Read this to learn from my latest investing blunder

By Matt Brazier - June 15, 2015

I bought a parcel of shares in **Compumedics Limited** (ASX: CMP) on 22 July 2014 for 15.5 cents and sold them on 17 April 2015 for 29 cents. In the process, I realised an 87% gain in under a year before transaction costs and taxes, but the gain should have been much larger for the following reasons.

1. When I purchased Compumedics, it was a very illiquid stock with a large buy/sell spread. I rushed my trade and paid too much by meeting the ask price. With illiquid shares, it usually pays to patiently sit on the bid and wait for a seller to meet your price, since the spread often represents more than 10% of the price.
2. Between August 2014 and March 2015, Compumedics traded below 15.5 cents and I had the opportunity to pick up more shares for less than 10 cents. Averaging down requires a high level of conviction, which in turn requires deep research and analysis. My research and analysis on Compumedics was lacking and therefore I did not have enough confidence to take advantage of the bargain prices on offer.
3. I sold out of my position at close to an intraday high during a price surge and at the time was very pleased with my timing. But today, just two months later, the stock has traded as high as 36 cents. Thanks again to a lack of thorough knowledge of Compumedic's business, I was happy to part with it for less than the possible true value of the company. In addition, because I held shares for less than a year, I will not benefit from a 50% capital gains tax discount.

Why Compumedics could be worth more than 29 cents per share

Compumedics is a global developer, manufacturer and distributor of sleep and brain diagnostic devices.

At 29 cents per share, the market capitalisation of Compumedics was $48.4 million. The company has provided market guidance of net profit after tax of between $1.8 and $2 million for 2015 and therefore the price to earnings ratio (PER) was just over 25. The company also has a small amount of debt of around $1 million after adjusting for cash.

Different types of stocks require different valuation techniques to come up with a reasonable estimate of future cash flows and hence intrinsic value. In this way, investing is much more of an art than a science since it takes judgement and creativity to look at a business in the right way to coax out a realistic valuation.

PER is a key valuation tool but as with most investing metrics, it is limited when used to analyse a small and fast growing company like Compumedics. Thanks to its size, the company is capable of massive profit growth and this has an equivalent impact on PER, so what looks expensive today becomes very cheap in just a year's time.

For example, Compumedics has said that it will double profits this year from $0.9 million to over $1.8 million.

Some people like to use the price to earnings growth ratio to take into account such high growth rates, but it is not very useful in my view as it relies on too many assumptions.

In the absence of strong quantitative methods for valuing small growth stocks, qualitative aspects become increasingly important. Here are some qualitative factors that suggest Compumedics has the potential to grow into a much larger company than it is today.

- It is set to benefit from the aging population trend because sleep conditions tend to become more prevalent with age.
- It is the market leader in China, a rapidly growing market.
- It has world class technology thanks to heavy investment in research and development.
- It has won contracts to supply its new eHealth product, which has the potential to open up the sleep diagnostics market.
- It has recently outsourced manufacturing to South East Asia which should improve profit margins.
- It is looking to spin off some of its non-core divisions, its DWL division in particular could be worth more than $30 million in such a transaction.

Since companies like Compumedics are difficult to value accurately, investors must allow for a larger range of possible values than would be appropriate for larger, more mature businesses. This means that when buying stock, a greater margin of safety is required, and also that it is important to demand a higher price when selling.

Furthermore, if you own shares in a company that **may** have the ability to grow its earnings strongly for many years without requiring any additional shareholder funds, selling rarely makes sense at all.

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