GENERATING IDEAS

An Interview with Nancy Prial

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Q: Where do your investment ideas come from?

A: How we describe the process doesn't initially sound all that different from countless other firms: we run a quantitative screen, and then conduct fundamental analysis to determine candidates for purchase. Based on valuation and growth prospects, we build our portfolios from the bottom up.

But that really doesn't do our idea generation process justice. We have a very clear idea of what an ideal candidate looks like: unrecognized growth story, growth has yet to be discounted in the stock's price, improving fundamentals near an inflection point.

Importantly, we have a fairly unconstrained approach in that we will go wherever growth is happening. In addition, if we find an ideal candidate at the company level, we will then expand our research to include the industry as a whole to see if there are specific industry fundamentals that, for the moment, provide a compelling case for further study.

Q: What are the common traits you look for in stock selection?

A: We look for early stage growth on an individual company level, then use that intelligence to move into the broader industry, searching for companies that may fit our criteria as well.

We require improving business fundamentals that are near their inflection point, revenue growth, tangible product offerings (pie-in-the-sky "idea" companies don't work for us), evidence that all of these characteristics are sustainable, and a stock price in which the company's future growth has yet to be discounted.

While we have a lot of independence from the Street initially, we need other investors to eventually come around to our way of thinking, otherwise the portfolio can lag significantly. That's why we need to be early (but not too early) on our bets.

"...The key is to be early, but not too early...."

Q: Are you able to find accelerating small cap stocks early in the current environment?

A: Sure. There are always interesting companies out there doing interesting things. For us, the key is to be early, but not too early.

Over the past few years, as the economic and market conditions have been steadily improving, investors have been increasingly willing to take on some risk, which is really important for our process. When you go in early on a stock, you need the market to eventually see what you're seeing in order to make a buck off the stock.

Q: What do you want to know about a company's management?

A: Competent, thoughtful, and forward-looking are all important considerations for our process. We spend a lot of time listening to conference calls, and I feel as though we can glean a pretty good sense of a management team's competence by how they handle those calls. Honest and direct peaks our interest.

Q: Does your bottom-up approach tend to eliminate certain sectors or industries?

A: Philosophically, no. We will go anywhere we see a compelling growth story.

That said, there are certain industries that don't lend themselves to our criteria very often. For example, early-stage technology companies rarely have viable products that are generating meaningful revenues nor are under-the-radar. Many of these firms have been backed by venture capital firms during their incubation stages, so there is usually a lot of intelligence about them floating around already. It makes it tough for us to find our needles in haystacks as a result.

"...We will go anywhere we see a compelling growth story...."

Q: How have you been able to protect the downside?

A: We don't hedge at all, so our downside protection comes down to a risk management discipline which includes diversification and understanding underlying correlations. Our portfolios have some lower beta stocks because of their growth cycle stage, but at the end of the day, if you're going to swim in the small cap pool, you can't be afraid of volatility. It is part and parcel of the strategy.

Q: Tell us about your sell discipline.

A: Our sell discipline is a residual of the investment process. We don't mandate selling a stock once it reaches a certain valuation, or if it comprises a certain percentage of the portfolio's value. We will sell if we think we were wrong, or if we think a stock's fundamentals no longer support the price.

We will hold a stock as long as we retain confidence in our analysis and believe the market will eventually come around. So long as we're not getting absolutely crushed, we'll be patient.

If we sell, it has to be for a reason.

Q: How diversified is your portfolio?

A: From our perspective, the portfolios are fairly concentrated, with about 50-100 stocks. It is important to understand that our investment process often leads us to go naked on a sector and make some fairly sizeable bets. Our attitude is: follow the growth. If that means an over weighted industry or sector, so be it.

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Q: How have your portfolios performed in different market environments?

A: Our strategy is quite dependent on a "risk-on" market. We look for companies flying under the radar of most investors, in an early stage of growth, with growth not yet discounted in the stock price. When we invest, it is a bet that the market will eventually recognize these growth stories and drive up the stock price as a result.

Suffice to say, we need other investors to be interested in finding new names. In risk-on markets, this typically isn't a problem, so long as we've done our jobs as it relates to stock picking. But in "risk-off" markets, particularly when most small cap investors are living at the top of the Russell 2000 Growth Index, it can negatively impact our numbers. We need other investors to be investigative for our strategy to work.