The Allure of Small Cap Stocks

by Tom Tresnowski

Most of us are aware of the tragic events of the Titanic hitting the iceberg in 1912. Unsinkable arrogance, unable to change course quickly, and communication mechanisms not in place to handle emergencies were some of the problems that ship had. In many ways, it is these same characteristics that exist for the larger cap stocks. The size of these larger companies reflect the years of success they had in the past with the products and services they offered. It is difficult to question what worked so well in the past for moving forward in the future. This is especially problematic for the bureaucracies in place with most of these larger companies.

Unlike these large companies, smaller companies often are formed with an exciting idea and unmet needs in the marketplace. Granted, many of these ideas do not pan out and the pink sheets are littered with many small caps that failed. However, there are a small universe of these small caps that eventually do well and some that do very well. All of the large cap leaders came from this small universe of small caps. Below are three advantages for considering small cap stocks:

- **Higher Growth/Nimble Operations**
  Small companies grow from a smaller arithmetic base. It is easier to double sales of a $10 million company than sales of a $10 billion company. Small companies are often in growing industries and find it easier to change their strategy in response to market conditions. Smaller companies are often run by their founders or a small group of managers who are more motivated to increase shareholder value.
- **Greater universe of opportunities**
  The 80-20 rule of investing: 80% of Wall Street research is focused on under 20% of publicly traded companies, those with market capitalizations of over $1.5B. This leaves a large number of companies with little analyst coverage. With few investment managers performing in-depth research on small cap firms and the rest relying on conventional research, an astounding number of small cap companies get overlooked. Focusing on this larger number of undiscovered companies increases the odds of uncovering hidden value.
- **Inefficient market**
  Because few, if any, brokerage firms cover small companies, there is a greater possibility of market inefficiencies. Because most small companies have relatively few shares freely trading, a liquidity problem exists. This liquidity problem prevents many large institutions from investing in these companies. This reduces the number of buyers for the stock and can cause the stock price to be unjustifiably low. Conversely, when a large buyer tries to buy an illiquid stock, the price can go up dramatically. A small company that grows and performs well will draw more attention, increasing trading volume and driving up valuation.

Small Caps are usually defined as stocks having a market capitalization between $300 million and $2 billion where market capitalization is the share price times the number of shares outstanding. The shares outstanding minus the shares locked up is equal to the float. The float is the number of shares that are available for the public to trade in. There are several thousand small caps that trade today on the national US stock exchanges. As noted above in the inefficient market characteristic, a small company that grows and performs well will draw more attention, increasing trading volume for the float available. It has the many benefits of quickly driving up the share price because of the low float (relative to large

caps), increasing earnings and expansion of the PE ratio. Many of the small cap winners in the past had a PE ratio well above the market/sector it belongs to before they started their explosive moves.

In upcoming articles, I will highlight: the importance of the overall markets and industries these small caps belong to, characteristics of small cap winners before they make their explosive moves and a case study of a small cap stock that returned over 1,000% in a short period of time.

About the Author

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