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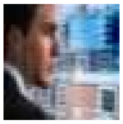

Intelligent Investing

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INVESTING | 2/19/2014 @ 11:32AM | 9,147 views

If Only Buffett Could Buy These Five Small Caps

 **John Reese**, Contributor

With a fortune close to $60 billion and a reputation as perhaps the smartest investor of all time, Warren Buffett has plenty of advantages over individual investors. If Buffett wants to have an in-depth discussion with the CEO of a company he's considering investing in, for example, you can bet that CEO will take Mr. Buffett's call.

In addition, Buffett's own personal fortune probably gives him an advantage in terms of being patient and focusing on the long-term—he could lose half of his net worth in the short term and still be one of the richest people in the world; if you lose half your net worth, there's a good chance that panic could set in and lead you to compound your losses with more rash decisions.

Finally, of course, Buffett's contacts and friends include some of the business and political worlds' most influential people, which one would have to imagine gives him a leg up on getting the inside scoop on a whole variety of issues that impact investing decisions.

But make no mistake: As an individual investor, you have at least one advantage over Buffett, and it's a very big one. The advantage: Buffett is constrained by the size of his Berkshire Hathaway empire. Because the company has a market cap of nearly $300 billion and an investment portfolio of more than $90 billion, the universe of stocks from which Buffett can choose is dramatically smaller than the universe from which you and I can choose.

In order for an investment to make any sort of significant impact on Berkshire's massive portfolio, Buffett has to be able to deploy a big chunk of capital into that investment. If he were to buy 10% of a $200 million market cap company's shares, he'd have an investment that would barely move the needle at Berkshire, regardless of how well that particular stock did.

That doesn't mean Berkshire won't occasionally invest in smaller firms. Managers Ted Weschler and Todd Combs handle smaller portfolios for the firm while Buffett focuses on Berkshire's big, core holdings, like Coca-Cola and American Express. That gives Combs and Weschler a chance to dip into somewhat smaller stocks.

But the point is that even if they or Buffett find a big time winner of a small-cap, it's just not going to make a big impact on the company's returns. You, on the other hand, can make the small-cap universe a big chunk of your portfolio, if that's where you see the best opportunities. (And, over the long haul, many studies have shown that small caps tend to outperform their larger peers.)

My Buffett inspired Guru Strategy uses Buffett's approach (as described in the book *Buffettology*, written by his former daughter-in-law and colleague Mary Buffett and David Clark) to screen thousands of stocks, including small caps.

Among the model's criteria: the company should have a decade-long track record of increasing annual earnings per share; long-term debt should be no more than five times annual earnings; average return on equity over the past ten years should be at least 15%, while average return on retained earnings (those not paid out as dividends) should be at least 12% over that span; and earnings yield should be higher than the long term Treasury yield.

The strategy often will find smaller stocks that meet its criteria, and, while Buffett and Berkshire can't really profit much from these stocks, you can. Here's a sampling of some of the small stocks it's keen on now. (As always, you should invest in stocks like these as part of a broader, diversified portfolio.)

Hibbett Sports: This Alabama-based sporting goods retailer focuses on small and mid-sized markets, mostly in the South, Southwest, Mid-Atlantic and Midwest. It has about 850 retail stores across 26 states, mostly under the Hibbett Sports name but with some also under the Sports Additions and Sports & Co. names.

Hibbett ($1.5 billion market cap) gets a 100% score from my Buffett-based model. It has upped EPS in all but one year of the past decade, has no long-term debt, and has a 23% average 10-year ROE.

Raven Industries (RAVN): Formed more than 50 years ago as a manufacturer of high-altitude research balloons for the U.S. space program, South Dakota-based Raven ($1.3 billion market cap) still makes research balloons and other products like parachutes and protective wear. It also has operations that blend technology and agriculture, making field computers, planter and boom controls, GPS guidance, and protective films and sheeting used to protect environmental resources.

Raven gets a strong 92% score from my Buffett-based model. A few reasons: Its EPS have dipped in only one year of the past decade; it has no long-term debt; and its 10-year average ROE is 25.3%.

Ebix (EBIX): Atlanta-based Ebix ($570 million market cap) supplies software and e-commerce solutions to the insurance industry. Shares have struggled over the past year as growth has slowed, but my Buffett strategy thinks that has made it a great bargain, giving it a 99% score. It likes that EBIX has upped EPS in every year of the past decade (it is on track for a dip this year, but the model sees that as a buying opportunity).

It also likes that Ebix has more annual earnings ($62 million) than long term debt ($46 million), and that it has averaged a return on retained earnings of nearly 23% over the past decade. Factor in a 10.9% earnings yield and there's quite a bit to like.

First Cash Financial Services (FCFS): Texas-based First Cash ($1.5 billion market cap) is the rare financial that has actually increased EPS in every year of the past decade. It operates pawn stores—businesses that may actually do better when times are tough—and my Buffett model gives it a 93% score, thanks in part to that tremendous earnings persistence.

In addition, First Cash has averaged a 17.6% ROE and 15.1% return on retained earnings over the past decade. It trades at a reasonable earnings yield of 5.6%.

Bio-Reference Laboratories (BRLI): The fourth-largest full service laboratory in the U.S., Bio-Reference offers an array of testing services that range from blood to genetic to urinalysis to pap smears. The small-cap ($750 million) has some very solid fundamentals, with just one EPS dip in the past decade; $46 million in annual earnings vs. $14 million in debt; and a 17.3% ROE over the past decade. It gets a 92% score from my Buffett model.

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Disclosure: I have positions in HIBB, FCFS, RAVN and EBIX.

John Reese is a money manager, editor of Validea Hot List and the author of The Guru Investor: How to Beat The Market Using History's Best Investment Strategies (John Wiley, 2009).
