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Previous Page

The Dark Secret of the Best-Performing Stocks

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I've seen this list of the past decade's top-performing stocks so many times, I can recite most of them from memory. But there's good reason to keep picking apart these top performers: Any one of them had the potential to turn a mediocre portfolio into a market-beater.

Here's a peek at 10 of the top 25 performing stocks of the past decade:

Company	Price Change Jan. 1, 2000, to Jan. 1, 2010
Bally Technologies	5,975%
XTO Energy	5,917%
Southwestern Energy	5,776%
Clean Harbors	4,669%
Deckers Outdoor	3,775%
Jos. A. Bank Clothiers	3,196%
Range Resources	2,246%
FTI Consulting	2,022%
CarMax	1,997%
Terra Industries	1,960%

Source: Capital IQ, a Standard & Poor's company.

The list may look pretty familiar. But you may not know that these companies, and many of the decade's other top performers, share a dark secret.

Small and powerful
All of these companies are small, and all have absolutely beaten the pants off large, well-known stocks like **IBM** (NYSE: IBM) and **Clorox** (NYSE: CLX), each of which returned 21% over the same period.

That's not to say that you should avoid bigger companies. IBM may have a bright future ahead of it, now that it's shifted its business from low-margin technology hardware to higher-margin software and services. Clorox, meanwhile, has a well-established brand, selling cleaning products that seem to find their way into shoppers' carts during both peaks and troughs in the economic cycle. The company's stock pays a 3.1% dividend, and it's the kind of investment that will let you sleep very soundly.

However, we're not looking for investments with *good* returns here; we're looking for the *best* returns. So we're going to stick with the smaller companies. But small size isn't exactly a dark secret.

So what's that dark secret?!?!

Let's take another look at the companies listed above. See whether you can figure it out:

Company	Price Change Jan. 1, 1998, to Jan. 1, 2000	Return on Equity in 1999	Debt to Equity in Early 2000
Bally Technologies	(84.1%)	Unprofitable	Negative book value
XTO Energy	(45.5%)	19.5%	340.8%
Southwestern Energy	(49.0%)	5.3%	140.5%
Clean Harbors	(20.0%)	Unprofitable	230.2%
Deckers Outdoor	(65.0%)	5.3%	14.6%
Jos. A. Bank Clothiers	(44.2%)	3.2%	35.9%
Range Resources	(80.4%)	Unprofitable	417.5%
FTI Consulting	(60.0%)	2.9%	206.7%
CarMax	(74.3%)	Unprofitable	62.2%
Terra Industries	(88.0%)	Unprofitable	77.7%

Source: Capital IQ, a Standard & Poor's company.

What would you say ties all of these top-performing companies together?

If you said something to the tune of, "They looked like terrible investments," then you get a gold star. Even a quick glance at that chart would send chills up the spine of most fundamentals-oriented investors. Many of the companies were unprofitable, the ones that weren't produced lackluster returns on capital, and quite a few were swimming in debt.

Maybe it's not so surprising, then, that the market *hated* these stocks at the time. Those are some massive declines posted above, and bear in mind that this was over a period when the S&P jumped more than 50%.

There are certainly companies out there today that could fit a similar bill. **JA Solar Holdings** (Nasdaq: JASO), **Take-Two Interactive** (Nasdaq: TTWO), and **Western Refining** (NYSE: WNR) have all seen their stocks fall significantly over the past two years. And within those companies, we can find unprofitability, negative cash flow, and debt problems.

But there's a case to be made for each of these beaten-down stocks. Solar is down and out at the moment, but if the industry starts to pick up again, JA Solar could ride the wave right back into growth and profitability. Take-Two Interactive owns the hugely popular *Grand Theft Auto* series -- which alone could help turn the company's fortunes back around -- and we can't count out the potential for the company to pump out another blockbuster. Meanwhile, a turnaround in refining margins could provide a big bottom-line boost for the heavily indebted Western Refining.

Will these companies end up on the list of the next decade's top performers? Time will tell. For now, we can say that the ugly financials these three are showing today make them look a lot like the past decade's top performers, back when they started their own runs.

Time to scrap everything we know?
But does this mean we should forget about looking for high-quality companies trading at reasonable prices, in favor of rummaging in the garbage bin? I don't think so.

According to Capital IQ, 667 publicly traded companies with market caps greater than $10 million filed for bankruptcy protection over the past decade. In 2000, only 22 of those companies could claim a return on equity greater than 15%, and debt-to-equity below 50%. The rest of the companies that went belly-up sported numbers that looked a lot like those in the chart above.

In other words, taking fliers on companies with ugly-looking financials could land you a massive winner, but it also gives you a big chance of taking hefty losses.

Swing at good pitches
By sticking to investing in reasonably capitalized and solidly profitable companies that are trading at attractive prices, we vastly reduce the chances of sticking ourselves with clunkers headed toward bankruptcy, and we can still end up bagging some of the very best performers. **Green Mountain Coffee Roasters** and **Hansen Natural**, for example, both would have fit a "high quality at a reasonable price" strategy back in 2000, and they returned 9,211% and 7,024%, respectively, in the decade that followed.

What do these companies look like? Well, they look a lot like **Ebix** (Nasdaq: EBIX) and **AZZ** (NYSE: AZZ). Like the two companies mentioned above, Ebix and AZZ could have a bright future ahead of them. For Ebix, that future would come from bringing 21st-century technology to the stodgy insurance industry. For AZZ, the opportunity stems from the aging U.S. power grid.

But when it comes to the financial statements, Ebix and AZZ are very different from JA Solar, Take Two, and Western Refining. Both are nicely profitable, conservatively capitalized, and have exhibited significant growth over the past five years. In other words, we don't have to hope that they'll deliver strong financial performance. They already do.

And these aren't the only small companies with solid financials that could deliver big gains over the next 10 years. The investment team at *Motley Fool Hidden Gems* focuses solely on finding small, promising stocks that the rest of the market has overlooked. Just this month, the team dug up a big player in the messy business of dealing with radioactive materials.

To take a peek at that stock, and all of the recent moves and recommendations at *Hidden Gems*, you can take a free 30-day trial.

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Fool contributor Matt Koppenheffer does not own shares of any of the companies mentioned. CarMax is a Motley Fool Inside Value *choice. Ebix, Green Mountain Coffee Roasters, Hansen Natural, and Take-Two Interactive Software are* Rule Breakers *selections. Clorox is an* Income Investor *selection.* Motley Fool Options *has recommended a bull call spread position on Ebix. The Fool owns shares of AZZ incorporated, Ebix, and XTO Energy. The Fool's disclosure policy assures you that no Wookiees were harmed in the making of this article.*

Previous Page