How to Get Rich SAFELY Off Canadian Small-Cap Stocks

Description

Small-cap stocks, on average, are riskier than their bigger brothers. That's a major reason why many retail investors have shunned them in favour of their blue-chip counterparts. Moreover, most institutional investors aren't even allowed to dip their toes in the small-cap pond, because oftentimes their assets under management dwarf the market cap of any given small-cap name.

With that in mind, it may seem wise to steer clear of small-caps too, especially since there's a lack of analyst coverage on an up-and-comer versus that of an established behemoth like **BCE Inc.** for which there's no shortage of content!

By choosing to shun small-cap stocks though, you could be closing the door to potential multi-baggers.

It's a heck of a lot easier to double, triple or quadruple up with a small-cap name than it is for a massive behemoth like BCE, with its nearly $50 billion market cap. The risks are indeed higher with small-cap names, but so too are the potential rewards, and if you're an experienced investor with the willingness to do the homework, you'll be able to cut down on the risks.

I believe the average retail investor can tilt the risk/reward trade-off on their side through careful and prudent analysis of an individual small-cap firm under the microscope. One primary reason why small-cap stocks are "riskier" is that, on average, their financial structure is less favourable.

Larger businesses have more assets on their balance sheet that can be used as collateral if things get ugly (like in a recession). Smaller companies are less established and are lacking in the same magnitude of collateral. Thus, creditors are less likely to be willing to loan large sums of cash for small-cap names to unlock their full near-term growth potential. As a small firm continues to grow in size though, it'll eventually hit a point where it's able to reach the optimal amount of leverage to deliver an optimal return on equity for shareholders.

There are small-cap firms out there that have no issues attracting financing from more relaxed lenders, however. While this ease of raising debt may seem like a boon on growth, the fact of the matter is that leverage is really a double-edged sword for small-cap businesses.

On one side, it can help maximize growth by financing investing initiatives, but on the other, more leverage means a higher risk of insolvency over the long term.

Small-cap firms that bite off more debt than they can chew are staggeringly less solvent than their large-cap peers or small-cap firms that opt to not double down on leverage to maximize their growth potential in the early stages of their lives.

Companies that are less solvent are more likely to go belly up, as the chances of defaulting on the long-term debt obligations are high. Thus, by choosing to steer clear of highly leveraged small-caps that may be "firing on all cylinders," you can avoid potential disasters should longer-term obligations ever become a problem, whether due to the state of the economy or other contingent issues that may arise due to the inexperience of a management team.

Two key metrics to look for are the debt-to-equity ratio and financial leverage (assets divided by equity).

The lower these numbers are, the more solvent a company under question is, and the less likely the stock will blow up in your portfolio during tough times.

Of course, there are highly leveraged small-caps that *can* be great buys if they're within an industry that allows for stable, potentially regulated operating cash flow streams.

Moreover, monopoly-like firms, like **Cargojet Inc.** (TSX:CJT), may also get a pass in spite of less attractive solvency metrics (debt-to-equity ratio of 2.53 and financial leverage of 4.1).

Cargojet is an anomaly, however, because a massive chunk of its assets are comprised of valuable pieces of equipment like high-payload jets, and it's also operating in a monopolistic market.

For now, steer on the side of caution and stick with solvent stocks, so you can minimize one of the most significant risks that come with small-cap investing.

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