

Investing In Small Cap Stocks Explained (Definition, Indexes, Strategy, Risks & FTSE Example)

Small Cap Stocks Investing - Introduction

I have recently analysed the complete FTSE Small Cap Stock Index. The FTSE SmallCap Index is an index of small market capitalisation companies consisting of the 351st to the 619th largest-listed companies on the London Stock Exchange main market.

I have gone one by one and analysed the whole list. I simply follow Buffett's advice where if you want to find investments, simply start with the As. For those interested in my research on the FTSE Small Cap Index, you can find the [stock by stock list here](#), the [summary on the 16 small cap stocks](#) I found most interesting (I didn't bother with structure of the reports – mostly notes) and the [research report on the one small cap stock](#) that I picked as potentially interesting to follow. Apart from the above, usually boring, research, during the research process I have also noted some very interesting findings related to investing into small cap stocks that I think will be very valuable to all of you who consider investing into such stocks. I've been investing in small caps for the past two decades so I think this article will add value to your investing journey.

I'll start by defining small cap stocks, discussing their behaviour, risk and reward when it comes to investing, I'll explain the main fallacy when it comes to small cap indexes and finish with probably the only strategy that works when it comes to small caps, one that I always apply and later found also that Peter Lynch was an avid user.

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Small Cap Stocks Definition – Between \$300 million and \$2 billion

Small Cap Stocks are defined as businesses that have a market capitalisation below \$1 billion. However, in some small cap stocks indexes you will find stocks with market capitalizations of even \$4 billion. Given the current exuberant market situation, the range within something is defined as a small cap stock is also expanding. The general consensus nowadays is that a small cap stock has a market capitalization between \$300 million and \$2 billion. Due to stock price fluctuation, that can vary on the upside but also on the downside.

Apart from market capitalization, small cap stocks are usually businesses that just recently went public, operate in a really small niche or geographic location or simply have remained

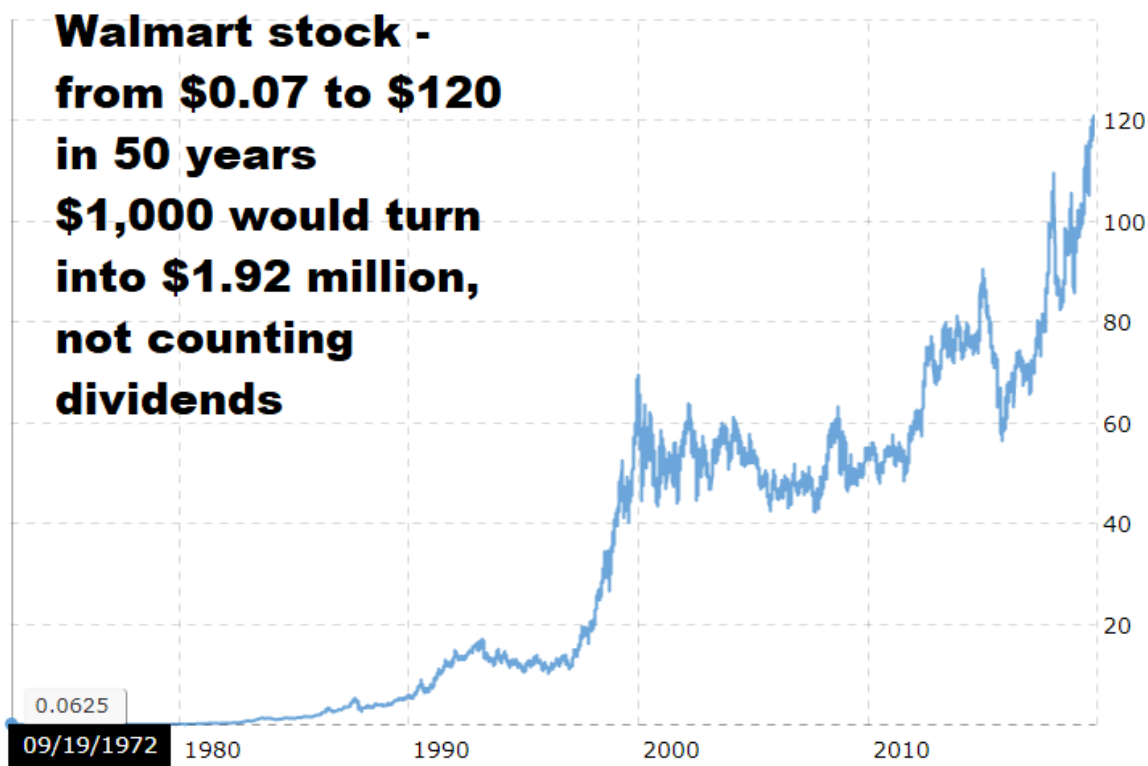
small for a long time. This leads to significant differences when it comes to investing in such businesses.

