A Mispriced Growth Stock That's Ripe for a Massive Upside Correction

Description

Those who buy into the concept of the efficient market hypothesis believe that no alpha (excess risk-adjusted returns) can be gained, as the market is quick to adjust stock prices relatively close to their intrinsic values based on all currently available information.

In other words, fundamental analysis doesn't work to help you beat the market, nor does technical analysis, if it is, in fact, efficient. The academics who believe in efficient markets think that Mr. Market does his job well, isn't irrational, and that retail investors would be best served by plopping their cash in low-cost index funds.

While the magnitude of market efficiency is up for debate, the fact remains that complete market efficiency (where the market value of a security equals its intrinsic value) is impossible, especially in today's market, where amplified fear and greed is in the aura of Wall and Bay Street.

Bubbles are inflating and deflating left, right, and centre (cryptocurrencies, marijuana, cobalt) thanks to the FOMO (fear of missing out) mentality and the loss-averse, fearful nature of individuals who participate in the financial markets. As humans, we sometimes don't react based on logic. Rather, we react to our emotions, which is a horrible way to manage your wealth. We all want to get rich, and we all want it ASAP. But we don't like losses, and some inexperienced "investors" don't fully understand what taking a risk entails.

As a result, corrections happen nearly every year on average, because sometimes Mr. Market just has it completely wrong! A stock measures the reaction to material dissemination of information, but when there's a lack of such material, a stock still fluctuates, and it's this fluctuation that's a meaningless measure of fear and greed.

Mr. Market overreacts to negative or positive events quite frequently. And it's his negative overreactions that warrant the attention of contrarian investors looking to score excess risk-adjusted returns.

Consider **Spin Master** (TSX:TOY), a small-cap stock that Mr. Market has marked down of late thanks to "material" events that probably should have been treated as immaterial. As a small- to mid-cap stock, the name doesn't get the same degree of analyst coverage as a blue chip that everybody and their parents own within their TFSAs.

This lack of coverage causes investors to overreact to every single piece of "noisy" information that's released. Each quarter is three months, and in those months are some pretty irrational movements that are based mainly on noise. Investors want to take action, so they wait for any opportunity that warrants it.

In the case of Spin Master, a recent round of insider selling caused shares to fall 2.7% in a single trading session. The stock is down around 16% from its high, and it's clear that investors aren't willing to stick it out, despite the incredible long-term growth story and overly depressed valuation.

Over the last three years, the company has enjoyed 30% in revenue growth, 34% in operating income growth, and 46% in net income growth. With no signs of slowing down, you would think the stock would trade at a +30 P/E multiple, but it doesn't.

Spin Master stock trades like a stalwart at just 18.5 times forward earnings. The company is firing on all cylinders and is heading into a period of profound seasonal strength. While insiders have ditched shares, including the founders, who've sold a considerable amount in a block trade, I don't believe such a massive decline in shares is warranted, especially after the company showed it could thrive in an era without Toys "R" Us (in the U.S. market).

Insider sales deserve attention, but they're not to be treated as though something insidious is happening behind the scenes. If you have a look at past-year insider trades on your average stock, you'll see that insider sells heavily outweigh insider buys, so Spin Master's insider activities are by no means an anomaly.

Foolish takeaway

Spin Master is a magnificent growth stock led by an exceptional management team. The company is growing very fast, and it's remarkably profitable. The company is a freight train that can't be stopped, so don't let small, adverse events cause you to follow the herd.

I think Mr. Market has this company wholly wrong and his mispricing will eventually be corrected come the next earnings release, because, in the grander scheme of things, it'll be the quarterly results that'll ultimately dictate the trajectory of the stock.

Stay hungry. Stay Foolish.

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