

# Discovering Great Small Cap Stocks

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Collectively, small caps outperform the market over long periods. However, investing in small caps is a higher-stakes game than investing in mid or large cap, with the stakes usually getting higher as the companies get smaller. You can improve your odds by looking for companies with strong fundamentals, good management, and a competitive angle in the market. Both quantitative and qualitative research is necessary.

## What is a small cap stock?

- Market cap less than \$2B
  - examples: Barnes & Noble (BKS), Ann Taylor (ANN) HubSpot (HUBS)
- Less than \$250M is considered micro cap
  - examples: RadioShack (RSH), Pacific Sunwear (PSUN)
- Less than \$50M is considered nano cap
  - examples: Books-A-Million (BAMM), Blackrock Massachusetts (MHE), Wet Seal (WTSL)

## A few other considerations:

- Often traded on NASDAQ or over-the-counter (OTC/Pink Sheet) exchanges
  - Lower barriers to entry on these exchanges
- Often not included in mutual funds due to mutual fund restrictions on buying too many of any one company's shares
- With some exceptions, small caps tend to be less well-known and therefore less frequently traded
- Do not usually pay dividends
- Things to be aware of in Stock Rover:
  - Market cap is in units of millions of dollars, so market cap < 2000 translates to small cap in Stock Rover
  - For lightly traded stocks, information is updated less frequently (every 5-15 minutes)
  - If analysts do not follow the stock, some estimate-based metrics will be unavailable
  - Please get in touch ([support@stocrover.com](mailto:support@stocrover.com)) if we are missing information that you are looking for

## Market environment right now:

- Small caps have been underperforming for months, even before the recent downturn in the market; some believe their performance predicted the current situation (i.e. canary in the coal mine)
- Are they a bargain or a falling knife?
  - No one can say, but this question is most critical for shorter-term investments; it is less critical (but still helpful to consider) if you are planning to buy and hold
  - Market research as well as reading technicals will help you plan when to buy



## Small Cap Characteristics

Characteristic	Advantage	Disadvantage
<b>Small market cap</b>	Company has room to grow (by a lot)	Less proven & riskier
<b>Generally thin market</b>	A little bit of extra demand can have a meaningful positive impact on price	If company disappoints, the price movement can be extreme; less liquid (may be harder to sell shares when you want to)
<b>Price volatility &gt; market volatility</b>	Potential for big gains	Potential for big losses
<b>Lack of institutional ownership</b>	More nimble; opportunity to beat funds; if you do your own research you might have an information advantage over institutional investors	Retail investors may panic more easily (see above)
<b>Lower visibility in market means valuation is less directly connected to fundamentals (i.e. market is not perfectly efficient)</b>	May be a great value not yet recognized by the market	Value may take time to catch up, if it does at all; value could also be more easily inflated
<b>Less analyst coverage</b>	Market is more sensitive to any upgrades by the analysts who do follow the stock	Market is more sensitive to any downgrades by the analysts who do follow the stock
<b>Increased probability of being acquired</b>	Can act as a buoy in tough times for promising companies; if acquired you get a big premium	No disadvantage, but the advantage is not bankable
<b>Less likely to pay dividends</b>	Ideally using capital to grow	No dividends means no demand for stock from income-oriented investors

## Two Common Small Cap Philosophies

### Value

- Seeks fundamentally-sound companies that are inexpensive/undervalued using metrics such as Price/Book, EV/EBITDA, and earnings yield
- Focus on finding inexpensive stocks that have a long track record of solid financials (with the promise of continued success)
- The value philosophy has been out of favor in the past 5 years, meaning this may be a good time to invest
- Examples of small cap value index funds: IJS, IWN, JKL, VBR

### Growth

- Seeks fundamentally-sound companies that have significant growth potential using metrics such as sales, EPS, research, and operating expenses
- Track record may not be as long (companies may be newer and less proven)
- Look for positive trends in the existing record, such as increasing sales and increasing efficiency, and look for a ramp up of expenses that is well spent, not worrisome
- Growth stocks have generally been in favor since the Great Recession—this means on the whole they might be due to lose favor in the market, but a great growth stock is still a great growth stock no matter what the trend is
- Examples of small cap growth index funds: IJT, IWO, JKK, VBK

### Screening

Screeners are a great place to start your research to find a population of stocks with many of the quantitative aspects you are seeking. Then follow up with additional research, both quantitative and qualitative, to determine if the stock is something you want to bet on.