Small Cap Stocks Investing Rewards and Risks

The upside is clear, if you buy a business that has the capacity to grow while it is small and scale, your whole portfolio can benefit from such an investment, for the rest of your life.

Those who invested in Walmart (WMT) at its IPO did really well.

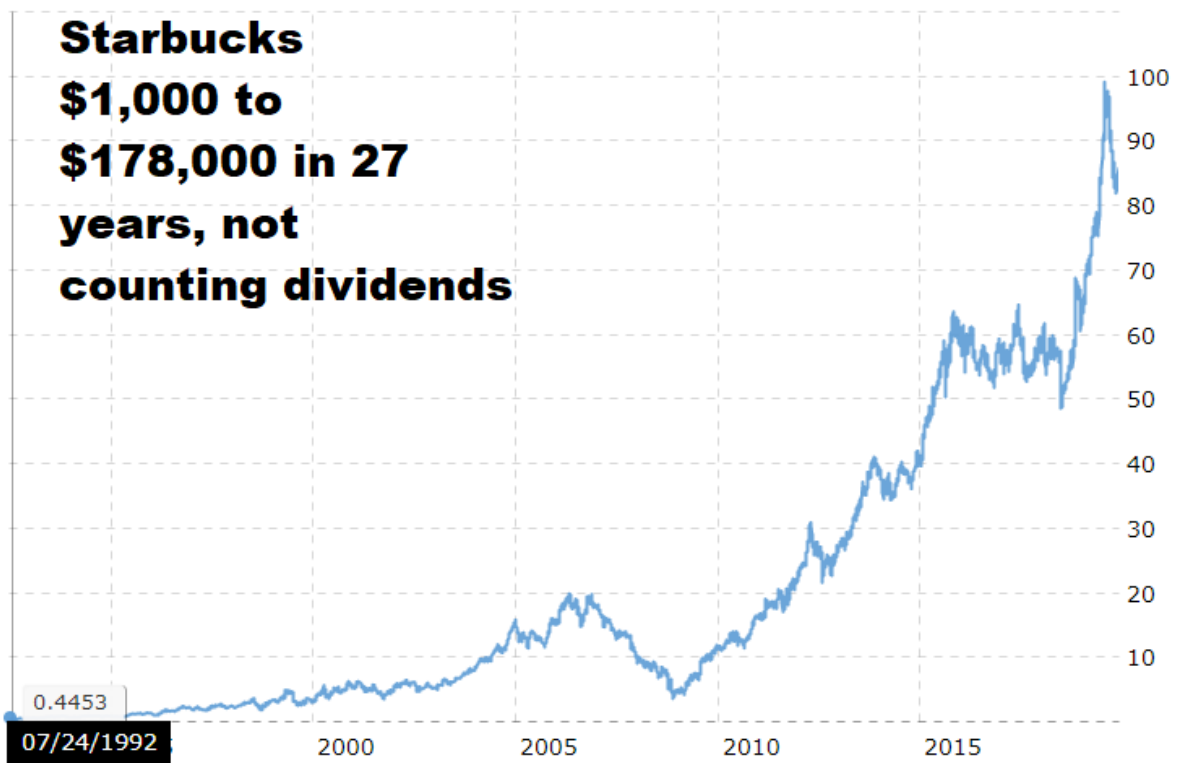
Figure 1 Walmart (WMT) was a small cap stock too



