

Diversify Your Stock Portfolio by Size

By David McPherson

You can break down stocks into an almost endless number of categories. You can find growth stocks and value stocks, blue chips and orphans, industrials and financials. The list goes on and on. But the basic starting point is market capitalization, or size; that is, how much is a company worth? How big is it?

Using the market-capitalization measure, stocks are categorized into three broad groups: large caps, mid caps, and small caps. These terms frequently appear in the names of mutual funds that focus on particular segments of the stock market.

In this strategy, you look at one of the best ways to ease the uncertainty of investing in good times and bad: being sure your portfolio includes portions of large caps, mid caps, and small caps. This type of diversification can help you capture the strong performance of one category and offset the declines in another. For most individual investors, the best way to diversify by cap size is through mutual funds or exchange-traded funds (ETFs) rather than individual stocks. (See Strategy #21 for info on mutual funds; Strategy #23 discusses ETFs.)

Know the Market Cap Categories

The *market-capitalization* measure that people use to categorize stocks as large caps, mid caps, or small caps is a simple calculation that involves multiplying the number of outstanding shares in a company by the price of a single share. For example, a company with 100 million shares worth \$10 each has a market capitalization of \$1 billion.

In defining market cap categories, different institutions use different standards that can change with market conditions. But in general, sizes are defined in the following manner:

✓ **Large cap:** These stocks represent the largest companies trading on Wall Street and usually feature companies with market capitalization of \$5 billion or more. They include some of the best-known companies in the United States, such as General Electric, Microsoft, and Bank of America. They also include lesser known companies such as Schlumberger Ltd., an oil-field services company, and Avery Dennison Corp., a label maker.

This category accounts for about three-quarters of the overall U.S. stock market in terms of value. A frequently used gauge of U.S. large cap stocks is the Standard & Poor's 500 Index, or S&P 500.

✓ **Mid cap:** This category encompasses stocks that fall within a market capitalization range of \$2 billion to \$5 billion. Though considered medium size by Wall Street, a number of nationally known companies such as 3Com Corp., American Eagle Outfitters, and Netflix, Inc., are mid caps. Mid cap benchmarks include the Standard & Poor's MidCap 400 Index and the Russell Midcap Index.

✓ **Small cap:** This group encompasses publicly traded companies with market capitalizations of less than \$2 billion. Though they account for only about 10 percent of the U.S. stock market in dollar value, small caps make up the majority of the nation's publicly traded companies. Chances are you recognize few of the names on this list — they include U.S. Concrete, Inc., Kosan Biosciences, Inc., and Illumina, Inc.

A subcategory of small caps known as *micro caps* makes up the smallest of the small in terms of market capitalization. The definition of a micro cap varies widely, with some people starting at a market capitalization of \$500 million or less. Others use a \$100 million starting point. Either way, these are the riskiest of stocks and are best avoided by most individual investors. Many micro caps qualify as *penny stocks* because their shares regularly trade for less than \$1.

Get the Right Mix in Your Portfolio

Different types of investors may be drawn to one category over another based on the traits of large caps, mid caps, and small caps, particularly in times of market turmoil. See Table 42-1 to see how the stock categories compare.

<i>Size</i>	<i>Makeup</i>	<i>Returns</i>	<i>Dividends</i>	<i>Ideal for</i>
Large caps	Older and better-established companies; in difficult times, they stand a better chance of surviving than young upstart companies	Less risk for investors also means less potential for future growth. The chances of seeing a stock price double or triple in a short period aren't great.	They typically feature higher dividend payments than mid caps or small caps, which can make large caps particularly appealing during periods of uncertainty.	Those who want the inflation-beating returns of stocks without taking on too much risk
Mid caps	Both companies on the way up and those unlikely to grow any larger	Though less risky than small caps, mid caps over the last ten years have delivered higher average annual returns.	They tend to pay investors little, if anything, in the way of dividends.	Investors who seek higher growth potential but can't stomach the volatility inherent in small caps
Small caps	Less-established companies that contain tremendous growth potential but also run a higher risk of failure	Historically, this category has featured the highest returns in exchange for higher degrees of volatility.	They tend to pay little, if anything, in the way of dividends; there may not be enough cash to go around, or the companies are hoarding it to finance growth.	Investors with appetites for risk who plan to buy into this category after prices fall and are ready to hold for the long haul



Under most circumstances, you should own a little bit of each category to counter the uncertainty that surrounds money and markets. The right mix of large caps, mid caps, and small caps depends on your risk tolerance, goals, and circumstances. Traditional asset allocation models call for higher portions of large caps and smaller portions of mid and small caps. More-aggressive investors who seek higher returns and can withstand the volatility may want to allocate larger shares to mid caps and small caps.



If you're seeking diversification and simplicity at the same time, consider a total stock market fund or an extended market index fund. A *total stock market fund* invests in large, mid, and small caps in proportion to their overall representation in the market — that is, large caps make up about 75 percent of the fund. An *extended market fund* replicates the mid and small cap markets in a single fund but leaves out the large cap companies. Both options reduce the number of holdings needed to diversify your portfolio and simplify the investing process. The trade-off is that you have less flexibility in overweighting or underweighting a given category.