Import the following screeners into your account from the Stock Rover library. Use them as they are or modify them to see how the results change.

**Premium Tip:** Use quant weights to rank the passing stocks according to metrics that you may not have filters on. For example, the rank can help you find stocks with the strongest profitability, efficiency, or momentum indicators among the stocks that pass a screener.

### Small Cap Value Quant (Premium)

Inexpensive valuation; good ROE with an upward trend; ranked according to sales and earnings combined with low valuation

- Market Cap less than \$2B
- Price/Book less than 1.2
- P/E less than 10
- Return on Equity (ROE) greater than 15%
- Current ROE greater than last year's ROE, which itself is greater than the ROE from 5 years ago
- *Highest ROE: 25% weight*



- *Highest EPS 5-Year Average: 25% weight*
- *Highest Sales 5-Year Average: 25% weight*
- *Highest Earnings Yield: 13%*
- *Lowest EV/EBITDA: 12%*

### Small Cap Growth Quant (Premium)

Upward trends in sales and EPS; debt does not exceed equity; upward trend in ROE and ROIC; ranked according to strong growth metrics and less expensive valuation

- Market cap less than \$2B
- Debt/Equity less than 1
- Sales 1-Year Change greater than the Sales 5-Year Average
- EPS 1-Year Change greater than the EPS 5-Year Average
- Operating Income 1-Year Change greater than the Operating Income 5-Year Average
- Current ROIC greater than the average ROIC from the past 5 years
- *Highest Sales 5-Year Average: 20% weight*
- *Highest EPS 5-Year Average: 20% weight*
- *Highest Operating Income 5-Year Average: 20% weight*
- *Lowest PEG Trailing: 25% weight*
- *Lowest EV/EBITDA: 15% weight*

### Small Cap Value (comes with Stock Rover as a default)

Inexpensive valuation; growing sales and earnings

- Market cap less than \$2B
- P/E between 2 and 10
- Price/Sales less than 2
- Price/Book less than 1.2
- EPS 5-Year Average greater than 10%
- Sales 5-Year Average greater than 4%

**Premium Tip:** Convert this screener into a freeform equation screener that also incorporates 10-year historical metrics to ensure that passing stocks has a long track record of solid financials.

### Small Cap Rockets (comes with Stock Rover as a default)

Growing sales and earnings; demonstrating price momentum

- Market cap less than \$2B
- Sales 1-Year Change greater than 15%
- Sales 3 Year Average greater than 12%
- Operating Income 1-Year Change greater than 15%
- Operating Income 3-Year Average greater than 12%
- EPS 1-Year Change greater than 15%
- EPS 3-Year Change greater than 12%



- Price within 85% of its 52-Week High
- 1-Year Return over 5% greater than the S&P 500
- 3-Year Return over 12% greater than the S&P 500

**Premium Tip:** Convert this into a freeform equation screener that ensures that sales, operating income, and EPS are increasing over time. For example, replace the first Sales criterion above with Sales 1-Year Change > Sales 3-Year Average, while keeping the second Sales criterion as is (Sales 3-Year Average > 12%).

## Filtering

Turn any screener into a small cap screener by filtering for market cap after running a screener. To filter the Table, click the ‘Filter’ button in the Table’s toolbar, or right-click a column header to filter on that column. Market cap is in units of millions of dollars, so filtering for **market cap < 2000** will filter for small caps.

Try out filtering on these screeners we have recently added to the library:

### Buffetology Inspired

This screener is based on criteria described in the bestselling Buffetology book. The company should have a 10-year track record of generally increasing EPS with no negative earnings years; long-term debt not more than 5 times annual earnings; average ROE over the past ten years at least 15%, average ROIC over the last 10 years at least 12%, and earnings yield should be higher than the long term Treasury yield.

