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SMALL CAP'S – GOLDMINE OR LANDMINE?

With the stock market indices hitting new highs every day, more and more small investors are getting ready to enter the market. What stocks will they be buying? L&T? ITC? Sun Pharma? Reliance? Glaxo? Tata Motors? M&M? TCS? Not a chance! These stocks are too expensive. Too old-fashioned. They belong to the portfolios of grey-haired grandfathers, and are unlikely to give multibagger returns in 3 to 6 months. The name of the game is quick money.

And so, another generation of young investors are going to suffer from the 'fatal attraction' to small cap stocks in the hope of hitting a 'six' – just like it happens in every bull cycle. How do I know? Been there and done that. And lived to tell the tale, albeit with a big hole in my pocket.

If you buy a small-cap stock and it immediately spikes up and doubles your investment within a matter of days, you won't know what you did right! Picking that stock at that time was pure luck – unless you happen to be knowledgeable about fundamental and technical analysis.

A bull market is like a high tide that lifts all boats. Stocks with ridiculously poor fundamentals often rise the highest in a short span of time due to their small trading volumes – sucking in investors and separating them from their hard-earned cash. Such stocks plummet just as fast, giving no chance to investors to exit.

Typically, small-cap companies belong to owners who wish to retain majority control and service a small niche product or service segment. The good news is that small niche segments are avoided by large players because of lower profit potential or lack of technology or expertise in the field.

That allows a niche segment leader to dominate the segment and make good profits without any threat from the big guys. That is why some small-cap companies often deservedly get high valuations and provide good returns to shareholders. But such 'good' companies are few.

Many small-cap companies are out there to fleece the public. They make money from the IPO. Then they make money from the plant and equipment they install. Then they take bank loans for expansion and siphon off the funds to a chain of unrelated privately-held subsidiaries. Then they indulge in circular trading to jack up their stock price to trap unsuspecting buyers.

Then change their name, and repeat the whole fraudulent process. If they get caught, they bribe their way out and disappear to South America or Dubai. Their low equity capital facilitates price manipulation – which is not possible in a large-cap stock.

There is a market myth: small-cap stocks will become large-cap some day. Aren't the large-cap stocks of today the small-caps of yesterday? Yes. That does not mean every small-cap you buy will eventually make the transition. Most will not. Some will remain small-cap for 50 years. Others will disappear from the face of the earth (with your money!).

Small investors have three choices about investing in small-cap stocks:

1) Avoid small-caps completely and stick to large-caps.

2) Spend time and effort to learn how to pick stocks through detailed analysis (it is not rocket science – neither is it as simple as opening a demat account and listening to experts on business channels about what to buy)

3) Invest through mutual funds (less adrenaline rush but good returns).

I pray that the small investors heed this advice, and not let it be as water on a duck's back – it didn't last long.

"START WITH A PRAYER, END WITH HOPE"

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