Source: [Macrotrends – Walmart Stock](#)

Similarly, if you picked Starbucks (SBUX) at its IPO 25 year ago, you would have turned \$1,000 in \$178,000, not even counting dividends. Dividends would increase many times the return because if you paid \$0.47 (adjusted for splits) for a stock of Starbucks in 1992, the dividend on that now would be \$1.63. This reinvested would skyrocket your returns even higher.

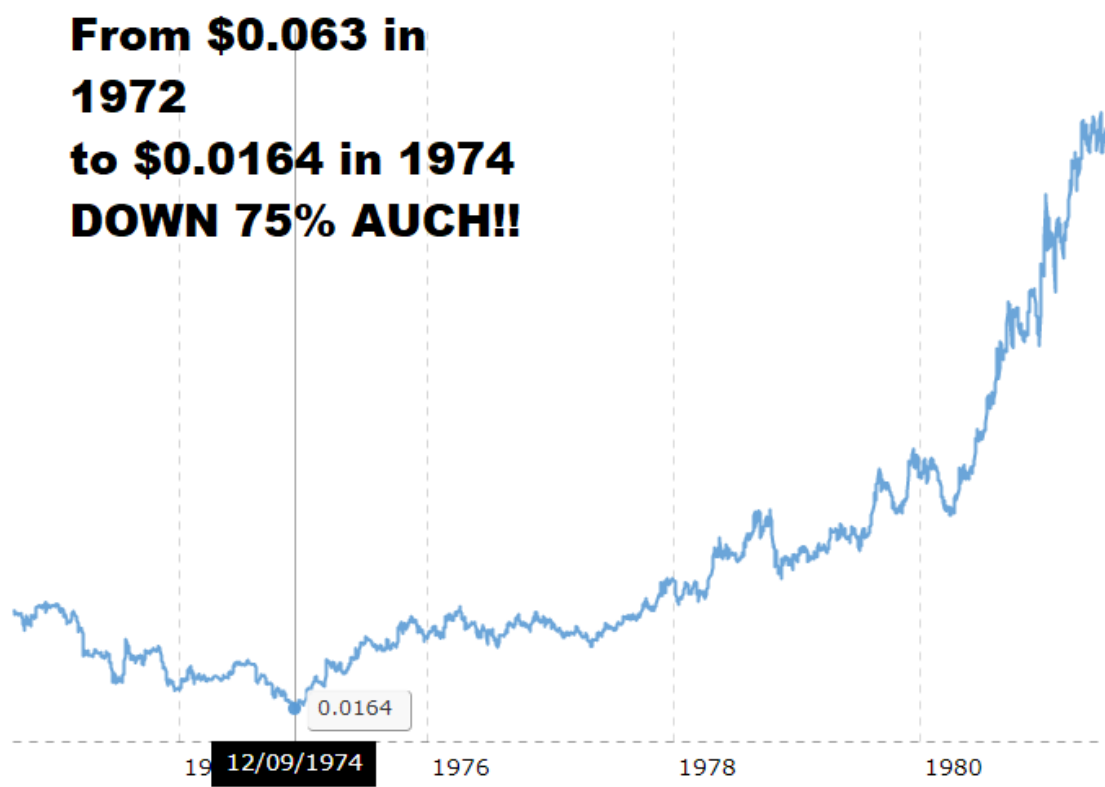
Figure 2 Starbucks is another small cap success story



Source: [Macrotrends – Starbucks stock](#)

However, both Starbucks and Walmart had untested business models when they started. Many fail to grasp that Walmart's small cap stock fell 75% from 1972 to 1974 which perfectly explains the risks of investing in small caps. Starbucks also fell 75% in the 2009 crisis.

