

# Investor Insight

Shewchuk Watson Strategic Investments

## A Look at Small Cap Stocks

The small capitalization (small cap) sector often gets attention for its potential growth prospects. Although the definition of a small cap varies by country, in Canada a company with a market capitalization (share price multiplied by number of shares outstanding) between \$300 million and \$2 billion is generally considered a small cap.

During difficult economic times, the small cap sector may experience significant volatility which may make many investors shy away from investing in the sector. However, as economic situations improve and investors feel more comfortable investing in equity markets, there is often renewed interest in the small cap sector.

Here in Canada, after strong gains between 2009 and 2011, small cap performance has since been slow and has significantly underperformed relative to the global small cap market. This is partially due to the concentration of small caps in the resource sector, a sector which has struggled over recent years, with low oil and lower commodities prices.\*

In the U.S., the Russell 2000 Index is the benchmark small capitalization index for U.S. shares trading on American exchanges. The Russell 2000 Index represents the 2,000 largest small caps, an index similar to its large cap counterpart, the Standard and Poor's 500 Index (S&P 500). However, the Russell 2000 Index has an average market capitalization of only about \$1.8 billion, contrasting the S&P 500 average capitalization of around \$36.8 billion.\*\*

In Canada, small cap trading has been tracked on the Toronto Stock Exchange (TSX) since 1999. The S&P/TSX SmallCap Index consists of 220 companies with an average market capitalization of about \$530 million. Over 50 percent of these companies are resource-based, from the energy, materials and industrial sectors.\*\*\*

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### **Why Small Caps?**

Growth potential is one of the main reasons that the small cap sector is attractive to investors. Many small caps may have higher growth prospects, compared to large caps that often have more established operations and may have potentially less opportunity for growth. Given that small caps are often growth-oriented, they have historically been less likely to pay dividends. However, this has been changing in recent years. In fact, in the U.S. about 30 percent of small cap stocks pay dividends, and many Canadian small cap companies are also paying dividends to shareholders.\*\*\*\* As investors search for income opportunities, some have turned to small cap dividend stocks to supplement their portfolios.

### **Challenges with Small Caps**

As with any investment, investors should be aware of the challenges associated with investing in the small cap sector. Small caps are viewed as more risky than large caps largely because of their higher volatility. Small caps are more thinly traded, which can amplify price swings in either direction.

As well, since many small caps are in growth mode and may not have as much stability as their large cap counterparts, their financial performance can be more variable. The small cap sector also has limited coverage by research analysts.

Conducting in-depth due diligence is very important when considering an investment in a small cap company. Investing in a fund may be one way to help mitigate some of the risks associated with investing in a single small cap stock. It may also be one of the more practical ways to invest in this limited-coverage sector.

### **We Can Help**

Investing in smaller companies in high growth industries or new technologies can help to enhance portfolio diversification. Having some exposure to small caps may be one way to complement an already diversified portfolio. Let us know if you are interested in a further discussion on small cap opportunities for your particular situation.

\*Based on S&P/TSX SmallCap Index, 1-year Annualized Returns as of Sept. 18, 2015 of -23.56%. \*\*Russell 200 index as of August 31, 2015. \*\*\*S&P/TSX SmallCap Index and S&P 500 Index market capitalization figures as of August 31, 2015. \*\*\*\*As of end of 2014, by Royce Funds, “The Importance of Dividends in Small-Cap Investing”, April 2015.