Sticking with stocks

InsiderQ&A
with Stephen Goddard

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Stephen Goddard says stock prices can continue to press higher even without strong economic growth. Mergers, buyouts and other activity should help lift prices, he says. He is chief investment officer of The London Company, which has over $1.6 billion in assets under management. He also helps run the Touchstone Small Cap Core fund (TSFAX), which ranks in the top third of its category for one-year returns.

After the best September for stocks since 1939, are you worried prices went too far, too quickly?
There's still a fairly wide gap between valuations (of what companies go for in the stock market) and what these companies are worth to private market buyers. You've seen premiums of 40 to 50 percent or more (offered in bids to take companies private). Normally, you get something like a 20 percent premium. As long as you have a gap that wide between true private market values and public, there should be more acquisitions across the board. … We think this is just the beginning for the M&A activity.

It's not that I'm anticipating any rapid growth in the economy. I just think it's the right environment for M&A – low-cost financing on debt, fairly reasonable or cheap valuations on equity, plenty of excess capital sitting on corporate balance sheets, at least in the non-financial sector.

When you talk to the companies in your portfolio, how confident or discouraged do they sound?
Any company that's directly related to housing, they're very cautious. They're not seeing the turnaround in improvement as quickly as they'd like. Outside that area, I'd say more than not, companies are seeing very good growth and pickup in revenues. Some are back to their prior peak levels. But they're also seeing their margins enhanced, sometimes quite dramatically because capacity is tight globally.

No one is really adding capacity out there. Companies are just really reluctant to hire or add new capacity, because they don't know what the rules are. Not knowing what health care is going to be, taxes are going to be, that's what's causing it.

You've said insider buying is a better indicator than insider selling. Why is that?
A lot of times what happens is when your options are expiring, that will motivate someone to sell. Buying, with the exception of buying that's required by directors, can be a fairly good indicator as long as you're buying with a longer time horizon. A lot of times, they're buying for two or three years out, not something imminent because then they could get in some trouble (for insider trading violations).

Nothing's a perfect indicator, but we certainly like to see it.

Selling can be an indicator too if you see a CEO exercising options that don't expire for another 10 years, and he's blowing out over half his holdings. A lot of times, you find out three months later why he did that.

You've got a prison operator with Corrections Corp. and a gun maker with Sturm, Ruger in the portfolio. Is there a takeaway there, with all that doom and gloom?
A lot of times you pick up companies like that for cheaper valuation, the sin stocks – tobacco, guns or alcohol because a lot of funds are prohibited from buying those companies. But Corrections Corp. is a dominant player in the private prison market. State and federal governments are really starving for funds; the prison system is overcrowded. They can't build themselves because of a lack of funding, and they can save money from outsourcing to Corrections Corp.

It's a fairly predictable business; you've got a fairly captive consumer.