Figure 3 WMT fell 75% from 1972 to 1974



Source: [Macrotrends – Walmart Stock](#)

Similarly, many small cap stocks that were promising in the past, fall down but don't rebound like Walmart. A few examples are Tailored Brands (TLRD), Lumber Liquidators Holdings (LL) and Fiesta Restaurant Group (FF) and AA Plc, to give an example of a recent IPO gone bad.

Figure 4 Four bad small cap examples down more than 90% from peak






My FTSE Small Cap Index research shows how in a good economic environment, 4 out of 5 small cap investment turn out terribly, while only one does ok or really ok. But, then again, out of that one doing good, only perhaps 50% do really good over the long term as recessions often stop their growth and show their weaknesses. All of the above makes investing into small caps really tricky. However, I think there is a strategy that works, even with small caps. However, before discussing the strategy, let me first discuss the biggest fallacy of small cap index funds and the reason one should never invest in them.

Small Cap Stocks Index Funds and ETFs

Small cap stocks index funds or ETFs are very attractive because you don't have to bother to pick the right stock to invest in, you simply invest in every small cap out there and, if small caps deliver higher returns thanks to their higher risk, according to the efficient market theory, you should be set.

I would strongly disagree with the above because there are a few things that don't work that way. When looking at the FTSE small cap index for example, a significant percentage of the index constituents were closed end funds, trusts, holdings and other various investment vehicles. These vehicles are just middle man so that on top of your ETF fee, that is usually high when it comes to small caps, you indirectly pay hidden fees within such investment vehicles, included in an index just thanks to their market capitalization.

Figure 5 It is hard to find a real business by looking at the FTSE Small Cap Index constituents

EPIC	Name
	Page: 1 2 3
AA.	AA plc
AAS	Aberdeen Asia Focus Investment Trust
AAIF	Aberdeen Asian Income Fund
ADIG	Aberdeen Diversified Income And Growth Trust
ABD	Aberdeen New Dawn Investment Trust plc
ANII	Aberdeen New India Investment Trust
ASEI	Aberdeen Standard Equity Income Trust Plc
ASLI	Aberdeen Standard European Logistics Income plc
ASIT	Aberforth Split Level Income Trust plc
AEWU	AEW UK REIT plc
AEFS	Alcentra European Floating Rate Income Fund
ALFA	Alfa Financial Software Holdings Ltd
ATT	Allianz Technology Trust
ALM	Allied Minds plc 
AMGO	Amigo Holdings

Source: Hl.co.uk

Perhaps the biggest fallacy is that when you invest in small caps, and those do good, their market capitalization increases. What does an index fund do when the market capitalization

surpasses a certain level? It sells the stock and buys something else. The key when investing in risky small caps is to actually hold the good forever. Amazon's current market capitalization is \$879 billion. If an index fund would have sold the stock when the market capitalization reached \$4 billion, it would have missed on a 219x increase in the stock price. This means that the index fund would sell Amazon at a price of \$8 per share.



So, by investing in small cap stocks index funds or ETFs, you would have probably owned Amazon from its IPO in 1997 at \$1.7 (adjusted for splits) and sold it in 1998 when the stock passed \$8 and wasn't a small cap anymore.

If you wish to invest in small caps, it is smart to be diversified, but when you find the one that is really good, don't ever sell it, you'll regret selling. Further, by buying your own small caps and having a diversified basket of them, you avoid the expensive index fund or ETF fees. Peter Lynch was the one that probably had the best strategy when it comes to investing in small cap stocks.

Small Cap Stocks Best Investing Strategy

Peter Lynch's book, [One Up On Wall Street](#) (chapter 6 – Stalking the Tenbagger), discusses how the best way to find 10-bagger stocks (stocks that will go up 10x) is to look around you before Wall Street notices what is going on. By looking at what is going on close to home, you can see the crowds in front of that new coffee shop or restaurant, you can see how the business model works and then simply ask yourself: is there a stock? If there is, then you perform a fundamental analysis, ask the people that work there etc.

