First Investors Funds

Market Commentary

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Brian Watts is Director of Research and Strategy for Foresters Investment Management Company, Inc. (FIMCO). Brian is responsible for several areas, including oversight of subadvisers, new manager search and selection, investment strategy development, asset allocation study and tools, development and management of new advisory portfolios and product development. Brian has more than 20 years of experience in the financial services industry, having worked at Fortune 500 financial services firms developing and overseeing investment platforms.

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Benefits of Small-Cap Investing

Small-cap stocks can add diversification to a portfolio and augment returns. In fact, over time, small-cap stocks have outperformed large caps. One reason for this outperformance is that large-cap companies—the ones that make up the Dow Jones Index and FTSE 100—are large, mature companies with their best days, in terms of growth at least, behind them. Indeed, many investors seek such stocks not as growth plays, but purely as dividend payers.

At the small-cap end of the spectrum, things are much different. Yes, smaller companies can be riskier, but they may also offer a greater reward potential because they often tend to be undervalued and underrecognized. We caught up with Brian Watts, FIMCO's Director of Research and Strategy, to get his thoughts about small-cap investing and how it may help diversify an investment portfolio.

What Are Small-Cap Equities?

Small Capitalization (Cap) equities (stocks) are defined by Lipper as companies with market capitalizations below $5.4 billion. Other sources may have slightly different capitalization ranges and the parameters for determining whether an issuer is a small-cap company may vary. Small-cap stocks are usually beyond the startup stage, but still early in their growth cycle. As a result, these companies—when compared to large caps—often have potentially higher growth rates. However, the higher growth potential also comes with additional volatility. Historically, the risk in small-cap equities has been higher than large-cap equities.

Why Can Small Caps Make Sense?

There are significantly more small-cap companies than large caps. Small caps provide a larger investing universe. Wall Street's analysts' coverage is concentrated primarily on large-cap equities. This results in small-cap stocks having less or, at times, no Wall Street analyst coverage. This lack of coverage can create opportunities for talented, small-cap portfolio managers who can find and invest in these stocks before they are discovered by the broader market.

What Characteristics Do You Like About Small-Cap Companies?

Small-cap companies are usually more nimble than large-cap ones. Intuitively this makes a great deal of sense. For example, if a small-cap company increases its work force by 10 percent, it may only have to hire 10 people, whereas a large-cap company that wants to increase its work force by 10 percent would have to hire 1,000 people. This nimbleness allows small caps to react more quickly to both market opportunity and external economic factors. The smaller size also means that each incremental dollar of revenue has a greater impact on profitability.

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Why Then Are Investors Cautious About Small Caps?

Many investors shy away from small-cap companies because they do not recognize the names or because of the higher potential risk. Historically, there has been more variance in return in the small-cap sector, but over longer periods of time, investors have been rewarded for this increased volatility. It is important to note that small caps do not always outperform large caps.

What Are the Causes of Small-Cap Volatility?

Earnings are a key factor. Small caps have less predictable earnings which can cause these swings in volatility. In addition, because small caps are not followed by many analysts, they may not be as liquid as large caps. This reduced liquidity can negatively impact the price if you need to sell a stock quickly.

What is an Appropriate Asset Allocation for Small Caps in a Portfolio?

Due to risk factors, small caps are generally invested at a smaller asset allocation. Average asset allocation in portfolios is generally modest, but the actual allocation is client specific. For example, the allocation may be higher if the client has a longer investment time horizon and can accept the higher risk.

In summary, over time investors have been rewarded by investing in small-cap funds, however they need to be able to withstand the additional volatility, and thus risk, of these funds.

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