

Small wonders can get ahead of the game



The smaller Thrifty 30 companies that Share Sleuth seeks out should, over time, be nimble enough to beat the leviathans we feature in the Nifty Thrifty, says **Richard Beddard**

I am writing this column about the portfolio after emailing the Nifty Thrifty cover story, which you can read on page 26, to *Money Observer's* editor. That extravaganza describes the big profits investors can make in companies we have dubbed both nifty and thrifty: companies that are not just cheap and financially strong but also large and highly profitable.

The companies in the Thrifty 30 are small and down on their luck. Finding them requires considerable sleuthing. The first stage is to filter the market for portfolio candidates. I spend at least a day on every company, recalculating its financial ratios and familiarising myself with its history. Only when I understand the business and feel confident about its future will I add it to the portfolio.

A Nifty Thrifty investor need never go beyond stage one. The strategy is based on Joel Greenblatt's Magic Formula, which is the investing equivalent of colouring by numbers. To follow the formula you don't need to know anything about the shares you are buying except

that they are ranked highly. A year later you sell them and replace them with a new batch of highly ranked companies.

In defiance of financial theory, which holds that opportunities to make exceptional profits should disappear once they become well known, Greenblatt's formula has continued to work despite the fact that he has published it in a book, established a free website listing Magic Formula companies (www.magicformulainvesting.com) and founded a stock brokerage that invests in them.

In collaboration with Greenblatt, Royal Bank of Scotland publishes US and global indices of Magic Formula companies, which UK investors can trade. It is planning funds later in the year that will track the indices.

But with so many easy ways to profit from the big familiar companies available, why should I bother tracking down the very cheapest companies that I can be confident will prosper? Surely nifty and thrifty is better than just plain thrifty? Not necessarily. If the fund managers I interviewed for the cover story are right, smaller companies will lag larger companies for years.

However, there is considerable evidence that smaller and cheaper companies deliver greater returns over long periods. The Magic Formula works even better on smaller companies and the predictive power of Piotroski's F-Score, which I combined with the Magic Formula in the Nifty Thrifty filter, is

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stronger when applied to small, cheap companies.

Also, it's wise to remember the first rule of investing: know oneself. Just as I'm uncomfortable letting another person manage my investments, I am uneasy outsourcing my portfolio to an algorithm. I want to know what I own.

The Thrifty 30 doesn't exclude companies with nifty characteristics. XP Power, which I added last month, is much smaller than the minimum \$1 billion (£670 million) minimum market capitalisation I set for the Nifty Thrifty filter, but it's a fast-growing multinational manufacturer of power adapters.

The Nifty Thrifty approach has one big advantage: it's ideal for idlers. Active investors must not only better the passive alternative, they must do it by a margin that justifies the extra effort.

Comparing the performance of the Thrifty 30 with a mechanical Nifty Thrifty portfolio pits man against machine and my portfolio against a much more challenging benchmark than the FTSE All-Share index. In future, I may be able to make that comparison as we're starting a Nifty Thrifty portfolio on the *Money Observer* website in early June.

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