The Washington Post

MONDAY, SEPTEMBER 5, 1988

For Debra Diamond, Small Stocks Often Reap Big Rewards

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Somewhere out there is a small, young company with a great product, booming sales, fat profit margins and a stock that is going to triple in the next few years. You know it's there, and you know you could find it—if only you had the time to look.

Debra Diamond has time. Finding little known but potentially powerful stocks is her job. And she's been pretty good at it, although she has had her share of clinkers.

Diamond is the president of the New Frontier Fund, a quasi-private investment pool operated for European investors by T. Rowe Price Associates of Baltimore.

Diamond's fund started three years ago with $20 million raised from about 25 institutional investors overseas. The $20 million grew to $39 million. But then came October and Diamond's fund plunged to $22 million.

"It went into a free-fall," Diamond recalls with a grimace.

Ten months later, small company stocks have recovered and Diamond's fund is back up to $34.1 million.

Unlike most funds at T. Rowe Price, which manages $24 billion, the New Frontier Fund is not available to public investors. But Diamond's stock selections offer an interesting glimpse into the strategies and pitfalls of investing in very small companies.

T. Rowe Price created the fund to build some bridges to the international investment community. In return for their investments, the overseas portfolio managers got Diamond's experience and expertise in finding tomorrow's winning stocks.

It was a job that most overseas investors were not equipped to do themselves. They were glad to leave it to Diamond and T. Rowe Price, which designed New Frontier as a limited partnership and which operates like a closed-end fund. When the fund closes its doors after five to seven years, T. Rowe Price will get 15 percent of the profits on top of its annual 1.75 percent management fee.

Diamond was well prepared for the challenge of guiding New Frontier. The 35-year-old portfolio manager came to her job by way of the New Horizons Fund at T. Rowe Price, where she was a health-care analyst, an experience that has helped her find emerging stocks in the medical field.

Diamond, who grew up in Youngstown, Ohio, was a bright student who graduated from George Washington University at the age of 20. She went on to get her master's degree in business before heading back to Cleveland, where she went to work as a research analyst at McDonald & Co., a conventionally conservative firm.

"I was a new entity to them," recalls Diamond. "Remember, it was 12 years ago. I was a woman. I was young. I was inexperienced. They didn't know what to make of me. They gave me all the cats and dogs to analyze. They didn't have too many clients in them, so they figured I couldn't do much damage."

As it turned out, the stocks Diamond recommended went up, the ones she ignored went down. And McDonald's clients made some money.

A report she wrote on The Limited, a women's apparel chain, helped boost her into a job as an analyst at T. Rowe Price. While in Cleveland, she was married to a physician, Mark Diamond. Today, the Diamonds have three children.

At T. Rowe Price, Diamond found she much preferred to manage money than to write about stocks. "I like to take action . . . If I see an opportunity, I want to do something about it . . . " she said.

On the frontier where Diamond works, many stocks are culled but few are chosen. Diamond keeps watch over 3,000 stocks. But she has limited her portfolio to only 50, give or take a few.

When Diamond is prospecting—which is most of the time—she looks for companies with a market capitalization of no more than $50 million. That's figured by multiplying the price of the stock by the number of the company's shares. A company with 5 million shares selling at $10 each would have a $50 million "market cap."

She looks, too, for companies whose profits are growing by at least 25 percent a year, companies with relatively high returns on the stockholders' investment, companies without long-term debt. It helps if a company is still undiscovered by Wall Street's biggest stock pickers and if its products are unique and have potentially broad markets.

Diamond also wants to know about the people running the company.

"I like to invest with people who like to make money," she says firmly. "I like people who have had their share of hard knocks. It gives them good perspective," she says. What she doesn't like are the flashy promoters in white patent leather shoes and glittering pinky rings.

After Diamond has studied the numbers and met the management, it's decision time. It finally all boils down to a gut feeling, says Diamond. "I tend to go with my instincts."

Those instincts have produced investments, as of June 30, in Windmere Corp., up 136 percent; the American List Corp., up 82 percent; and Florida Steel Corp., up 47 percent; and Jackpot Enterprises, up 56 percent.

But those instincts also have produced some losers. Philip Crosby Associates, is down 26 percent. And United Coasts Corp., is off 32 percent. In both cases, Diamond is holding on. The business fundamentals at both firms are strong. In fact, she is adding to her holdings in Philip Crosby.

The tricky nature of Diamond's challenge is reflected in what happened to 14 stocks that she added to her portfolio in April, May and June. As of the end of June, nine stocks had gone up, five had gone down.

The nine new winners are American Biltrite, Index Technology, Stockholder Systems, Baldwin Piano & Organ, International Research & Development Corp., Laclede Steel Co., Proler International Corp., Quanex Corp. and X-Rite. The five new losers are Detection Systems, Zeus Components, Timberjack Corp., Gotaas-Larsen Shipping Co. and Universal Medical Buildings.

How does it happen, we asked, that one third of the stocks that are so carefully screened and analyzed would drop in price so soon after they were bought?

Diamond's answer is that it is important to separate the company from the stock. A company can do well in business and yet its stock can do poorly. Some stocks are so thinly traded that merely buying shares for the fund boosts the price temporarily. In other cases, investors may get discouraged for a variety of reasons.

"There's a lot of opportunity when people walk away from a stock," Diamond said.

But Diamond will stick to a stock only if she thinks the company's business is sound.

Let a company announce that its profits have slipped for the past quarter and Diamond is likely to accept the first bid on the stock that the traders will give her.

"When a company disappoints me, I eliminate the stock and move on," she says.

One stock that Diamond dropped recently was Tempest Technolgies of Herndon, whose earnings fell sharply.

Companies often will tell investors that their lagging profit is only a temporary problem that will be resolved by the next quarter. Diamond tends to be cynical. "My observation is that one quarter's problems tend to last two years," she said.

Diamond's track record looks like this:

- From the fund's beginning on May 31, 1985, to July 31, 1988, the fund is up 80.4 percent. The Standard & Poor's 500 was up 60.1 percent, the Nasdaq industrials were up 31.6 percent.
- In 1987, with help from the October crash, the fund dropped 9.2 percent, compared with 3 percent for Nasdaq and 5.3 percent for the S&P 500.
- Thus far this year, as of July 31, the fund was up 33.9 percent, compared with 17.4 percent for Nasdaq and 12.4 percent for the S&P 500.

Fortunately for Diamond, small stocks have been on the comeback trail. Perhaps, that is because they had almost no place to go but up. First, they lagged the big stocks for several years while the bull market was building. Then in October, the small stocks were hit again. That left plenty of room for rebuilding.

Diamond agrees: "We're in the process of resusitating the the patient."