

# LSGI Advisors Report

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The number of stocks trading on U.S. exchanges has declined by 39% since 1997 – and many of the stocks no longer public are those of smaller companies that we like to invest in. We think the fact we have fewer small companies trading makes the market more inefficient, all of which is good for small and micro-cap investors and active portfolio managers.

The LSGI Fund, and some of our favorite companies, are mentioned in a recent article by financial journalist and investor Michael Brush of MSN Money:



Company Focus 8/31/2010 6:00 PM ET

## How the stock market is killing jobs

Today's rapid-fire, anyone-can-play market makes it tougher for small companies to raise money to grow and hire. Do we need a new market to save the economy?

By Michael Brush  
MSN Money

While economists debate whether we're headed for another Great Depression, we're already in one of another sort: a great depression in the number of stocks available on U.S. stock exchanges.

In fact, this may be one reason for the economic woes that swamp us now.

The number of stocks trading on U.S. exchanges has declined a troubling 39% over the past 15 years, while the numbers continue to rocket higher virtually everywhere else in the world.

Experts blame the revolution in the U.S. stock market since the mid-1990s. That has changed the game for the pros and brought in throngs of small investors. But it's also made the U.S. market a tougher place for young, creative companies that need capital to grow.

What we need is a brand-new stock market.

### **The moribund marketplace**

This market revolution brought a host of transformational changes: online brokerage accounts, cheap trades, fast trades and a proliferation of electronic exchanges. This allowed many more everyday investors to dive into stocks.

It also opened the way for computerized high-frequency trading of millions of shares for tiny gains on each one, because trading costs are now so low. Much of the action has shifted to trading indexes instead of stocks. (Read "Is investing (in companies) dead?")

All this made the stock market a far more hostile place for small companies, because the changes steamrolled an old Wall Street regime that once nurtured and supported newbies. Instead, the vast scale of rapid-fire, index-based trading favors big companies.

The result is that decidedly fewer small companies are joining the market each year through initial public offerings, or IPOs. Though the numbers are up over last year -- read "3-D IPO and other hot new stocks" -- they're not close to what we saw in the booming 1990s.

This means fewer companies can raise capital to invest and grow, and we're losing the jobs and growth they might have created.

### **The new market**

There may be a fix: a new stock market that would cater to small companies and bring back the old ecosystem that used to support them.

This is the master plan of David Weild and Edward Kim, two small-capitalization-stock experts who work for auditing firm Grant Thornton. Weild and Kim advise small companies on how to go public. A cynic might argue they're just trying to drum up business and, to some extent, they are.

But they're also both career experts in the small-cap market. So their idea for a new but old-school stock exchange for small-cap companies may not be as wacky as it sounds.

As an investment banker, Weild helped bring more than 500 companies public earlier in his career at Prudential Securities. Kim once actively supported the market in small-cap stocks as a research analyst at Robertson Stephens, one of the small-cap specialist brokerage shops put out of business by the stock market revolution, and as a trader at Lehman Brothers.

### **The damage done**

If you doubt their view that big changes in the market have created problems for our economy, consider the case:

The number of stocks on U.S. exchanges has declined by nearly 39% since 1997, the peak year for U.S. stock listings. Adjusted for a bigger economy, listings are down 55% since 1997. And the total is down 22% since 1991, so this isn't just the result of all those dot-com companies that blew up when the tech sector crashed.

In contrast, the number of listed companies in Hong Kong, which trades many Chinese stocks, has nearly doubled since 1997. "We are the only market in the world that has a steady decline in listings since 1997," Kim says.

The reason the U.S. has fewer listed stocks is simple: Fewer small companies are going public. The U.S. has averaged 166 IPOs a year since 2001, compared with 530 a year, on average, from 1991 to 2000. We need 360 a year just to keep even as companies disappear -- a number we haven't seen since 2000.

Particularly troubling is the decline in very small IPOs raising just \$5 million to \$10 million in capital -- deals that used to be routine. "Many advisers won't do a deal under \$50 million," Kim says.

Why does this matter? Intel (INTC, news, msgs) went public in 1971, raising just \$8 million and trading with a market cap of just \$51 million after the IPO. Even accounting for inflation, "that is not the kind of deal that would get done today," Kim says.

### **Lost jobs**

Fewer companies going public hurts us all, because small companies can simply grow faster than huge companies. As many as 22 million jobs may have been lost since 1997 because the stock market is less hospitable to small companies. Weild and Kim get at this estimate by taking the number of jobs typically

created by a young company each year, then multiplying it by the number of "lost" IPOs and the number of years they would have been in business.

Of course, many entrepreneurs who might have gone public still go into business and raise capital in other ways. But those businesses might have grown a lot more had they had been able to go public and used the stock market machine to raise cash.

