Characteristics of winning small caps before they make their explosive moves

by Tom Tresnowski

Most of the small caps that performed the best included the following characteristics: Healthy markets in an uptrend, part of an industry group leading the market and superior fundamentals and technicals. Although many winners had weak fundamentals and strong technicals, such as biotech, and some had strong fundamentals and weak technicals, your odds for profitable trades improve when you have a small cap that has both strong fundamentals and technicals.

For fundamentals, the obvious important need here is explosive EPS. While looking at the past three years EPS trend is helpful, quarterly EPS trends and projected EPS for the upcoming year is the most important metric to look at along with those that are revising their estimates higher over the past 60 days. Strong revenue, margins, positive free cash flow, and low debt are other key metrics of these winners. Diving into specific lines of the balance sheet, income statement and cash flow statements, while always a good learning exercise, has rarely yielded any indication of the future direction for a specific stock. Insider buying is usually a positive event for the future direction. With small caps though, many of the founders/officers already have stock options as a major component of their compensation and many exercise these options as the stock increases rather than purchasing more stock at the open market.

An important risk management practice is to dive into the 10Q reports and review the risk factors of the company. Focusing in on the concentration of their customer base is very important for these small caps. Many obtained success from one customer, and it is not unusual to see 50% or more of their revenue tied to this customer. You want to make sure the percentage of revenue for this major customer is rapidly dwindling down as the company continues to derive their revenue from other customers. With regards to PE ratios, while lower PEs are favorable (often called Growth at a Reasonable Price – GARP), many winners in the past had high PEs before their explosive runs. Forward looking PEs (one year or more) is a better metric to look at.

From a technical analysis perspective, most of the major runs started from a consolidation base. A consolidation base is nothing more than a stock quietly trading in a range bound mode for weeks or months. The average directional index (ADX) indicator is a good one to use during this resting/consolidation phase. Some of the best technical patterns include: cup-with-handle, flag, double bottom, head and shoulders bottom, flat base and wedge. Breakouts from these patterns need to include heavy volume – two or more times the average trading volume of the stock. The higher the volume, the better the odds that the breakout has staying power. A breakout is simply a jump above the consolidation resistance mark on high volume. A key part of these consolidation patterns is that you want to focus on those patterns that have smooth patterns and avoid those patterns that show erratic trading behavior. Think of it as viewing a healthy heartbeat vs. a heartbeat that is no longer beating – you want to focus on those that show a heartbeat that is no longer beating, smooth lines when viewing at a daily or weekly angle.

Combining strong fundamentals that is quietly consolidating in a common consolidation pattern is a safe bet for picking the next small cap winner.

About the Author

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