

STOCK STRATEGIES

An Opportunistic, and Disciplined, Approach to Small-Cap Investing

Finding good companies trading at reasonable valuations that can be owned for the long term.

BY JOHN DEYSHER, CFA

Much has been written recently about small-cap stocks (often measured by the Russell 2000 index) outperforming their large-cap cousins (often measured by the S&P 500 index). This has happened over the years, and as the manager of the small-cap Pinnacle Value fund (PVFIX), I hope it continues. But even when large-cap stocks outperform small-cap stocks, there are ways to prosper in small-cap land.

This article details Pinnacle's approach, which has been refined over years of application. While it is not perfect, it may tilt the odds in your favor.

Defining Small-Cap Stocks

We at Pinnacle usually target companies with a market capitalization of $30 million to $2 billion, which is often the upper limit of what many define as a small-cap stock. Thousands of U.S. companies fall within this range—including many that operate in attractive and understandable businesses. (Our fund's weighted-average market cap is $670 million as of August 2026.)

Stocks of smaller companies are often overlooked in the marketplace because of their size and limited trading volume. Many brokers do not provide research coverage on small-cap stocks because they generate limited commissions and investment banking fees. Furthermore, many institutions cannot buy enough shares of a small-cap stock to move the needle without owning a large percentage of the firm. This lack of intuitional interest means less competition for us and the possibility of inefficiently priced securities.

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Our Opportunistic Selection Process

Now that we have defined the market, how do we approach it?

At Pinnacle, we often initially look for stocks that have suffered price declines, indicating that something is wrong. Every day, we check the list of stocks hitting new lows. Frequently, this means that the "hot money" has fled the scene, which may help limit the downside. It also provides a road map for a future recovery. Something drove the stock price up and then down. We try to understand that dynamic and whether the decline is permanent or temporary. If it is temporary, we investigate what must change to resurrect the upside and how long it will take.

We emphasize a bottom-up approach rather than a top-down approach. The latter focuses on forecasting the economy, the sectors that might do well and the stocks within those sectors that have the highest potential. We're not very good at predicting, so we focus simply on finding good companies trading at reasonable valuations that we can own for the long term. We build our portfolio stock by stock and always focus on the possible downside to minimize our risk.

We view the stock market's volatility as our friend. Volatility allows us to accumulate a position when prices are low and lighten up a position when prices are high. Previously owned companies represent an important source of ideas and require minimal time to get up to speed since we already know the firm and management.

Sources of Small-Cap Stock Ideas

Of course, we are also always looking for new ideas, which come from many sources. Here are the primary places we check for potential small-cap stock candidates.

New Lows List

The list of stocks of hitting new lows is published daily in The Wall Street Journal and is available on an intraday basis at Barchart's website (www.barchart.com). These are stocks that have disappointed investors.

While the new lows list does not contain automatic buy candidates, it often alerts us to possible bargains that merit further analysis.

Stock Screens

We run proprietary stock screens that incorporate variables like market cap, leverage, returns, cash flows, earnings, dividends, insider ownership and valuations, to name a few. We look for strong companies trading at a discount to their underlying asset value or their potential earnings power.

Some may be high-return companies that have suffered a temporary earnings blip, while others may be low-return companies trading at deeply discounted valuations. We especially favor special situations like spin-offs, post-bankruptcy reorganizations and other corporate restructurings.

Pinnacle's Primary Rules for Selling Small-Cap Stocks

- Any stock that hits its price target becomes a candidate for sale. We constantly adjust our price targets as each stock's fundamentals evolve.
- The surfacing of governance issues or heavy selling by insiders are signs to exit the position.
- Failure of an anticipated catalyst to materialize after a long period leads us to sell the stock. If the catalyst does appear but the stock price fails to react to it, we often view it as an opportunity to buy shares instead of exiting our position.
- If a mistake is made in our facts, reasoning or judgment, the stock is sold.

Financial Publications

We do a lot of reading. Many ideas come from mainstream publications like The Wall Street Journal, the Financial Times, Barron's and Bloomberg Businessweek.

We also subscribe to specialty publications like Oil & Gas Journal, Aviation Week and Engineering News-Record. All are excellent sources of industry and company-specific news. They often highlight trends and companies ahead of the mainstream business media.

New Listings

In the back pages of the Barron's print edition (and in the Market Lab section of www.barrons.com), there is a small New Listings table that shows all the stocks that began trading on a U.S. exchange in the past week.

