Investing in Small Cap Stocks

Description

Small-cap stocks can be some of the most exciting stocks you will ever own, with immense growth potential that rewards you handsomely. They can also be extremely volatile, carrying more risks than mid- and large-caps.

Though they're certainly not for the faint-of-heart, small-caps could have a place in your investment portfolio, especially if you're interested in picking growth stocks.

What exactly are small-cap stocks, and how can you pick them wisely? Below we'll discuss small-caps in more detail.

What are small-cap stocks?

A small-cap is a type of stock, whose market capitalization falls between $300 million and $2 billion. Small-caps are often small companies with the potential for growth and higher returns, but less profits and stability than older, more established companies.

They can be highly volatile, though. Over long periods of time, they tend to outperform mid- and large-caps.

Small-cap vs. large-cap stocks

Large-cap stocks are companies with market caps higher than $10 billion. These are large companies with well-established brands, such as **Royal Bank of Canada, Enbridge,** and **Canadian National Railway.**

In general, large-cap stocks are less volatile and more stable than small-cap companies. Their larger market capitalization and higher outstanding shares give large-cap companies more financial muscle and deeper cash reserves, while their competitive position anchors them during deeply uncertain financial times. Large-cap stocks are often more likely to pay out dividends, too.

Small-caps may be more volatile, but they do have a leg-up on their larger counterparts: growth potential. While large-caps have deeper funds, they also have less room to grow, whereas the best small-cap companies are just getting started. They may be small now, but if they realize their full potential, they could offer investors higher returns.

Top small-cap stocks in Canada

Let's take a look at some of the top small-cap stocks on the Toronto Stock Exchange (TSX).

Small-Cap Stocks	Description
Park Lawn (TSX: PLC)	Funeral services company operating in Canada and the U.S.
Docebo (TSX: DCBO)	eLearning software for companies that trains employees with AI-curated content
goeasy (TSX: GSY)	Financial company that offers loans and financing to non-prime borrowers
WELL Health Technologies (TSX: WELL)	Digital healthcare company specializing in telehealth
Absolute Software (TSX: ABST)	Cybersecurity company specializing in endpoint and zero trust security

Park Lawn

Park Lawn is a funeral and cremation business—and the only cemetery company listed on the TSX. With roots stretching back to 1892, Park Lawn now owns 30 cemetery properties and 136 funeral homes stretching across Canada and the United States.

Park Lawn offers pre-planning funeral services, as well as sells caskets and cremations, and direct funeral arrangements. The funeral service business is led by an ambitious leadership team who continue to acquire new properties, expand the business into new markets, and deliver high-quality funeral services.

The company's sales and revenue growth has trended upward over the last 5 years, though its stock has trended downward year over year. Even so, this "death care" stock is highly defensive, as funeral and burial services are broadly considered a necessity.

Docebo

Docebo (pronounced "doh-che-bo") is a learning management system that helps companies train their employees, partners, and customers. More than 1,600 companies use Docebo for educational purposes, including Starbucks, Thomson Reuters, Uber, and Samsung.

Docebo's learning platform is both secured by the cloud and powered by Artificial Intelligence (AI). Unlike the lesson planning on most eLearning platforms, which require users to watch lessons and take quizzes in a linear, pre-fabricated timeline, Docebo's AI curates educational materials based entirely on the needs of each user. You'll still see the same content as another employee, but Docebo might structure it differently to fit your unique learning style and needs.

Docebo has had solid retention rates, continued growth, and an increase in multi-year contracts. Like other tech stocks, Docebo has seen its price drop significantly in 2022 (hence why it's back in small-cap territory). But given the importance of eLearning in a workforce that's growing more and more remote, Docebo certainly has plenty of growth potential ahead.

goeasy

goeasy (never capitalized) is a financial company that provides lending options to non-buyers, that is, buyers who don't qualify for traditional loans because of limited credit history, temporary financial setbacks (job loss, forced leave, etc.), or bad credit.

