THIS WAY FORWARD

YOUR WEALTH

Don't Rush Into Small Cap Investing

>>> Rational expectations and diligent research are required.

By Scott Mahoney

The largest winners of the fabled California gold rush, sparked in 1848 by a construction foreman's discovery of the precious metal at Sutter's Mill, were Californians already there. They were in the right place at the right time, becoming the earliest miners – and they did well.

By August of that year, a major East Coast newspaper confirmed there was gold in California … and the rush was on.

Getting in early, before the masses, is a key strategy behind small cap investing. Not for the faint hearted, small cap investing presents significant risk, yet with the allure of possibly noteworthy profit. Small cap stocks can be particularly volatile, but, for those willing to do necessary research, they also have the potential for gratifying returns.

A company not being followed by financial analysts, for example, has a two-fold benefit. First, its pricing will be less efficient and may not reflect future potential, sometimes allowing purchase at an undervalued price. In and of itself, buying low could reap profits. Second, if Wall Street does take an interest in your small cap company, never a guarantee of course, trading volume may increase and with it – if all goes as hoped – an increase in the stock price. Small cap investment strategy is the epitome of buy low, sell high.

A small cap investment strategy should not mimic the frenetic pace of a gold rush. The long-term, disciplined approach to an overall portfolio strategy also can be aptly applied to small cap investments. Holding on to companies that appear resilient in a dynamic environment, in healthcare and technology sectors, for example, where companies can be innovative and adapt readily to demand, could prove advantageous over the years.

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The biggest disadvantages to investing in small caps are the difficulty in choosing the right companies and their vulnerability in the marketplace. When companies go largely unnoticed by analysts, it leaves the burden of due diligence on the investor. Analyzing balance sheets, tracking the markets and studying political and economic news can be overwhelming for many individual investors. Additionally, what draws investors to small caps is also what makes them risky. While a positive event could throw your small cap company into the spotlight, attracting the "masses" and bringing you profits, a negative event could put the company under water and quickly sink your investment.

When investing in small caps, it's important to manage your expectations, deciding in advance what level of risk you are willing to accept, weighting your small cap allocation appropriately against your overall portfolio.

Like the early gold miners in California in 1848, rational expectations and diligent research might just result in finding a nugget of gold for your portfolio. NJB

About the Author

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