Why private investors should focus mainly on smaller companies

Little fish are sweet

Guy Thomas

A striking feature of some of the most successful private investors is their focus on smaller companies. Most of the 'Isa millionaires' I have interviewed during the course of my research ignore the top 90% of the stock market by market capitalisation. I agree with this approach and in my own investing, I seldom hold companies in the FTSE 350 index.

Academic research has found some evidence of a 'size effect': smaller companies tend on average to give slightly higher risk-adjusted returns than larger firms. However, in my view the main point is not that smaller companies *in general* are better investments than larger companies, but rather that a few *specific* smaller companies are exceptional investments.

Key advantages

There are a number of reasons for this, which can be summarised by the following five points:

- **Elephants don't gallop**
- **Takeover targets**
- **The proprietorial mentality**
- **Informational edge**
- **Volatility is your friend**

Larger companies tend to operate mainly in the growth markets of the past (this is how they became large). Their operations may include some current growth markets, but these are unlikely to be very significant to their overall finances. Changes in technology, regulation, or consumer demand are unlikely to make much difference to them. But for a smaller company the same changes could be transformational. Elephants don't gallop, but fleas can leap.

Because takeovers usually involve a larger bidder acquiring a smaller target, smaller companies are more likely to be takeover targets. In a takeover the bidder generally pays a 'control premium' above the market price.

The proprietorial mentality point relates to the fact that directors of smaller companies often have a large part of their wealth tied up in the business, and so have a personal interest in long-term shareholder value and dividends, not just salaries. This aligns the directors' interests with external shareholders.

Guy Thomas is the author of *Free Capital: How 12 private investors made millions in the stock market*

Any successful investor can relate to the fourth point, the idea of an informational edge, which is much easier to achieve when investing in a small company. To generate superior investment returns, a successful investor not only needs to foresee the future but foresee something which most investors have yet to realise. Every time you trade, you believe (or should believe) that you have superior information; but the counterparties on the other side of the trade usually believe that they have superior information. To generate superior investment returns, you need on average to be better informed than your counterparties.

Larger companies are usually followed by dozens of analysts, who have privileged access to management and many proprietary sources of information. Even if you spend many hours researching a larger company, it seems implausible that you will be better informed than these analysts and their clients.

On the other hand, smaller companies are usually less well researched, often with no analyst coverage. Despite being less well covered, they are also easier to research. The limited scale of their operations makes them comprehensible; their accounts run to 50 pages, not 200; and their directors are generally accessible to the private investor. With a few hours work on a smaller company, you can become better informed than most investors, and in particular better informed than any likely counterparties to your trades. This informational edge is the essential source of superior investment returns, and it is easier to obtain for a smaller company than for a larger one.

Conventional wisdom says smaller companies are more risky than larger ones. They are certainly more risky in the sense their share prices are more volatile. But to the investor with an informational edge, this is not a disadvantage: volatility allows you to buy low and sell high. Smaller companies may also be more risky in the sense fraud or corporate failure are on average more likely than in larger companies. These risks can be reduced by paying careful attention to the background of the directors and avoiding companies with substantial debt.

Cash at the ready

In some periods the investor focused on finding exceptional small caps may be unable to find enough ideas to produce a reasonably diversified portfolio. At such times it is important to be disciplined and wait for a good opportunity. You can hold cash in the meantime, but some investors I have interviewed during my research mention the idea of a 'placeholder' investment in a large company with very liquid shares. This is an investment which is expected to produce an adequate rather than superior return, but can be quickly exchanged in to cash to invest when the next small cap opportunity comes along.