



# The Goldman Guide

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We touched upon the Knight Capital Group (NYSE – KCG - \$4.05) story on Thursday, since I had a relationship with some of the founders early on. If developments proceed as advertised on Sunday evening, this knight will drop from its Friday close and on the ensuing days likely rise, thus presenting an opportunity to make some quick cash, for those understanding how to play it.

After speaking with some people in the investment business that did not seem to have a clue about this situation, even though they have followed it in the financial press, I felt it was necessary to provide a little background before elaborating on the play of the day. After all, if some of the pros don't get it Joe Retail may not, either.

Who is Knight and what do they do? Knight is the firm that probably executes some, most, or all of your trades. You just didn't know that. Knight is the number one executor of retail trades in the country. When you place an order online, the firm that is given the order is just an order-taker that routes the order to a market-maker or firm that trades in a given stock. Knight is so large that not only do they account for 10% of all U.S. equity volume, trades or makes a market in over 19,000 equities and are the number one market maker in OTCBB and OTC securities.

You have all heard how a computer glitch caused the company to create a bunch of trades that were in error. In order to deal with it in a less complicated fashion, they borrowed \$440M from Goldman Sachs (NYSE – GS) who bought the error position and needs the money by Monday to finish the transaction. (cont'd)

### Key Takeaways

- ⇒ Knight will survive as it is too key a player, especially in our OTC world.
- ⇒ Stock will likely drop sharply but could be a great trade.
- ⇒ Small cap and microcap stocks underperforming but may have reached a double bottom.
- ⇒ This daily blog stock pick was up 32% last week.

## This Knight Will Rise Again ...How to Play KCG (cont'd)



The Company had less than that in cash and a good deal of debt, as well as a ton of equity positions. So, in order to stay in business Knight needs to raise the money to pay GS, have enough working capital to continue and give their customers (the brokerage firms and institutions) enough confidence to continue to give them business to weather this storm, and return to a thriving period.

The stock rallied big time on Friday as some firms that re-routed trades on Thursday returned to give Knight business again. On Sunday evening, rumors spread that Knight may have secured \$400M in a convertible debt or convertible preferred deal with one of its biggest clients, TD Ameritrade (NYSE -TD), Stifel Nicolaus (NYSE -SF) and other investment firms. Due to exclusive trading relationships with Knight, it is in TD Ameritrade's best interest to help keep them afloat.

The way it looks right now, the new financiers will own a substantial portion of the equity, upon conversion. As a result, we would not be surprised to see the stock possibly tank upon closure as the dilution from the financing will be pretty big. In addition to our viability concerns, we noted that investors should avoid the stock until financing is in place. If this gets executed, investors could reap rewards once the stock drops by buying it for a trade.

Knight may not renew its #1 trading status right away and may even get sold eventually. But, a Firm that is #1 in retail execution, has the title of exclusive trader to TD Ameritrade, the biggest brokerage by trading volume, and the clear leader in OTC trades, is not going away anytime soon.

Our back of the envelope guesstimate is that the stock could drop by more than 50% either upon closing or as we get an understanding of when conversion could occur when final terms are released. Once a small rally occurs, the time to step in is likely to be there for opportunistic investors who could reap a 30-50% gain as confidence in viability and success increase.

I for one, hope someone looks at the Knight website and makes some changes. It is probably not a good idea to tout "The Science of Trading" and "The Standard of Trust" on the top of the front page.

### Key Statistics

<u>Index</u>	<u>Close</u>	<u>YTD</u>
DJIA	13096	7.2%
S&P 500	1391	10.6%
NASDAQ	2968	14.0%
Russell 2K	788	6.3%

(figures are rounded)

## When Will Small Stocks Behave Better?

The Russell 2000 and the Russell Microcap Indices both declined last week while their larger cap index brethren rose incrementally. This continues the trend that began in late Q2. In fact, the S&P 500 Index is up over 2% since the end of Q2, while the Russell 2000 has dropped 1%. So, if it feels like you have not been making money recently, well, you are right.

Still, the S&P is off 7% from its 52-week high and the Russell is just 5% away from its 52-week high. We might look back at mid-late July and see that the Russell 2000 may have succeeded in forming a double bottom at the 765 level. If so, we could be in for a decent run even this summer, although it is unlikely to begin in earnest until the fall.

Speaking of the fall, it is amazing that a week ago I was singing the ECB President Draghi's praises and then he follows it up with a whimper. Thank goodness the unemployment numbers were better than expected, with the rate dropping incrementally, and prompting the market to rally. We did become officially bullish a month ago so it was nice to see.

Meanwhile, the balance of what is left of earnings season, will continue for the next 2 weeks and it will be dominated by small cap and micro cap stocks, so be mindful. I suspect that we will have a bit of a hibernation from late August until after Labor Day. These are usually good times for savvy traders and we will try to highlight some stocks for you during this time.

For example, **we recommended Green Mountain Roasters (NASDAQ—GMCR—\$21.63) on Tuesday in our free daily blogs section of the website called Market Monitor section and it reached a peak return of 33% in just a couple of days.** This gain follows a 30% return in our ARNA recommendation from our premium The 30-30 Report. Haven't signed up for that yet? Get on board before our next issue is released on August 15th.

While we would not chase GMCR above \$20, Pixelworks—NASDAQ—PXLW—\$3.02), which rose 8%, still looks good.

Until next week...



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Rob Goldman founded Goldman Small Cap Research (GSCR) in 2009. Rob has over 20 years of investment and research experience as a senior research analyst and as a portfolio and mutual fund manager. During his tenure as a sell-side analyst, he was a senior member of Piper Jaffray's Technology team. Prior to joining Piper, Rob led Josephthal & Co.'s Emerging Growth Research Group. Rob has also served as Chief Investment Officer of two boutique investment management firms, where he managed Small Cap Growth and Balanced portfolios and *The Blue and White Fund*. As an investment manager, Rob's model portfolio was once ranked the 4th best small cap growth performer in the U.S. by *Money Manager Review*. In addition to his work at GSCR, Rob is the editor of Penny Stock Junction ([www.pennystockjunction.com](http://www.pennystockjunction.com)).

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