Small Cap Stocks: Don't Sweat the Small Stuff

By Elaine F. Phipps, MBA, CFA, Portfolio Manager

Given today's market volatility, investors are craving the equivalent of a market security blanket. Even the old reliable treasury bonds no longer promise safety and the reward of a sound night's sleep. The last thing investors want to entertain is the idea of adding small-cap stocks to their portfolio. The popular perception of small-caps is that they are tiny, unseasoned, earnings negative and cash-flow challenged companies trying to get a foothold in their respective markets. The risk level seems too great to take on during these volatile times. However, as with all investment sectors, small-cap stocks can contribute to enhanced diversification in your portfolio.

Small Caps: How to Define? Small-cap stocks are traditionally defined as those with a market capitalization of less than $1 billion, although the modern day definition encompasses a range of $300 million to $2 billion. Market capitalization is defined as the price of a stock multiplied by the number of shares outstanding. This represents the market's estimate of the value of the company, although to be more accurate the market value of the company's public debt should also be included. A market proxy for these stocks is the Russell 2000 Index, an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index. The latter index is made up of 3,000 of the biggest U.S. stocks. The weighted average market capitalization for companies in the Russell 2000 is about $1.8 billion with a median market cap of $800 million. The index is frequently used as a benchmark for small-cap mutual funds.

Small Cap Myths: While the technical size definition of a small-cap company evolves over time, investors often associate certain characteristics with the term. Common perception is that a small-cap company lacks a wide range of financial resources, which may or may not be true. A $2 billion market cap company with a solid credit profile can expect to enjoy numerous banking relationships, access to fixed income capital markets and cash on the balance sheet. The companies are also thought to have a narrow market focus and sales base. It is true that many small-cap companies derive the majority of their revenue from domestic markets, but this is not necessarily a negative. Small-caps are often thought to be more sensitive to tightening credit, as banks demand tougher terms at the first sign of distress. This can be problematic in a rising rate environment, but not for well-positioned and financed firms. Investors must do their research before throwing the baby out with the bathwater and lumping all small stocks in this universe together.

Small Cap Benefits:

- Small-caps generally tend to be more correlated to the domestic economy. These companies often don't have the ability to devote production and marketing dollars to both domestic and overseas markets. The "small" nature tends to keep them focused at home

until the product catches on and enjoys increased sales, thus freeing up resources to launch overseas production. They therefore derive most of their revenue from the U.S. and aren't as exposed to international challenges, including a strong dollar. Approximately 80% of the Russell 2000 revenues come from the U.S., vs about 60% for the S&P 500.

- Small-cap companies often have higher growth rates than their larger, more international competitors. Watching investor concern over Apple mount, we all realize it is hard to continue to grow a market behemoth. Investors tend to expect stellar growth from smaller companies in order to justify the risk they are taking in owning exposure. However, for that reason, multiples of small-cap companies are often very rich versus the broader market.

- Market Inefficiency – Wall Street analysts spend the majority of their time researching large-cap companies. Major large names can have several dozen analysts providing coverage. Many small-caps have no analyst coverage, meaning a diligent investor who wants to take the time to do the analysis can find values. Similarly, many mutual funds have restrictions that limit them from buying large positions in any one issuer's outstanding shares, unless they file with the SEC. Thus, many mutual funds do not have meaningful positions in small-cap companies, which provide individual investors with a unique opportunity.

- More supply to choose from- The small-cap world is a bigger universe. At the end of the second quarter, there were close to 4,000 U.S. publicly traded U.S. companies that fit the definition of small-cap versus 1,400 which would be defined as mid and large-cap.

Recent Performance: After a terrible 2014, small-cap stocks had a strong first half of the year in 2015, outperforming larger market counterparts. Bio-tech stocks were a large contributor to this outperformance, as valuations soared. Through June 30 on a price return basis, the Russell 2000 was up 4.1% vs. 1.2% for the S&P 500. Factors driving the positive returns were the economic slowdown in China, collapsing overseas markets, and the strong U.S. dollar. U.S. economic growth is one of the bright spots in the developed world today, further benefitting companies with small, domestic based exposure. As international economies, especially China, struggled, the resulting strengthening U.S. dollar has hurt U.S. companies trying to do business abroad. It makes the price of their goods more expensive for overseas consumers to purchase, cutting into profits and subsequently making it harder to export and sell goods. Smaller companies, which have more of their business based in the U.S., do not have this issue.

However, as evidenced by the Russell's underperformance since July, investor sentiment may be changing as overall markets become more volatile. As a flight to safety and quality, investors are now favoring larger, time-tested companies that have withstood historic market swings and survived. Small-caps are feeling the brunt of investor worries. With more risk

usually comes more return but in a spooked market, that risk is not worth taking for many investors. The tide can turn quickly.

Conclusion: Small-cap stocks offer a unique investment profile, which tends to differ from what is seen in the broader market. They can shelter a portfolio from the risks of too much international exposure, a rising dollar and often offer superior growth rates. However, they also have greater volatility, are more thinly traded and can be easily spooked by Fed actions regarding interest rate movements. Small-caps can play a valuable role in a diversified portfolio and should not be ignored by investors. Stick with high quality companies, or look into a fund that offers a range of stocks such as the Royce Micro-Cap Fund (RMT), the Fidelity Small-Cap Enhanced Index Fund (FCPEX) or the Fidelity Small-Cap Stock Fund (FSLCX).