You will probably come across the average prospect a few times per year. One of my best investments was a small camping site in 2010. It was a small business, 95% owned by employees, it paid a large dividend, was constantly growing alongside a high ROIC, business was good despite the Great Recession.

Figure 7 A small camping site I invested in 2010



Source: [Turisthotel](#)

The company was paying an 8% dividend in 2010 and growing at 15% per year. It had no debt and valuable land. As a local, I could easily see the long-term value that others, like the Norwegian fund that was selling, could not understand. The investment became a 5 bagger for me over 4 years.

Small cap investments from 2010 to 2014



Source: Mojedionice

So, look around at what is going on, understand the fundamentals of the business, talk to employees and sometimes, you will find your great small cap investment before Wall Street does. An important note here – don't fall prey to the strong marketing stories small caps must have in order to get liquidity and the necessary capital for growth, first see by yourself whether the business is doing really great. If a business is doing really great, they don't need to market it at all. Further, another thing when it comes to small-cap stocks, but not only them, is timing your investment.

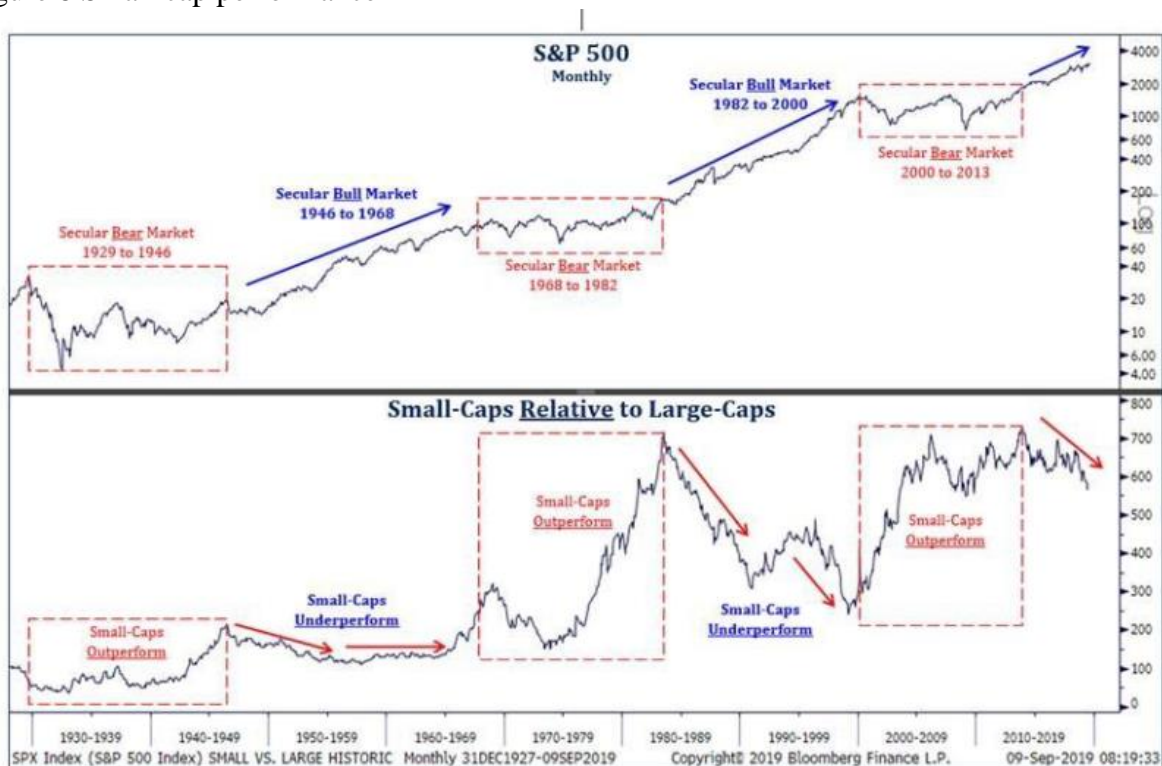
Timing your Small Cap Stocks Investment

When it comes to investing, a certain asset class can be in favour or out of favour. The same holds for small cap stocks. Given their small scale, financial instability, untested businesses, small cap stocks can often be out of favour. Now, this doesn't mean that you invest when

those are relatively undervalued and sell when those are overvalued. It simply means that you look at them when the fundamentals look cheap to you and avoid when the fundamentals are expensive.