While we rarely invest in initial public offerings (IPOs), the list often includes spin-offs or other stocks that trigger our further analysis. Newly listed banks, insurance firms and financial institutions are also of interest and often come to market at reasonable valuations.

Company Executives

When interviewing a CEO or CFO, we often ask questions like: Who is your toughest competitor? Who is your best customer? Who is your best vendor? Through these discussions, we often learn of public companies that we were not familiar with.

Attractive Qualities Sought in Small Caps

Once we have an idea, we look for attractive qualities that merit further investigation. Much of what we're looking for can be found in a company's regulatory filings.

These include the annual Form 10-K, the quarterly Form 10-Q, news and announcements discussed in Form 8-K, and proxy filings (Form DEF 14A) available via the U.S. Securities and Exchange Commission's (SEC) EDGAR database (www.sec.gov/edgar/search). Company websites are also good sources of information.

Here are the factors we examine.

Financial Condition

When assessing companies, we look for a strong balance sheet and overall solid financial condition. Small companies are more vulnerable to economic downturns, so they must have the financial strength to survive any slowdown.

Proxy Statement

The proxy statement tells us who the large shareholders are and how much the insiders own. The presence of a large activist shareholder is normally a good sign since such shareholders can often help unlock shareholder value.

The proxy statement also indicates pay packages and perks, how incentive compensation works, related party transactions and other governance details.

To get an idea of current insider buying or selling, visit www.SecForm4.com.

Schedules 13D and 13G

On an ongoing basis we monitor Schedule 13D and Schedule 13G filings, which can also be found in the SEC's EDGAR database.

Schedule 13D filings are used by activist shareholders who plan to change or influence control of a company. They must be filed within five days of when a shareholder crosses the 5% ownership threshold. They include details about funding, background and future plans.

Schedule 13G filings are used by passive investors who own over 5% of a company but have no intention of influencing executives or the board of directors. It requires much less information and generally allows for a more flexible filing window.

Sometimes a Schedule 13G filer converts to a Schedule

13D filer; this always piques our interest.

Operating Metrics

On the operating front, we look at sales, margins, earnings and cash flows. The historical results tell us what a company is capable of and how significantly a rise or fall in sales can impact results.

We've made good money over the years by buying cyclical companies with strong balance sheets at the low point in their business cycle and waiting for the cycle to rebound. A good current example is the homebuilders and furniture companies that are being penalized by high mortgage rates.

Management

Finally, capable management is critical in small-cap investing. Poor management can destroy shareholder value quickly, especially if the board of directors is slow to react. Some of our biggest winners have come from a new CEO with a mandate to fix the company.

We attempt to talk with new CEOs as soon as possible to assess their game plan and execution capability. We like CEOs who have turned around other companies and know the ropes. We also like new CEOs who are getting their first shot at running a public company.

Bottom line, we look for ability, ethics, energy and a hands-on mentality. These executives must think like entrepreneurs, not corporate caretakers, and understand return on capital, capital allocation and incentive compensation.

Potential Small-Cap Rebound Catalysts

Many stocks decline due to company- or sector-specific problems. A large number of those stocks do not bounce back in a meaningful manner. Avoiding them requires identifying fallen stocks that possess traits of other stocks that have rebounded strongly.

We seek out commonalities in company or business cycle changes like the following.

- New management or activist shareholders that move the company in the right direction.
- Changes in the business that can improve revenues and/or profit margins, including new products, improved distribution, cost reductions, revamped marketing campaigns and bolt-on acquisitions.
- Accretive share repurchases by the company, or large insider buys on the open market.
- Corporate restructuring—including spin-offs, divestitures, debt restructurings and rights offerings—can be a good catalyst.
- An announcement by the board of directors of a strategic review of alternatives to maximize shareholder value. These proposed actions may include the sale of all or part of the company, mergers, or other transactions. Financial advisers are frequently retained to assist the board of directors. Often, this announcement triggers a stock price rise.
- A cyclical rebound in earnings. This can lead to dual tailwinds on the upside: Earnings rise, and the price-earnings (P/E) ratio usually expands. The combination is very powerful.

What if there is no visible catalyst? We try to avoid value traps, which are stocks with cheap prices that reflect eroding value or an otherwise leaky boat.

