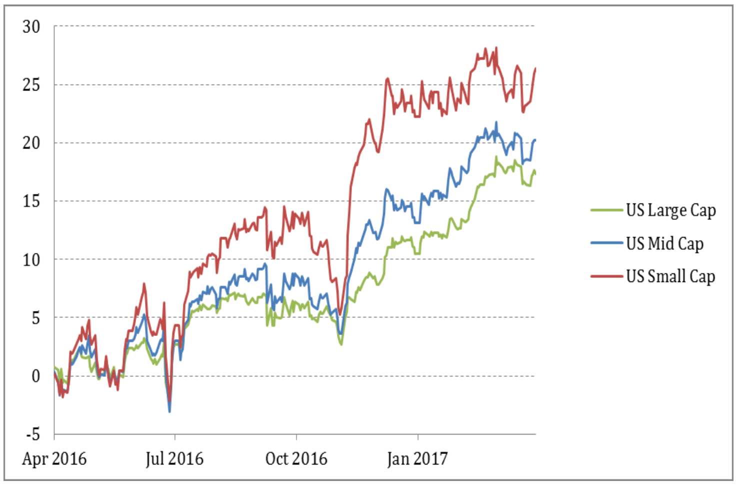
Why invest in large caps?

In hindsight of Brexit referendum and US presidential elections, investors in US have invested most of their funds in large companies in order to safeguard their investments. Investors generally look for a safer investment strategy that could beat the volatility outbreaks at the time of uncertainties. Money managers also advise investors to stick to large cap stocks and reduce exposure to mid and small cap stocks in the days of unstable macroeconomic and political environment. The chart below shows the impact of US elections and Brexit referendum on different indexes around the end of 2016.[1]

US Large vs Mid vs Small Cap Returns (%)

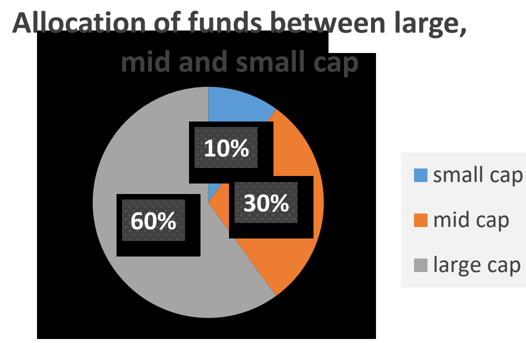


What are large cap mid-cap and small-cap stocks?

Large caps are the companies which typically have market capitalization of $10 billion or above, mid-caps are the companies that have market capitalization between $10 billion and $2 billion and small caps are the companies that have market capitalization of less than $2 billion.

Large caps tend to be the companies that are stable and dominate their industries. Large cap stocks are less volatile than mid cap and small cap stocks and are therefore considered to be safer investments. The risk of failure is greater with mid cap stocks and small cap stocks, than with large cap, as a result they tend to be the more volatile (and therefore riskier) than large cap.

The optimal mix of investment in equities is based on individual investment goals and risk tolerance. Investors aiming for higher returns and willing to take higher risk typically devote more of their portfolio to mid and small cap stocks, whereas more conservative investors allocate a higher percentage of portfolio towards large cap stocks. A typical mix for an average investor is approximately 60% exposure to large cap, 30% to mid and 10% to small cap stocks[2].



S&P 500

The S&P 500 is a stock market index that comprises of common stocks issued by 500 large cap companies that are traded on American exchanges, and covers about 80% of the American equity market by capitalization. The average one-year return for S&P 500 over the last decade has been around 9%. The recent rally in stock prices has improved the performance of S&P 500 index, witnessing a 12.6% increase from November 2016 lows.[3]

Aspect of investing in Large Cap VS Small and Mid-cap

<u>WHY LARGE CAPS?</u> *Less risky* *Stable growth* *Low Cost of financing* *Reasonable multiples* *Comparative advantage* *Liquidity*

Less risk of investments:

Small cap companies may give more returns on average, but they are more volatile at the same time. With high volatility, the realized return by investors may vary significantly from the expected return, hence making it a risky investment. During the period 1997-2012, the Russell 2000 (an index of small companies in US) returned 8.6% on an annualized basis, compared to 4.8% for the S&P 500. Whereas, during the same period, the Russell 2000 had approximately 33% higher volatility than the S&P 500 index.[4]

Stable growth:

Generally reported earnings and return on capital employed metrics are used to assess the profitability of a company, it's even more important to determine the growth sustainability of these metrics. Many large cap stocks have shown a sustainable increase in profits overtime making them favorable for long-term investment.