The company has three major divisions: easyfinancial, its non-prime lending service; easyhome, a lease-to-own lending service for home goods; and LendCare, a lending service for businesses that offers financing options to customers. goeasy earns most of its revenues from interest on each of these services, with another large portion coming from loan origination.

goeasy has had a rocky 2022, which will likely extend in 2023. Though the company has posted extremely impressive financial results (achieving record revenues in 2021 and increasing its loan originations to $1.5 billion), investors are concerned about rising interest rates. Higher rates will make it less affordable for borrowers, which could crush goeasy's loan originations.

Still, this is most certainly a small-cap stock to watch, as it has immense long-term growth potential.

WELL Health Technologies

WELL Health Technologies is a digital healthcare company. The owner and operator of several primary healthcare facilities in Canada and the U.S. has made numerous strategic acquisitions that have helped it expand into new markets.

The company has also built digital solutions for healthcare practitioners and patients alike. Its practitioner enablement platform helps doctors with teleconferencing, electronic medical records (EMRs), cybersecurity, billing and revenues, and even manage digital apps. On the patient side, WELL Health Technologies connects patients to physicians through its telehealth services, including video, phone calls, and secure messaging.

The company experienced immense growth during the COVID-19 pandemic, during which patients couldn't attend regular in-person doctor visits. The stock has cooled since then, but the company has continued to grow both in Canada and the United States.

Absolute Software

Absolute Software is a cybersecurity company that specializes in endpoint security, data management, and zero-trust security.

The company's target audience is companies with remote workforces. Its software protects devices from cyberthreats, no matter where the device goes. As a SaaS company, Absolute Software derives most of its revenues from subscriptions, with a portion coming from professional services.

Like other tech stocks, Absolute Software stock has plunged since its highs in 2021. But that doesn't mean the company itself is suffering. On the contrary, Absolute Software's recurring revenues continue to grow by double digits, with its retention rate remaining strong.

What should you look for in small-cap stocks?

To find truly great small-cap stocks, you have to learn to separate the bad from the good. Here are three ways to start digging for the best small-caps.

1. Look for "explosive" ideas

First, look for companies that have the potential to disrupt entire industries. For instance, you might look for companies that have a solid line of products (or ideas) that no other company in their industry is offering. Or you might look for a company that has a compelling business model or a way of earning revenue that differs from others. Or you might look for companies that are using technology in ways others just aren't.

Take banking, for instance. Many bank stocks are attached to banks that continue to do things the way they always have. But plenty of small fintech companies are challenging this traditional model with touch-free banking services, robo-investing, and even broker-free mortgages. These companies (often small-caps) are worth watching, as they could easily attract scores of people from all generations.

But new tech companies aren't the only industry disruptors. While, yes, in the past decade, many of the most innovative companies have been tech, we've seen retailers (lululemon) and consumer discretionary companies (Tesla) take a stab at convention. You just have to keep your eyes open for potentially explosive ideas.

2. Find strong businesses

A good idea means nothing if the company isn't making money. In order for a small-cap company to realize its explosive potential, it needs to have a strong business to back it up.

While finding strong businesses may require you to dig deeper than the surface, a few metrics can help you do the dirty work:

- **Revenue growth:** If a company isn't making money, it's probably losing money. And that's definitely not the kind of small-cap company you want to invest in. In general, look for a company with at least 20% revenue growth, as well as a long history of growing revenues. If a company's revenue isn't growing steadily over time, proceed with caution. Often, small-caps that stop growing are small-caps that never pick up the momentum they need to become bigger stocks.

