The Goldman Guide

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Growing, Peaking, or Peaked?

It is amazing how steady the rise in the small cap space has been since the beginning of the year. Despite the rise, valuations also seem to remain pretty favorable. One sign that there is a good deal of momentum and interest in these stocks is the way they behave when news is released. Even relatively innocuous news seems to drive stocks 3% higher or more. A pessimist or contrarian would say that this may be a sign of small stocks reaching a top, or overbought market.

I don't think we are there---yet. But, we are getting close. Let's look at the numbers. Year-to-date, the Russell small cap and microcap indices, which we follow closely as a barometer for the space, are rockin':

2012 YTD Small Cap Index Performance (1/3/12 – 2/10/12)

Russell 2000:	9.9%
Russell 2000 Growth:	***10.72%***
Russell 2500:	9.9%
Russell 2500 Growth:	***11.3%***
Russell Microcap:	11.7%
Russell Microcap Growth:	***12.9%***

Clearly, the growth indices are out-performing the basic indices and the smaller the company the greater the performance. We should also note that fully 50% of the performance generated in 2012 has been during the first week of February. Interestingly, volume remains relatively tepid, as compared to typical volume for this time of year. A back of the envelope study of NASDAQ volume for the first 6 weeks of the year illustrate that volume is down 20% from 2011.

The lower volume combined with sedated volatility and the steady moves higher indicate to us that we don't have a lot of sellers in the market. We will likely learn in the coming weeks that small cap mutual fund inflows may have increased incrementally, along with decreases in money market funds, aiding in developing the current trend.

So the $64,000 question remains:

Is the market still growing, peaking, or has it peaked?

What makes the current market difficult to call is the absence of sprints and spurts higher (or lower) thus far in 2012. We are of the mindset that the tale of the tape will be told when earnings season ends in 7-10 days. Would a likely decline in buyers cause stocks to drift, or drop? Will a steady move downward prompt profit-taking?

Favorable geopolitical and economic news could certainly extend this rally, but we can't predict these types of future events with any regularity. It is possible that investors will need a breather at the end of this 5K, rather than an extension into a 10K.

Thus, at this stage, we are leaning toward "the market is peaking" camp. This means that investors should identify big winners to lock in profits as those would be the first to be sold. Conversely, prospective buyers should monitor sales of these stocks as opportunities will likely present themselves. Short term traders should keep fingers on their triggers for both buys and sales.

We are hopeful that the steady rally continues but we are mindful of gravity. What goes up must come down.

Tricks of the Trade

Most investors in low-priced stocks are followers and not leaders. Most utilize technical analysis and trading strategies as their primary weapon in the fight for capital gains. I am a big proponent of technical analysis (TA) but only as a component of an overall investing and trading strategy.

By engaging in a TA-heavy strategy you miss out on what could be real methods of eking out some nice gains without a great deal of work.

There are two tricks of the trade in particular that should be a regular staple in your investment and due diligence diet.

The first is the trick of the pre-market trade. Not everyone can do this but more importantly, it can only be done with stocks that have pretty strong volume, such as Sirius XM (NASDAQ – SIRI - $2.14) which we introduced to you just 2 days ago. Pre-market trading is a great tool because low-priced stocks trade inefficiently and opportunities arise when you least expect it.

In the case of SIRI, it happened just yesterday. Before the market opened, SIRI released its 4Q11 and FY11 financial results. While EPS was in line, the Company barely missed Street consensus revenue by $1.5M, or only 0.2%. For 2012, management increased its EBITDA forecast and reiterated revenue guidance. Headlines touted the revenue “miss” but did not touch upon the increase in guidance. (Typical media move.)

So, in response, SIRI traded down 4% pre-market. Stocks trade mainly on future events not past events and a slight miss on revenue in the hundreds of millions is irrelevant so this drop was ridiculous. As usual, investors were too lazy to perform basic fundamental analysis, read the release and understand its implications.

For example, Groupon (NASDAQ – GRPN) released its 4Q11 and FY11 financial results the day before, after the close. The Company missed Street consensus EPS estimates. Badly. While revenue was ahead of expectations, GRPN recorded a loss, versus an expected profit. One would think that with revenue higher, the likelihood of profitability would increase, but apparently that was not the case. The Company also guided expectations for 1Q12 in a very wide range for revenue and earnings. It was down 10% in pre-market trading.

So a stock that screwed up is down 10% but a stock whose guidance is raised is down 5%? Makes no sense. The bottom line? One could have bought SIRI pre-market and either sold it for a 5% gain minutes after the market opened when trading normalized, or meaningfully lowered one’s cost basis for the long haul.

The second is the trick of the earnings comparable. When the leader in a particular segment releases its results and does exceedingly well, in large part based on industry growth and demand, it is logical to assume that its competitors are also doing well. From time to time, these comparables will rise in conjunction with that leader that same day.

For example, Akamai Technologies (NASDAQ – AKAM), an Internet content and application delivery provider, jumped to a 9-month high yesterday after reporting 4Q11 results that kicked butt. A smaller competitor, Limelight Networks, (NASDAQ – LLNW - $3.98) is slated to release its results on Monday. The Street is looking for revenue of $45.4M and a loss per share of $0.06. The stock was up 4% at one point on strong volume Friday, affirming our thesis. Let's see if Monday's results and guidance are actually as favorable as the stock trading suggests.

LLNW has been on a tear of late, rising over 30% in recent weeks. For your chartists, the chart looks great. Fundamentally, we would not be surprised to see it approach $6.00 in the coming months as it claws its way back to its 52-week high of $8.58, with the aid of what we believe could be increased revenue growth in 2012.

The Week Ahead

Earnings season will have essentially reached its conclusion by week's end. What makes this week noteworthy is the fact that these financial results reports are almost exclusively dominated by a ton of small cap and micro cap companies, especially in the early going. First, the market hopes it can finally put the whole Greek financial malaise to bed. We may even see some bankers drinking some ouzo in celebration.

While small caps are likely to be active, volume will probably begin to subside somewhat as many investors get an early jump on the 3-day President's Day weekend.

Be on the lookout for any visible uneasiness regarding global geopolitics. An undercurrent seems to be brewing which we will monitor closely and perhaps comment on by week's end.

Until next week…

Analyst: Robert Goldman

Rob Goldman has over 20 years of investment and company research experience as a senior research analyst and as a portfolio and mutual fund manager. During his tenure as a sell-side analyst, Rob was a senior member of Piper Jaffray's Technology and Communications teams. Prior to joining Piper, Rob led Josephthal & Co.'s Washington-based Emerging Growth Research Group. In addition to his sell-side experience Rob served as Chief Investment Officer of a boutique investment management firm and Blue and White Investment Management, where he managed Small Cap Growth portfolios and *The Blue and White Fund*.

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