The Goldman Guide

GOLDMAN SMALL CAP RESEARCH

VOLUME 3 | ISSUE 34 | FEBRUARY 24, 2013

INSIDE THIS ISSUE:

KEY TAKEAWAYS

- ⇒ *Too many reasons why market is in for a rough patch*
- ⇒ *More M&A or shift in business cycle or big segment moves are only likely positive drivers*
- ⇒ *Bearish sentiment on rise could be a good thing down the road*
- ⇒ *Some segments still look like good bets right now*
- ⇒ *Why valuation is unimportant in this market when picking stocks*

KEY STATISTICS

Index	Close	2013
DJIA	14000	6.8%
S&P 500	1516	6.3%
NASDAQ	3162	4.7%
Russell 2K	916	7.9%

(figures are rounded)

Rough Week Ahead

It doesn't take a rocket scientist to forecast a rough patch ahead in the stock market. The sequestration issue, questionable Federal Reserve comments, higher jobless claims, health care cost stories, and higher consumer prices don't help. Moreover, with the exception of small stocks, and stocks whose fiscal year matches the calendar, earnings season is basically over. Which beg the questions? Where do we go from here? Or, what will keep the stock market train chugging?

We have made a number of comments in these pages on how to prepare for this inevitability, so there is no use re-hashing it. Frankly, in the absence of additional M&A or some new phase in the business cycle or consumer/technology fad, it looks like the market will probably take a breather, for the most part. Investors have surely noticed that NASDAQ and the Russell 2000 Index took it on the chin last week while the biggest stocks continue to move higher.

Still, this does not mean that there are not some favorable signals as well as areas or segments that may yet have legs.

For example, bearish sentiment is above its historical average for the first time in seven weeks, according to the latest AAIII (American Association of Individual Investors) Sentiment Survey. Since this survey can be used as a contrarian or lagging indicator, it may be a good sign of things to come. Plus, as one could see in many of the financial reports, companies remain flush with cash and are eking out operating gains.

Interestingly, we believe that real estate is on the rebound in what may be the most sustained advance in prices and decreases in inventory, especially in the Southeast, in some time. We also see strength in some regional banks, natural gas, biotech, and energy. Consumer stocks still look weak. The rise in inventory of retail gift cards and the commensurate drop in their aftermarket prices are also negative signs.

Why Valuation is Unimportant

Valuation seems to garner less and less importance these days in favor of momentum and an industry or theme du jour mentality. Still, valuation remains an extremely critical function of one's overall investment process. By the way, when we refer to valuation we are usually highlighting a price/earnings ratio rather than price/book, price/revenue, or price/cash flow. In all cases, stocks trade at a premium or a discount to an industry, a peer group, an index, or the stock market itself. Stocks are afforded these attributes based upon a variety of factors which on the surface can appear to be exuberant or punitive, depending upon which side of the fence one sits.

Many investors believe that they have reached the nirvana situation when they have found a stock that seems to be unfairly treated with a low valuation. That is not necessarily the case as there are many factors that go into determining valuation in the first place, especially among peers.

An obvious factor in determining valuation is revenue growth. The higher the top-line growth, the higher the valuation, even for profitable companies. But, what if there were two companies in the same industry, the same industry segment, doing the exact same thing that exhibited the same revenue growth rates? Would they be afforded the same valuation?

The short answer is: not necessarily. For example, the market may discount a stock that has a high concentration of its revenue derived from a small number of customers. Why? The perception is that there is an inherent risk that even if only one customer was lost or reduced its orders, it would have a materially adverse impact on the company's operations and financials.

In another scenario, it may be the norm for companies to have a high concentration of revenue derived from a few customers. An extreme example is the airline equipment industry, where by its very nature a small number of customers exist in the in the entire space. Certainly not all companies have the same valuation even in this scenario.

Here, a stock's valuation can be affected by gross margin or operating margin. If Company A makes a product cheaper than Company B, and they both sell to the same type or even the same customer, it is likely that investors will migrate to the more profitable one.

Valuation (cont'd)

It is also possible that a stock's valuation can be driven by its geographic revenue breakdown. Even in today's global economy, it is not uncommon for stocks that have a higher concentration of sales or a particularly important customer/order to a country that is perceived to be risky, in terms of following through on payment terms, or even currency risk.

This is why stocks of companies that have a great deal of sales to emerging countries and especially those firms that are domiciled abroad with sales in its home country, trade at what are sometimes substantial discounts. A prime example is the phenomena afflicting China-based companies. Many investors frankly don't believe even audited financials of these firms as many have been proven to be "cooking the books" or engaging in questionable practices.

A number of investors that engage in bottom-fishing use valuation a measure and use it incorrectly, not realizing that a lower valuation for a company doesn't always mean it is a better investment than a stock trading at a premium valuation. Be careful how you weigh all of the factors and you can unearth a stock that exhibits favorable characteristics and trades at a reasonable valuation.

I confess some of my biggest losers have been stocks that appear to be great values that "the Street" just doesn't get, or has overlooked. A good way to avoid such a situation is remembering the old adage: If it looks too good to be true, it probably is."

Until next week...

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