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Outperform Warren Buffett With These Stocks

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Warren Buffett is far smarter than me. Odds are, he's far smarter than you, too. And he's probably a far better investor than either of us. Still, we can aim to beat him at his own game -- by doing what he can't do any more.

For Buffett, even the most promising small-cap stock would add up to no more than a drop in the ocean of his vast wealth. For us, investing in the right up-and-coming companies could make a far greater difference. Researchers Michael Weiss and Yuliya Tarasava studied five recessions over the past 30 years and found that small caps significantly outperformed large caps as America pulled out of each one. And hey, guess what's happening in our economy right now?

Even when we're not rebounding from recession, small caps can still stand out. From 1926 to 2006, small-cap stocks beat large-cap stocks by an average of 2.3 percentage points annually.

Why they perform
When smaller companies are good, they're *really* good. Their small size helps them grow far faster than larger, more established businesses. **General Electric**, which rakes in more than $150 *billion* annually. To add just 20% to that, it would need to add $30 billion in revenue -- the GDP of Malawi, Mongolia, Nicaragua, and Ghana *combined*. GE will likely achieve that over time, but it's just plain hard for behemoths to move fast.

Meanwhile, companies such as **Spectrum Pharmaceuticals** (Nasdaq: SPPI), with its market cap of just $220 million, can grow much more briskly. The biotech enterprise has an average annual revenue growth rate of more than 100% over the past five years. That growth has been slowing recently, but all the company needs to experience a big pop is to shepherd a promising drug successfully through clinical trials. Even before that happens, Spectrum can always ink lucrative deals with bigger pharma players.

Smaller companies are simply more nimble, and have more room to grow.

Warren says ...
Warren Buffett knows this. He's been warning his shareholders for many years that his future results are likely to pale next to his past results:

1991: "As Berkshire grows, the universe of opportunities that can significantly influence the company's performance constantly shrinks."

1995: "The giant disadvantage we face is size: In the early years, we needed only good ideas, but now we need good *big* ideas."

When Buffett made that last comment, **Berkshire Hathaway**'s (NYSE: BRK-B) per-share book value was $14,426. In 2009, it was $84,487, up nearly six-fold, and reflecting an annualized growth rate of 13%.

That's good, but Buffett has explained that his growth rate is likely to keep slowing as his company grows. With his company's market cap near $200 billion now, it's harder than ever for Buffett to find great investments.

But *we* can!
Your portfolio should ideally be a diverse mix of companies, including a bunch of small, healthy, and growing companies.

"Healthy" and "growing" are important caveats -- that's why I look for companies with a market cap between $250 million and $1 billion, a three-year average revenue growth rate of at least 10%, and a return on equity (ROE) of at least 15%.

It's true that a company's future growth is more important than its past growth. Still, looking for strong past growth can help you find companies that have been doing things right. Robust returns on equity reflect companies that put their assets to good use and build value for shareholders.

I've found a few lately with exactly these characteristics:

Company	Market Cap	3-Year Average Revenue Growth	ROE
Cirrus Logic (Nasdaq: CRUS)	$918 million	13.4%	27.3%
Neutral Tandem (Nasdaq: TNDM)	$506 million	29.3%	14%
Ebix (Nasdaq: EBIX)	$754 million	40.6%	26%
Hi-Tech Pharmacal (Nasdaq: HITK)	$281 million	41.2%	21.6%

Data: Motley Fool CAPS.

Screens like this one can point you toward strong performers like the companies above. But don't be too rigid in your search. Play around with your parameters, and you'll find even more contenders. Relax the revenue growth rate floor to 9%, for instance, and you'll get **Boston Beer**, which fails the 10% criteria for three-year growth, but exceeds that average over five years as it rides the trend toward craft beers and further strengthens its distribution network.

These kinds of companies can grow rapidly for at least several more years. In many cases, such companies can keep growing briskly even after they've expanded into mid-caps.

Intuitive Surgical (Nasdaq: ISRG) is flirting with large-cap status, sporting a five-year average revenue growth rate north of 40%. But the company's not done yet. Wall Street analysts expect it to average 25% growth over the next five years, since hospitals are still snapping up its expensive surgical robots, and then repeatedly buying supplies for them. Intuitive might serve new investors well now, but those who've owned it since it was a small cap have done far better.

However you go about it, you'll do well to pepper your portfolio with some small companies with big potential. That's how we build our *Million Dollar Portfolio*, a real-money service combining the best of the Fool investing universe. To learn more about *Million Dollar Portfolio*, simply enter your email address in the box below.

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