite the fact that small caps typically grow earnings at a much faster rate than large caps. One could argue that the Russell's multiple should be more akin to that of the NASDAQ 100, given the similar growth rate characteristics. However, with a P/E of 20x, the NASDAQ 100 trades at a 10% premium to the Russell 2000, even though historically the small cap index trades at a higher multiple than these big growth names. In my view, this situation affirms the greater value and potentially greater upside of small cap stocks.

The Stock Market Today

U.S. Stock Market Index Performance as 12/18/15								
Index	Close	52-Wk Hi	52-Wk Low	Hi Date	Low Date	% off High	% from Low	% Above 200-DMA
DJIA	17,127	18,351	15,370	5/19/15	8/24/15	6.7%	11.4%	-2.5%
S&P 500	2,005	2,135	1,867	5/20/15	10/17/14	6.1%	7.4%	-2.8%
NASDAQ	4,923	5,232	4,242	7/20/15	10/17/14	5.9%	16.1%	-1.1%
Russell 2000	1,121	1,296	1,079	6/23/15	10/20/14	13.5%	3.9%	-7.4%
Average						8.0%	9.7%	-2.6%
Source: www.BarChart.com, Goldman Small Cap Research								

Now that the first salvo in the interest rate game has resulted in a 1/4 rise in rates, it is time for the long forgotten sector to make its move. Financials would occasionally comprise more than 20% of the S&P 500 Index. Today, that figure is 16.6%, but had been lower in recent months. Look for this to rise at the expense of materials and industrials, along with energy.

With attention now on the Financials sector again, we have identified a stock we believe that you can “bank” on as the rise in interest rates will facilitate top line revenue growth with the increased borrowing/lending spread that will follow.

Perhaps foreshadowing these events has been **Preferred Bank (NASDAQ – PFBC - $33.53),** a regional bank headquartered in Los Angeles which has enjoyed a 26% price return over the past year. The first metric that struck us concerning **PFBC** was the operating margin of 60% versus the industry average of 35%. This efficiency will be critical in translating increased revenue to EPS performance. The growth story is also impressive with a forward P/E of 14x versus a trailing of metric of 16x with a five year PEG of 1.5x. This growth prompted a 25% increase in the quarterly dividend last week which is a nice bonus as the new annual yield on this growth-oriented bank is 1.8%. Our mid-year target is $38 and could be higher if the long-awaited M&A cycle hits the regional bank segment in 2016.

Fast Grower, Big Contract, Low P/E

This may sound over the top, but **Rovi Corporation (NASDAQ—ROVI—$15.86)** offers an opportunity that I come across only a few times a year.

With over 5,000 patents issued or pending worldwide, Rovi licenses its technology to providers that enable consumers to navigate content across multiple devices and screens via guides, metadata and recommendations. In turn, premier brands are able to increase their reach and drive consumer satisfaction regarding their offerings by using their products for advertising. Wall Street forecasts a 40% increase in EPS next year from $1.43 to $2.01 for this software leader, on a 12% rise in revenue from $509 million to $570 million. Despite the huge expected increase in EPS next year, the stock trades at a ridiculous 8x earnings!

I should note that on December 23rd, Rovi announced that AT&T's (NYSE—T) DirecTV unit renewed its patent license agreement with the company for seven years and also extends the existing product agreements between the companies. The stock soared on the news; however, since it was announced during a period when most investors are not paying much attention to stocks, I believe the move higher has only just begun, as the valuation has not yet caught up with the news or the projected earnings growth rate. My target price is $28, which is just above Rovi's 52-week high and reflects a 14x multiple on projected 2016 EPS.

Say What?

Great info, insights, and hard-hitting stories make up this week's *Say What?* feature...

Investor's Business Daily

http://news.investors.com/business/122415-786793-fast-casual-faces-many-issues-ahead-of-2016.htm?ref=HPLNews

We have been talking about this...very timely and useful insights. Bonus: Our PNRA pick from 2 weeks ago is noted here.

Bloomberg

http://www.bloomberg.com/news/articles/2015-12-28/china-s-slowdown-in-context

A week later, Bloomberg (with people on the ground) firing another warning shot.

The New York Post

http://nypost.com/2015/12/27/the-rise-and-fall-of-middle-class-america/

Yeah, we know but we choose to ignore it. That's the problem.

USA Today

http://www.usatoday.com/videos/tech/personal/2015/12/27/77943774/

Could not be more timely!

ZeroHedge

http://www.zerohedge.com/news/2015-12-27/guest-post-has-there-ever-been-more-selfish-generation

Ok, call me old, but seriously...

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