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Small-Cap Research

Second Coming Of Boutique Asset Managers

Nicholas F. Galluccio 06.16.09, 11:55 AM ET

It's no surprise that as a result of the credit crunch and stock market meltdown, Wall Street sell-side research is becoming a major casualty of the massive consolidation sweeping across financial services. The impact will likely fall hardest on coverage of small and micro-cap companies that generate fewer commission dollars than large caps for the brokers. In fact, street research on smaller capitalization companies could become an endangered species, forcing buy-side asset managers to pick up the slack.

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Long-only and hedge fund managers pay commissions to the brokers for basic research and meetings with companies. Equity research at the brokerage houses has almost always been a cost center funded by investment banking. But that's now prohibited by the legal wall of separation between research and banking. No surprise then that research will feel the brunt of the cutbacks, and asset managers will increase reliance on their in-house research teams.

With multiple brokerage mergers, research departments are firing their most expensive or redundant analysts and forcing others to drop small-cap coverage in favor of global leaders in their coverage universe. Centuries-old names are vanishing virtually overnight: Bear Stearns into JPMorgan, Merrill Lynch into Bank of America, Smith Barney into Morgan Stanley, AG Edwards into Wachovia, now into Wells Fargo. Not to mention Stanford Financial shutting down and Calyon Securities, among others, firing some 17 analysts who follow domestic companies.

Analysts are flocking to hedge funds for jobs, with one well-known manager fielding 90 resumes for one opening at his \$5 billion fund. FactSet Research Systems estimates that over the past six months, Wall Street research coverage has been reduced by nearly 25%, with more than 2,000 cases of analysts dropping company coverage. Smaller companies often suffer most from dropped coverage with their stocks sustaining less trading liquidity.

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The paradigm shift to a handful of giant firms is reminiscent of the late 1970s following "May Day" negotiated brokerage commissions. Back then, the lower commission structure forced a major industry contraction, leading to a new crop of specialized investment banking, brokerage and research boutiques, like Forstmann Little & Co., Gabelli & Co., A. Gary Shilling & Co., Montgomery Securities and a host of others. Likewise, we would expect the analysts not joining hedge funds or buy side asset managers to either start up their own shops or join small boutiques.

A number of such boutiques today stand to benefit from the paradigm shift. Among them, Sidoti & Co., a New York-based pure research outfit that covers some 500 small and micro-cap companies in 30 industry sectors. Two other firms expanding their research coverage of smaller companies are Birmingham, Ala.-based Sterne Agee & Leach, Inc. and Wedbush Morgan Securities on the West Coast.

Sterne Agee has doubled its research team to 22 analysts over the past two years and broadened its industry and stock research coverage to 260 companies with the goal of more than 300 companies over the near term. This past January, Wedbush acquired Pacific Growth Equities LLC and expanded from 18 to 30 analysts. Already publishing on consumer, media, entertainment, technology and industrial sectors, Wedbush has increased its breadth among small companies in technology and added coverage in life sciences.

Peter Sidoti founded his firm in 1999 after he was fired from Schroders, where he ran small-cap research. Within months of leaving Schroders, Sidoti held his first small company conference, which was attended by portfolio managers like Preston Athey of T. Rowe Price and Binkley Shorts, formerly of Wellington, to mention a few big names in the investment management business who supported Sidoti early on. Sidoti currently has 58 analysts and plans to hire an additional 12 analysts before year-end.

"Because investment banking can no longer fund research, the large firms are far less patient with money losing operations," says Sidoti, whose small-cap conference, held this past March at New York's Grand Hyatt, hosted 650 investors and 150 company managements.

Like Sidoti, Sterne Agee and Wedbush, other firms will follow, ultimately leading to a new crop of emerging firms reborn from the ashes of the great 2008-09 bear market. According to Andrew J. Melnick, former head of global equity research at Merrill Lynch from 1988 to 2001 and co-head of global research at Goldman Sachs from 2002 to 2004, "More buy-side research dollars will flow to the investment boutiques because large shops provide less research value."

Dropped research coverage should result in greater pricing inefficiencies, affording investors attractive valuations and the opportunity for significant appreciation potential especially in thinly traded stocks of smaller companies.

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At Teton Advisors, Inc. we manage the GAMCO Westwood SmallCap Equity Fund (WESCX) and GAMCO Westwood Mighty Mites Fund (WEMMX), which invest in small and micro-cap public companies. From a mutual fund manager's standpoint, the bear market has left in its wake many high quality cheap companies neglected by Wall Street coverage that offer tremendous investment opportunities. The seismic change reshaping the investment landscape will leave its indelible mark for many years to come.

Sidoti, Sterne Agee and Wedbush provide research coverage on the following companies held in Teton Advisors' GAMCO Westwood SmallCap Equity Fund (WESCX):

Kaman Corp.: Kaman is divided into two major businesses: industrial distribution and aerospace. Through distribution, it produces bearings, lubricants and other maintenance and repair items for some 50,000 industrial customers. The aerospace division manufactures specialty bearings, aero-structures and fusing devices for missile and bomb programs. While the company's trailing 12-month earnings per share is \$2.40, it has the potential to earn more than \$3 over the next few years, as distribution recovers with an improving economy. (Sidoti & Co.)

Rowan Companies: Rowan is an offshore premium jack-up driller that has focused internationally by moving its rigs from the Gulf of Mexico to the Middle East. Under its new management team, the company plans to expand its premium fleet and reduce its exposure to commodity pricing. While the company is expected to report depressed per share earnings of \$1.80 for the fiscal year ended September, 2010, following this year's \$2.90, we believe Rowan Companies can achieve normalized earnings in excess of \$3. (Sterne Agee)

Microsemi Corp.: Microsemi designs and manufactures analog, discrete and mixed signal semiconductors. The company, which has integrated three acquisitions over the past few years, has a strong market position in defense electronics along with chips used in radio frequency and battery management. Other end markets include medical, notebook and consumer. The company is debt free with \$2.00 per share in net cash and has the potential to earn \$1.35 in the next economic recovery cycle as it shows operating margin improvement from acquisition rationalization. (Wedbush)

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