Some look at how small caps perform in certain economic environments. I find it a flawed strategy. As investors, you have to look at the business, not at the market. When the business, the dividend yield and fundamentals fit your investment style, then you invest, it doesn't matter how is something compared to something else.

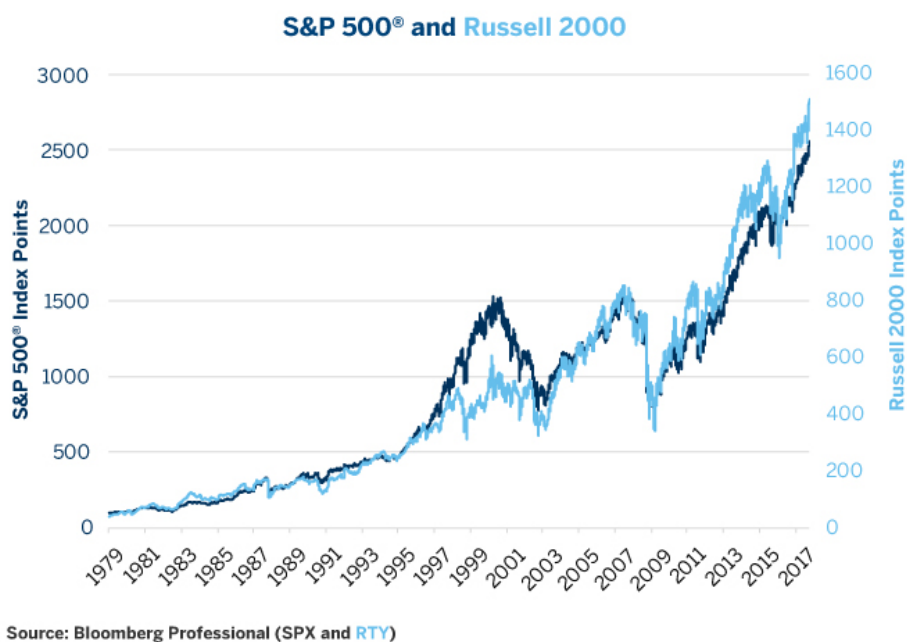
Figure 8 Small cap performance



Source: [Nasdaq Small Caps](#)

If we take a look at the long-term chart comparing the S&P 500 and the Russel 2000 Small Cap index, we can see that there are periods of under and over-performance. However, this doesn't tell you much whether it is a good time to buy or not. Fundamentals is what matters.

Figure 9 Small cap Russel 2000 compared to the S&P 500



Source: [CME Group](#)

Small Cap Stocks FTSE Example

For example, I looked at the fundamentals and business outlook for all the constituents of the [FTSE small cap index](#). I've narrowed the list down to [16 interesting stocks](#) and then picked only [one for a deeper analysis](#).

Unfortunately, after more than a week of hard work, I didn't find anything worth investing in or following from a value investing perspective. The good businesses are really pricy, while the bad, well what do you need them for?

The thing is that I have done the research and I'll keep looking. At some point in time, somewhere, at some level, there will be something interesting. In 2018 Brazil was cheap, Russia too, some miners were cheap too in 2018. So, investing in general, and especially investing in small caps, is about waiting for the right pitch at the right time.

Investing in small caps just because it looks like a healthy thing to do for your portfolio is simply stupid. I don't know in what other way to say it.

Small Cap Stocks Investing Conclusion

After all, whether a stock is a small cap, large cap, medium cap, Russian, Brazilian, American or German, mining copper, selling tyres, software or having an online platform, it doesn't really matter from an investing perspective.

What matters is the quality of the business, its moat, margin of safety, cash flow generation, scalability, the management, the environment and all the other things that make great investments.