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6 Small Caps For Big Profits Through The 'January Effect'

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December 29, 2011 | includes: CSTR, DMND, EBIX, ESI, USNA, VCI

In his book, *Stocks for the Long Run*, Jeremy Siegel mentions about a special market anomaly, which is known as the January effect. The January effect suggests that equity markets have a tendency to perform better in January, compared to other months of the year. This market anomaly is particularly evident in the small-cap stocks. Professor Siegel explains this concept as such:

> The most important calendar anomaly is that, historically, small stocks have far outperformed larger stocks in one specific month of the year: January. In fact, January is the only reason that small stocks have greater total returns than large stocks over the past 70 years!

Jeremy Siegel is a well-known professor from University of Pennsylvania's Wharton School of Business. He is also a prominent investor, and holds a significant stake in WisdomTree Investments. If the small-caps outperform the market in January, as claimed by Siegel, then one can make quick profits by switching to small-cap stocks.

Therefore, I specifically looked for the highly shorted small cap picks, since they might be subject to short-squeeze in an upward movement. As a safety net, I set the trailing and forward P/E ratios to a maximum value of 15. Here is a brief analysis of 6 highly shorted small cap stocks for big profits in January:

Diamond Foods (DMND)

Diamond Foods is one of the most shorted companies in the market. Float ratio is 55%. A day ago, it was around 60%. The rumors that Diamond could be a taker over target was enough to bump the stock to significantly higher levels on Wednesday.

Diamond's fundamentals look pretty strong. The stock is trading at a forward P/E ratio of 8.31. Based on 17% EPS growth estimate, it is also trading at a PEG ratio of 0.79. I do not know the primary motivation of the shorts, but they made great profits in 2011, since the stock lost almost half of its market cap since January. Nevertheless, it apparently bottomed at a price of $32. Diamond is my number #1 candidate for a short squeeze in January.

Coinstar (CSTR)

Coinstar's business model is primarily concentrated on the Red Box, where users can borrow DVDs for a nominal fee. Coinstar is also the owner of the coin counting machines around the U.S. I think Coinstar's Red Box business could be a serious threat to Netflix (NFLX), as I mentioned before.

The company was able to boost its earnings by 55% in this year, but the stock lost near 20%. The stock is trading at a pretty cheap P/FCF ratio of 8.34. From a technical perspective, $40 is a strong support level for the stock. Therefore, I rate Coinstar as a buy for January and beyond.

ITT Educational Services (ESI)

Educational service stocks were among the biggest losers of 2011, and ITT was no exception. Although the company boosted its earnings by 40%, it lost near 10% of its market cap in this year.

For-profit education companies are on the spotlight, primarily due their aggressive recruiting policies and record profits. While, I do not appreciate their aggressive recruitment policy, I think it is very normal for them to generate nifty profits. After all, their primary capital is human mind, and we have plenty of underpaid minds across our universities.

Those for-profit institutions create an additional source of income for many under-paid university faculty members in the U.S. The political risk is high, but these for-profit education companies also allow for the training of the many under-represented communities in the U.S. They obviously generate huge profits for their shareholders. Therefore, I rate ITT as a buy for January and beyond.

Ebix Inc. (EBIX)

Ebix is a software provider that works primarily for the insurance industry. Established in 1976, the Atlanta-based company showed a magnificent growth in the last 5 years. It was able to boost its earnings at a rate of 58% in the last 5 years.

Ebix is also highly profitable with a gross margin of 80%, and net margin of 43%. The stock returned almost 50% in this year, which explains the relatively high short interest of 33%. However, the shorts need to recognize that Ebix's stock performance is well-justified. The company is also trading at a relatively low price/book ratio of 2.70. It is near the overbought territory, but shorting such company with strong fundamentals is not a good idea.

Usana Health Sciences (USNA)

Usana is a medical science company which offers two product lines. The nutritional product line manufactures and distributes essential nutritional supplements. The Sense product line offers personal care products for the skin and hair.

Usana was able to boost its profits by 32% in this year, but the stock lost near 30% in 2011. It is trading at a cheap trailing P/E ratio of 9.64, and forward P/E ratio of 8.68. It has a clean balance sheet with zero debt. It is quite hard to see the motivation behind 32% short float. Given the low trading volume, Usana is a perfect stock for a short-squeeze.

Valassis Communications (VCI)

Valassis is an intercontinental media and marketing service provider that operates in the U.S. and Europe. It is a traditional company that is primarily dependent on USPS for the delivery of marketing materials. The stock lost near 42% in this year, falling into the dirt-cheap category.

Valassis is trading at a trailing P/E ratio of 9.22 and forward P/E ratio of 6.23. It has a pretty high short float of 26%, but analysts estimate near 17% EPS growth for the next 5 years. If analysts' estimates hold, the shorts might get in serious trouble. This is another short-squeeze candidate for the beginning of 2012.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.