Generally, if the balance sheet is strong and we like everything else, the lack of a visible catalyst does not prevent us from buying. A catalyst usually appears, often unexpectedly.

Time is the friend of a small-cap investor. Our average holding period is about four years, as we try to give our investment thesis time to work. This may take months or years, but as long as progress is moving in the right direction, we'll hang in there.

Intense Due Diligence

Our goal is to develop a deep understanding of the target and its industry by assessing the following factors.

Competitive Position

We ask who the major players are and what their share of the market is. Which companies are gaining market share, and which ones are losing? Most Form 10-Ks have a section on competition, as do company website presentations.

Often, the major competitors of small-cap companies are private firms. This means that it can take some effort and research to fully illuminate the playing field.

Customer Bargaining Power

The customer's bargaining power when it comes to dictating terms, especially price, is a function of customer concentration, switching costs, substitute offerings and the offering's importance to the customer. Be careful of companies that depend on a few large customers like Walmart Inc. (WMT), Amazon.com Inc. (AMZN), Target Corp. (TGT), Home Depot Inc. (HD) or Lowe's Companies Inc. (LOW).

Ideally, we want our investments to have a diversified customer base so that losing a customer is not catastrophic.

Supplier Bargaining Power

The supplier's bargaining power is the degree of leverage it has with its customers in terms of price, quality and service. Companies are at a disadvantage if they cannot pass on price increases from powerful suppliers.

Suppliers are well-positioned if they are more concentrated than their customers, if there are minimal substitute products and if there are high switching costs. Be careful of companies that source key raw materials from a single vendor.

Barriers to Entry

Barriers to entry determine how tough it is for a new competitor to enter a market. Barriers may include the capital required to enter a market, the strength of exiting brands, customer loyalty, access to distribution channels, economies of scale, switching costs and government regulations.

Availability of Substitute Offerings

The availability of substitute offerings tells you if a company faces limits on the prices it can charge. The greater a customer's ability to substitute, the lower the ceiling on potential returns. Substitute offerings usually exist, but an industry with fewer players is almost always better positioned than one with many.

The Importance of Speaking With Management

At this point, we're ready to speak with management. We've done the fundamental research and have a fairly good idea of what the critical issues are. Now it's time to get inside the heads of the management team to assess their strategic, financial and operating priorities. This is especially important for a firm with new executive leadership. We give careful thought to the questions we present.

If possible, we visit management on-site. There is a lot that can be learned by seeing the headquarters and possibly visiting a plant or warehouse. If an organized visit is not possible, we may attend the annual shareholder meeting, where we will have the opportunity to speak with the directors as well as management. We've attended annual meetings where we were the only shareholder present, and we always learn a lot. At a shareholder meeting, you might also run into likeminded investors who you can share ideas with.

We have met the managements of virtually all our holdings. If we can't meet management in person, at least initially, we set up a conference call. Ideally, we speak with the CEO or CFO, but a well-informed investor relations person is very helpful. We often find that participating in a couple of quarterly conference calls can help gain access to a private conversation.

We view access to management as an important part of our due diligence; with minor exceptions, we do not invest in companies that will not speak with shareholders.

Ways to Reduce Risk When Investing in Small-Cap Stocks

- Paying attention to risk enhances your long-term returns. It is essential to wait for stocks to trade at a price that represents a good margin of safety.
- Diversify by both company and industry; do not become overly concentrated in either.
- Maintain the ability to hold cash while waiting for the "fat pitch."
- Use a conservative approach to valuation and look at both a stock's absolute valuation and how that valuation compares to the stock's benchmarks (its own history, its peers, etc.).
- Always be disciplined when buying and selling. Setting buy and sell triggers on every position will make it easier to know when to act—and when not to.
- Seek strong balance sheets, as they will allow a company to survive difficult times.
- Think carefully about what can go wrong before acting.

A Final Step

Once we've taken an idea through initial grassroots research, intense due diligence and a company management interview, we take one more step before buying: We perform a "sanity check" to see if we're missing anything. How high is our conviction level?

If we're feeling uncertain, we go back a few steps to revisit our analysis.

Conclusion

Our approach to small-cap investing is not bulletproof. We make mistakes. But we always invest on the basis of fundamentals, not popularity.

We are disciplined on both style and execution, and we attempt to win by not losing with a focus on capital preservation. Being a successful small-cap investor is a challenge, but hopefully these steps will help you be successful.

Happy hunting! ■

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