Dividends are also considered an important component of a stock's total return. Dividend Aristocrats (small group of

[1] Source: http://thefreedomindex.com/category/news/index-commentaries

[2] Source: http://www.investopedia.com/ask/answers/072715/what-percentage-diversified-portfolio-should-large-cap-stocks-comprise.asp#ixzz4hP8sMgkC

[3] Source: https://in.investing.com/indices/us-spx-500-historical-data; www.moneychimp.com/features/market_cagr.htm

[4] Source: http://www.investopedia.com/ask/answers/022715/are-small-cap-companies-more-risky-investments-large-cap-companies.asp#ixzz4hVVIxuwr

companies that are part of the S&P 500) have increased dividends for 25 consecutive years.[5]

The top 20 companies on the S&P 500 have historically accounted for half the total cash on the balance sheets of all 500 companies. Since large caps possess large free cash flows which makes them a good opportunity to get dividends in return.[6]

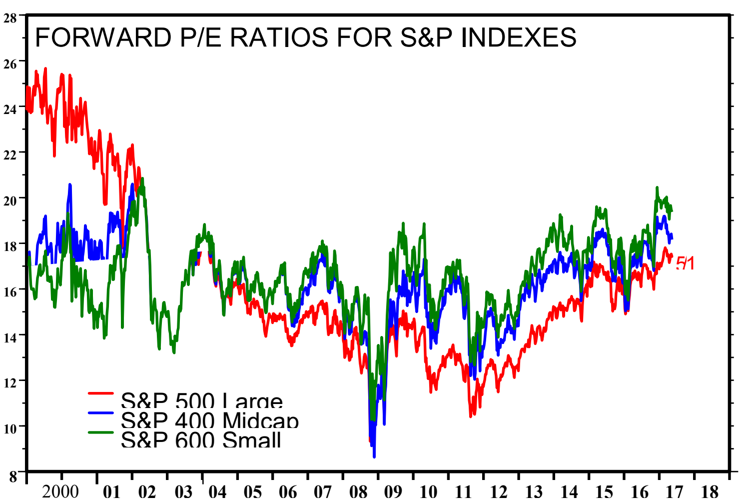
Low Cost of financing:

Large cap companies have an optimum capital structure (debt to equity ratio) and cash flow yields, as a result large caps often have a lower cost of capital. Large caps have an easy access to publically traded debt and equity market, which provides them an advantage over the smaller companies.

In the first decade of the 21st century, the bottom quartile realized an average ROIC of 6.7%, while the top quartile earned an average ROIC of 16.7%. The weighted average cost of capital for a typical S&P 500 firm was 8.2% over the same period.[7]

Reasonable multiples:

Large caps are much reasonably priced as compared to mid and small cap. Average forward PE ratio of large caps is around 17.5, while that of mid and small cap is around 18.4 and 19.5 respectively.[8]



Comparative advantage:

Large cap companies stay economically stable for a longer period of time because of their wide and diversified business models. They have economies of scale in every aspect either be operations, financing or production. They have diversified revenue streams and risk profile, high entry and exit barriers, and brand loyalty. Therefore, large caps are well placed in their respective industry where they can best defend against adverse market forces and can influence the market in its favor.

Liquidity:

The free float market capitalization percentage of small cap stocks is quite small due to large promoter shareholding in these companies. Free float shares are actively traded shares in the market. The problem with a small free float is that, if investors want to sell their shares, they may not find buyers in the market for all of their holdings. The investor has to wait to sell the shares, during this period the share price may fall and this will affect the return on investment, such situations generally prevail in distressed times. Both small and midcap stocks/ funds may be affected by liquidity distress, but the problem can be more severe for small cap stocks.

Conclusion

While investing in small and midcap stocks/ funds, you should check the risk profile of your entire portfolio. Large cap stocks are the most stable, followed by midcap and then small cap stocks. A well-constructed mutual fund portfolio comprising of large cap, midcap and small cap funds will have sufficient liquidity to meet your needs and also enable you to ride out uncertainties, so that you can get good returns when market recovers. Good financial planning practices suggest that, you should invest in a mix of large cap, midcap and small cap funds to meet your long term investment needs. You should consult with your financial advisor or expert, to allocate midcap or small cap funds or both that are suitable for your investment portfolio.

Small cap companies have smaller balance sheets compared to midcap companies, economic shock can cause severe financial distress for small cap companies. That said we have also seen small cap companies with strong business models which are less capital intensive and have nimble footed managements, emerge stronger from recessions by grabbing market share from their competitors and have provided exceptional returns. When investing in small cap and mid cap companies, it is important for investors to understand the business model and management quality of a company, something which good fund managers or consultants are equipped to do.

5 Source: https://en.wikipedia.org/wiki/S%26P_500_Dividend_Aristocrats

6 Source: http://topforeignstocks.com/2016/12/27/the-top-10-sp-500-companies-by-cash-and-cash-equivalents/

7 Source:https://www.jpmorgan.com/cm/BlobServer/Creating_ValuebrThrough_BestInClass_Capital_Allocation.pdf?blobkey=id&blobwhere=1158565843289&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs

8 Source:Yardini Research, Stock Market Briefing, 2017

--ADISH JAIN