### Piotroski High F-Score

This screener uses 9 criteria that look for companies that have solid financials that are getting better. The original 9-point system was developed by Joseph Piotroski, a professor of accounting. We have a blog post that explains this screener in depth at <http://www.stockrover.com/blog/piotroski-high-f-score-screener.html>

## Testing

Chart your screeners to see how they do. Are they performing as you would expect them to, based on the criteria you have entered? If not, you may want to modify the screener further before running it to find stocks.

Save tickers from a screener as a watchlist, and date the watchlist. Then you can see how those tickers do over time. While it won’t give you immediate insight into a screener’s success rate, you can check in on the list at various intervals, such as one month, 6 months, and a year

**Premium Tip:** Backtest your screener by copying it, and modifying the copy so that it runs on historical data. For example, “Market Cap < 2000” becomes “Market Cap [5 years ago] < 2000.” Import the Piotroski High-F-Score Small Cap Backtest screener for an example of how this works. Once you’ve created your backtest screener, chart it to see how those tickers have performed.



## Small Cap Research Guidance

What to Look For	General Guidance	Where to Look in SR
<b>Founders invested in the company</b>	Ideally 3–5+% share in company	Insight panel: Major Holders (Summary tab)
<b>Normal level of insider selling</b>	Some insider selling is normal, but a lot could be worrisome; no major increase in insider selling  Insider purchases a good sign (but rare)	Insight panel: Insider Transactions (Summary tab)
<b>A solid financial track record with generally positive trends</b>	Income metrics and efficiency metrics should be going up over time  Analyst estimates (where applicable) should be steady or increasing	Insight panel: Detail tab  Table: Growth and Profitability views  Chart: Fundamentals
<b>A manageable debt load</b>	Debt/Equity > 1 or debt decreasing over time  Interest Expense < 20% of operating income  Cap Ex, Research, and SG&A indicate where borrowed money may be going	Insight panel: Balance Sheet Summary (Detail tab)  Table: Income Statement view  Chart: Fundamentals
<b>Reasonable price given growth</b>	PEG Trailing < 1.2 (PEG Forward may not be available due to lack of analyst estimates)	Table: PEG Trailing can be added to any view via the 'Add Column' button
<b>Competitive advantage</b>	What does the company offer that is unique or better than others in the market space? Is this a profitable niche?  How does the company answer these questions in their own words? How do they position and pitch themselves?  Is there anything in the news about this company? Are competitors mentioned?	Insight panel: News tab; Peers tab; link to company homepage (Summary tab) and find investor relations from there; link to 10K and 10Q reports (Summary tab)  Table: add Industry/Sector comparison metrics via 'Add Column' button

**Stock Rover Tip:** Expand a table row by clicking the triangle to the left of the ticker cell (at the left side of the Table) to see how historical data for a metric. This makes it easy to see how a company has changed over time in key indicators.

### Other tips for investing in small caps:

- Focus on industries and technologies that you understand—you want to have a clear understanding of the company’s context and competitive advantage.
- Avoid “bleeding edge” technologies unless you have special insight into that particular technology and why it is likely to succeed.
- Be patient, banish expectations of instant runaway profits, and steel yourself for an occasionally bumpy ride.

### Additional Resources for Using Stock Rover

- Context-sensitive help links throughout program (anytime you see a “?” box)
- Videos & recorded webinars ([www.stockrover.com/video.html](http://www.stockrover.com/video.html))
  - Research-oriented webinars (such as “Real World Investment Research”) are recommended for walking through fundamental research steps in Stock Rover
  - Charting videos recommended to see additional chart features that can help you
  - “Technicals for the Fundamental Investor” webinar recommended if you are not accustomed to using technicals when making trading decisions
- Support Pages ([www.stockrover.com/support-data.html](http://www.stockrover.com/support-data.html))
  - answers to real questions from users
- Metrics & Tickers ([www.stockrover.com/metrics-profile.html](http://www.stockrover.com/metrics-profile.html))
  - all our metrics listed and defined (including custom metrics)
  - a list of all stocks and ETFs with their ticker symbols