- **Total addressable market (TAM):** The total addressable market is the total revenue opportunity available to a company. Basically, the TAM tells you how big a company could get if it hit its maximum limit. Many small-cap companies will cite their TAM during shareholder meetings as a way to show just how much potential they have. While the TAM alone shouldn't convince you to invest in certain small-caps, if the stock in question has a strong business model with disruptive potential in a market with a massive TAM, you may have found a stock that will make you rich.
- **Past price appreciation:** Another good indicator of a strong business is an upward trend in stock prices. If a small-cap has never gone above its IPO price, or if it has trended downwards or flat for a long period of time, it might not have much explosive potential. Stocks that explode are usually stocks that have been trending upward for some time. While there are exceptions to this, it's best to look for small-caps with a tract record of stock market growth.

3. Pay attention to value

Finally, you can use evaluation metrics to understand how much value a stock truly has. For instance, you can use the P/E ratios to compare a stock's price to the company's earnings.

If the stock is extremely expensive, but the company isn't making that much money, the stock may be overpriced. Likewise, if the stock is making lots of money, but the stock price is low, you may have found a deal.

What are the risks and rewards of small-cap stocks?

The main reason to invest in small-caps is the potential for higher returns. Unlike many large-caps, which offer security but limited growth potential, small-caps could grow immensely over long periods of time. Many small-caps end up being the kinds of stocks investors wish they *had* invested in before they grew into large- or mega-caps. When you hear people say, "I invested in Amazon when it was just starting out," you're hearing a story of successful small-cap investing.

But, of course, for every small-cap that becomes an Amazon, there are thousands of small-caps that fizzle out. Perhaps the greatest risk with small-caps, then, is the fact that they lack the resources that bigger companies have. Many just aren't profitable yet, which is okay for the short-term, but devastating for the long run.

If a small-cap company can't bring its products or services to the market, if they don't catch on like you assumed they would, they could easily fail, especially if the market or economy takes a turn for the worst.

In addition, small-caps are often far more volatile than other stocks. While, sure, all stocks have certain degrees of volatility, small-caps are far less stable, with price movements that rise and fall several percentiles within a single day. If you're risk tolerance is fairly low, you may not feel comfortable with a small-cap's wild swings.

When is the best time to invest in small-caps?

Small-caps tend to grow substantially in bull markets, while bear markets tend to cause small-caps to shrink.

The reason is fairly simple. During bull markets, a stronger economy gives small-caps more space to capture consumers' attention. During bull markets, consumers typically have more discretionary income, allowing them to try new products and services.

Are small-cap stocks right for you?

Small-cap investing is a great way to gain immense wealth. But they're not for everyone. If your risk tolerance is fairly low, or if you're near retirement, you may want to stick with safer investments, such as large-caps and blue chips.

Additionally, because many small-caps are relatively unknown, you might want to stick with companies you understand, especially if you're not the do-it-yourself type who will spend hours researching new stock picks.

That said, small-caps are great for investors who want to earn more than blue chips, large-caps, or index funds typically allow. They're also ideal for investors who have a long time horizon, that is, for young (or relatively young) investors who have a long way until retirement.

Since many small-caps are just getting off the ground, it could take years before they hit their growth potential, with many ups and downs along the way. As long as you take a buy-and-hold strategy, focusing on long-term growth and not short-term price movements, you'll put yourself in a good place to earn the utmost growth.

Keep in mind, however, that investing in small-caps can be risky. You definitely want to do your homework before you buy shares in a small-cap company. While the growth potential on small-caps can be amazing, the losses can be devastating. Use evaluation metrics and analysis to dig into your stock picks, and you'll avoid investing in a dud.

If you're not the kind of person who enjoys picking stocks, you could buy shares in a small-cap-focused exchange-traded fund (ETF). Basically, with an ETF, you'll spread your money across numerous different small-cap stocks. Your ETF manager will pick the stocks for you, and your shares will grow as the cumulative performance of all the small-caps grows.

TICKERS GLOBAL

1. TSX:ABST (Absolute Software)
2. TSX:DCBO (Docebo Inc.)
3. TSX:GSY (goeasy Ltd.)
4. TSX:PLC (Park Lawn Corporation)
5. TSX:WELL (WELL Health Technologies Corp.)

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