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4 points to remember when picking stocks from Ralph Wanger

Legendary asset manager Ralph Wanger is known for his interesting analogies and metaphors.

In **Zebra in Lion Country**, he employed the zebra metaphor to argue his case for investing in smaller-capitalization stocks. Zebras typically move in herds. Those at the edge get to graze on fresh grass, those at the center have to make do with trampled grass. But those chomping on the fresh grass are taking a higher risk, since they are prone to becoming lion lunch. While the skinny zebras have a higher chance of survival, they have to settle for the sub-standard grass.

Here's how to be a smart zebra "on the edge" in the investing ecosystem.

1) Ensure that your portfolio has small-cap stocks.

Smaller-cap stocks have provided higher rates of return over long time periods, even after adjusting for the risk. They are not blanketed by research coverage so it's possible to unearth hidden gems. They are more easy to understand because they are in only one or two lines of business, unlike large companies that are in many.

Stock prices rise due to a number of factors: earnings growth; acquisition by a larger company at an above-market price; stock repurchases by the company; and an increase in the price the market is willing to pay for one rupee of earnings due to increased institutional interest. Typically, large-company stock prices rise only for the first reason, while smaller companies will see prices rise for all.

Nonetheless, investing in small-cap stocks is a riskier strategy, particularly since misjudgments are bound to occur. It is hard to sell an illiquid stock in a down market. The one sure antidote to the liquidity problem is to buy stocks you don't have to sell for a long time.

Also remember that while small is good, micro is not. For the littlest companies, one misstep and you're out.

2) Avoid sexy, go for boring.

A dull business run by good businessmen is far better than a glamorous business with mediocre management.

Here he uses the analogy of drunk men setting their sights on the hottest woman in a bar, hoping to "get lucky". She eventually rejects all of them. "Wouldn't it be a lot better to look in the local library to find a woman? Most men don't look there. It's out of the way and not thought of as a sexy hangout. But a guy probably has a better shot of finding someone he could share his whole life with at the library than at a crowded bar with tons of competition."

3) Write down your investing thesis.

An articulated investment philosophy will keep you on the right track. Write down your buy decision clearly, not ambiguously, whenever you buy a stock. Keep it short – no more than a paragraph or two. When the reason you bought the stock is no longer true, sell. In this way, your sell strategy is built into your buy decision.

Let's say you buy shares of XYZ Corp. because you believe its profit margins will rise from 2% to 8% over the next 5 years.

• Scenario #1	• Scenario #2	• Scenario #3
After several years, the profit margins haven't budged. Your thesis - company's profit margins would rise - is false. Action: Dump the stock	After 2 years, XYZ Corp.'s profit margins are at 5%. Margins are rising. Your initial investment equation is still true. Action: Hold	Profit margins are at 9%. Your initial reason for buying the company is false. The company's margins rose above 8%. The company has exceeded your expectations. Action: Book profits

Have a reason for buying every stock. As soon as the reason comes into doubt, ask yourself if it is time for a change.

4) Have a determined stock-picking criteria.

For the stock to end up in his portfolio, Wanger believes that it must have a few characteristics.

1) Growth potential

The growth potential comes from a company's ability to exploit its long-term theme. He looks for companies that have a good product, an expanding market, and the ability to efficiently manufacture and market its products. In addition, it should have a special niche, in an area of the market that is not easily entered by competitors.

2) Financial strength

Companies that have survived various economic environments tend to display some form of financial strength.

A low debt level is another qualifying criteria as the impact of large debt is most pronounced with small- and micro-cap firms. It is important to keep this at a minimum. But debt levels must be judged relative to other companies in the industry.

Examine other balance sheet items to make note of other liabilities (for instance, pension liabilities) and other "hidden" assets (goodwill and other intangibles and undervalued real estate) and to determine if the company is actually generating cash or if reported earnings are primarily due to an accounting function. Inventories and receivables should be examined relative to revenues to note any changes over time; rising ratios are a warning that inventories are building up.

Adequate working capital, an understandable business model, credible sales and profit growth, preferably through an entrepreneurial management dominating a boring but profitable niche market, are other factors.

3) Fundamental value

The share price should be cheap relative to indications of earnings-growth prospects such as earnings, sales or cash flow, or relative to the asset value of the firm. Companies that are recognized for their growth potential by the market will have high multiples no matter which measure is used. But be aware, that P/E ratios can be misleading due to accounting manipulations of earnings. Operating profitability is best judged by using cash flow. The share price should be cheap relative to a company's asset value, which takes everything into consideration including long-term and short-term liabilities, as well as intangibles such as brands and patents.

A portfolio of well-researched, small companies should be no riskier than a portfolio of large, well-known companies.

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