The Importance of Markets and Industry Groups for Small Cap Stocks

by Tom Tresnowski

Did you know that approximately 50 to 70% of the movement of any stock has nothing to do with the fundamentals of that company? It is estimated that the overall stock markets and the industry group the stock belongs to make up to 70% of the movement for any stock. For small caps, the influence is much more dramatic. We have seen many promising small caps correct up to two times the movement of the Russell 2000 index during a correction/bear market. As highlighted in the Inefficient market section my previous article, **The Allure of Small Cap Stocks**, the benefits of the liquidity problem of the small number of shares that can be traded is also a problem or opportunity (from a shorting perspective) when the markets turn south. When institutions and individuals start to sell, usually because of profit taking, the liquidity problem causes these stocks to move quicker to the downside than the larger cap stocks.

There are more bubbles and meltdowns today compared to the past mainly because of the proliferation of information and instant communication we have across the globe. No longer are there safe havens for making consistent double digit returns. This environment has produced behavior of chasing the hottest stock/industry group of stocks to get these good returns thereby driving up and eventually driving down equity prices at extreme levels. Buying small caps or keeping positions during downturns in the markets is a risky/problematic strategy. Markets that drop 15% can see many of these small caps drop 20 to 35%. Building a portfolio of small caps during these downturns is a recipe for disaster. The best approach is to build a watch list of promising small caps during these times. Then use this list for buying when the markets start to turn up again.

All stocks belong to industry groups. Industry groups are groupings of like companies that operate in the same arena. Examples are Technology, Oil, Housing, and Health Care. Within each of these industries are further breakouts such as networking, internet content, and computer software within technology. Why do stocks within an industry group move together? Usually it is because of the macro or value aspects of those stocks. From a macro perspective, it is specific trends or events occurring around the world that are increasing the needs for the products and services for companies within these groups. Visible examples were technology when the internet became mainstream in the 1990s, housing in the early 2000s and solar energy companies in early 2008 from a positive perspective. On the downside, examples include oil earlier this year, housing during 2008/2009 and technology in early 2000. From a value perspective, we have seen stocks move together when the stocks for these companies have been beaten down for an extended period of time. Their fundamentals during this time are sound or have recovered to an acceptable level, thereby attracting buyers who view them as undervalued stocks.

The word "opportunity" comes from a Latin nautical term "opportunus" which means "(coming) toward port". A long time ago, traders would transport their goods to market via sailing vessels and ideally they made a profit when the vessel pulled into port. When they were off the coast of a port after a long journey, there was much excitement and anticipation. Nevertheless, there was still much work to be done before they could cash in. In those days, many of the best ports were protected by a reef. This meant that the captain and crew would have to position their sailing vessel such that when the tide was high enough and the wind was strong enough, at the opportune time, they could sail over the reef and into port where hopefully they profited for the risk that they took. If they missed the opportunity, they would evaluate the conditions, correct any errors made and wait for the next one to develop. The wind was one of the elements that the traders relied upon but couldn't control.

When considering small cap stocks, waiting for the opportunity when the wind (markets/industries) is in your favor, clearly increases your odds for profitable trades.

About the Author

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