"We believe there is a high correlation between IPOs that didn't happen and jobs that did not get created," Kim says.

The decline in IPOs also hurts early-stage developmental companies -- think two geniuses in a garage cooking up the next Google (GOOG, news, msgs). That's because venture capital firms use IPOs to cash out and free up capital to invest in new startups. "If they can't get exits, they have trouble raising more funds," says Kim.

He believes the decline in IPOs helps explain a relative decline in early-stage investing in capital-intensive industries such as semiconductors and drug development, in favor of social-networking websites that need far less capital.

"The decline in listings has serious implications for the economy," agrees James Angel, a stock market expert and professor of finance at Georgetown University's McDonough School of Business. "Without new listings, we basically have no new companies in the long run."

### **The 'Great Delisting Machine'**

What's caused all this? Weild and Kim blame it on the "Great Delisting Machine." That's their moniker for the series of regulatory and technological changes that lowered commissions and democratized the stock market.

Before the mid-1990s, brokerages might have charged a \$60 commission for a trade, and they quoted stocks with 25-cent spreads between the bid and the ask -- the price you sold a stock for and the price you bought it for. (The brokerages pocketed the difference.)

Regulatory changes took that bid-ask spread down to pennies, allowing virtually anyone to post quotes inside the bid and the ask, instead of just brokers and exchange specialists. Online brokerages knocked commissions down to just a few dollars a trade.

Here's one of the things we lost in that bargain: Old-school brokers used the profits from those commissions and the bid-ask spread to fund an ecosystem that supported small companies. They funded analyst research on small-cap companies, sales teams to work the phones and sell a company's story, and trading desks with enough capital to smooth out price moves in small-cap stocks by juggling supply and demand (all for more profit, of course).

All that's gone now -- and with it, a market that used to be friendlier to small companies. Now, small-cap research is scarce, so it's hard for investors to understand these businesses. The stocks can also swing wildly, because there are no trading desks committed to helping them grow.

"We think we automated in the name of progress and lower costs," Weild says. "But this ideology that faster and cheaper is better is incredibly misguided, and it's doing grave harm to the U.S. economy."

To bring back the old system, regulators such as the Securities and Exchange Commission would have to exempt a new exchange from the rules that killed the old system. But this is doable.

Pipeline Trading Systems, an alternative trading system that uses technology to help money managers disguise their intentions in the market, exists because it got exemptions from regulations -- like the requirement to openly display quotes in its system. Pipeline Trading Chairman Al Berkeley believes a new exchange for small-cap stocks is worth experimenting with, and he thinks regulators might be open to it. "The SEC is very sensible about this," he says.

Of course, not everyone believes we need a new stock exchange. "The global stock markets are not fundamentally broken," says Scott Laue of Savant Capital Management. Market Profile Theorems research director Michael Painchaud thinks theories about a broken stock market are just part of the overwhelmingly negative sentiment toward stocks.

### **3 Small-Cap Buys**

Painchaud also thinks the shortage of research on small-cap stocks can actually help investors, because it creates opportunities for anyone who does the homework needed to find good, undervalued companies.

A great example of this is the LSGI Technology Venture Fund, run by Joe Dancy. His fund has produced 11% annualized returns during its 11-year life -- compared with 4.6% returns for the Russell 2000 (\$RUT) small-capitalization index -- by digging up cheap small-cap stocks with good prospects.

"Most folks don't have the time to research microcap firms, and institutions are ignoring them," Dancy says. He believes the current rush to bonds has particularly punished microcap stocks, creating some "incredible" opportunities for long-term investors. "Stock valuations for small companies are way out of line with their true value," says Dancy.

One small company he likes is oil and gas producer **GeoResources (GEOI)**. The company's expected production is worth \$22 a share, says Dancy, but the stock sells for just \$14.70. He also likes **Evolution Petroleum (EPM)**, a domestic crude-oil producer that revives old oil fields by injecting them with carbon dioxide, which helps oil flow. This company's future production is worth \$10 to \$12 a share, but the stock sells for under \$5 a share.

A third favorite is **Ebix (EBIX)**, which sells software used by insurance companies that's increasingly popular. LSGI owns all three stocks.

But wait a minute. If these stocks look cheap because they're ignored by the market, won't they always remain cheap?

Not really. You might have to be patient, but sooner or later, they can pay off big. With relatively few shares in the market, stock prices can rise quickly when a company's story catches on. And if investors fail to recognize these companies, competitors will -- and take them over. Shares of network security software company **ArcSight (ARST)**, also an LSGI holding, shot up 39% last week when news leaked that it was shopping itself around.

"The merger-and-acquisition frenzy has just begun," says Dancy. "In a slow-growth economy, what better way to expand than by buying a fast-growing, profitable small- or microcap firm that is undervalued?"

