Take Stock – 1 Small Cap for Your Summer Radar

Description

Take Stock is the Motley Fool Canada's free investing newsletter. To have future editions delivered directly to you, simply [click here now](#).

Dear Fellow Fools,

One of the most conventional, widely held beliefs in the world of investing is that small stocks inherently come with more risk. But that mantra is incomplete, as it only accounts for half of one of the most important concepts you must keep in mind while investing: The relationship between risk and reward.

Sure, investing in a relatively young company with a market capitalization of $100 million may seem riskier than investing in, say, the **Royal Bank of Canada**. But if that $100 million company has a chance to become a $1 billion company over the next 10 years, you're being very fairly compensated for taking on this perceived "risk".

Ignoring this portion of the market acts as a disservice to your portfolio. Regardless of the stage that you're at in the investing life-cycle, you should aim to build a carefully selected collection of small-cap stocks.

Aswath Damodaran, a well-respected professor at New York University, has compiled a collection of research that supports this thesis. Highlights from Aswath's work are provided below (the entire presentation is available [here](#)):

- Since 1927, an equally weighted collection of the market's smallest stocks produced an average annual return of about 25%; in comparison, over the same period, an equally-weighted collection of the market's biggest stocks produced an average annual return of a little more than 10%.
- Over the 20-year period between 1973 and 1993, investors were more likely to own a large-cap stock that produced a negative return than they were a micro-, small-, or even mid-cap that produced a negative return. (While not completely current, we'd wager that this relationship holds over most 20-year periods.)
- The above two data points were derived from U.S. market data, but small caps have proven to be

> the way to go in Canada as well – and in many other world markets for that matter. Over both short-term and long-term time frames, Canadian small caps have outperformed their large-cap peers by approximately 5% on an annual basis.

If investing is all about putting the odds on your side, small-cap stocks are here to help.

…and so are we

One of the problems that individual investors have with small-cap stocks is that the good ones tend to be hard to find. Typically, these are companies you don't interact with on a day-to-day basis and gain little coverage in the financial press.

That's where we come in. Given our belief in small-cap investing, once we have our advisory service in place later this year, we're likely to dedicate a sizeable amount of time to digging up these ideas that many may consider to be off the beaten track.

For a taste of what one of these ideas might look like, profiled below is **Solium Capital** (TSX:SUM), an idea that came our way through a Take Stock reader, thus illustrating the power of the Foolish community you're a part of.

I had never heard of Solium. Few have. But it's a company with a solid product and a bright future — and in our mind, it's a name that Fools should at least be aware of.

Solium Capital

- Current Price: $5.27
- Market Cap: $225.4 million

Solium Capital provides a suite of web-based products that help companies, big and small, administer all aspects of their equity-based compensation plans (options, restricted share units, restricted stock awards, and so forth).

Tracking these plans is a complicated job, one that is only getting more complicated as companies expand geographically, compensation schemes become more focused on such rewards, and regulatory/accounting hurdles become more onerous.

Solium helps make it less complicated.

Why is this a good investment?

Solium's global opportunity is huge. Its online platforms have capabilities like no other, and it's really just getting started – even though it already has more than 3,000 direct clients. According to the company's literature, the global market for just its core offering of plan admin tools is estimated at about $2 billion annually. Solium's revenues are currently just $50 million.

Its technology completely disrupted the sleepy Canadian market and has gained sizeable traction here. Now, it is reaching out to other areas of the world — areas that look like the Canadian market did before Solium came along (namely, the UK and Australia). Newly formed partnership agreements with Barclay's and Macquarie are in place in these respective locations to help with distribution.

The company has also recently made three acquisitions that will give it greater exposure to private companies, predominantly in the U.S. Getting in bed, so to speak, with these entities at an early stage will allow Solium to grow as they grow.

Also, the business model is very sticky — full of recurring revenues (approximately 90%) — and scalable. Once Solium nabs a client, and its system becomes embedded within that client's operations, it becomes very difficult for that client to leave. And because the software is scalable, each new client requires little in the way of additional investment and should the client's needs increase, Solium's costs remain relatively fixed.

Looking forward

By all accounts Solium has a great product. The company is debt-free and reliably prints free cash. It has strong insider ownership, and seemingly has a vast opportunity in front of it.

And it's off the radar screen of the pros — the company is followed by just three Canadian analysts and is therefore largely unheard of.

Nobody, not even management, knows precisely what the future holds for Solium. We do know that because of the stickiness of the model, as long as they don't mess something up, it's hard to see this company going backwards anytime soon. If international distribution agreements gain traction, and some degree of success in the U.S. private market is achieved, growth from here could be significant.

Once an acceptable degree of market share has been achieved, and growth initiatives become less imperative, this company should begin paying out a dividend given the recurring nature of its business. (This is likely several years, and potentially many multiples in share price appreciation, away.)

The Foolish Bottom Line

Admittedly, for most, a portfolio rammed full of small cap stocks like Solium may be considered aggressive, or perhaps even outright small f-foolish. However, it's our belief that all portfolios have room for at least a few names like this. To temper this slightly, we also believe in diversification — so not all of our advisory efforts will be focused on this area of the market.

'Til next time … happy investing and Fool on!

Fool contributor Iain Butler does not own any of the stocks mentioned at this time. The Motley Fool does not own any of the stocks mentioned at this time.

CATEGORY

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Date
2025/06/29
Date Created
2013/07/25
Author
tmfohcanada