



## Investing in Asia's baby blue chips

### The opportunities and risks of small-cap investing in Asia

05:55 AM Apr 22, 2010

by **Judith Oliver**

Investing in small-cap stocks is popular with many investors. However, such investments can also be riskier, and investors venturing into this sector of the market should be aware of the hazards.

For investors, the "size" of a company refers to its market capitalisation, and not how large its sales are or how much profit it makes. It is calculated by multiplying the number of a company's shares with the company's share price.

In Asia, companies with a market capitalisation of below US\$500 million are typically considered small-cap stocks.

These offer potential for high returns for several reasons.

Small companies usually grow much faster than larger ones, because they are usually found in industries which are in their early stages of growth.

These companies would typically be offering a new product or service that is just catching on and the earnings of these small companies can grow very swiftly. Budget airlines are one recent example.

Innovation and inventions are also typically associated with small companies.

It is well known that some of the most successful technology companies, such as Apple and Google, started up in home garages. Small healthcare companies are also noted for making important medical breakthroughs, especially in the field of biotechnology.

Having an innovative product acts as a catalyst for mergers and acquisitions. When small companies become the target of takeovers, their share prices usually rise steeply.

Even in mature industries, small companies are frequently the target of takeovers. One sector where large companies are currently active in acquiring smaller ones is resources.

Finding new supplies of basic materials like copper and gold takes time, and acquiring small mining companies is a quicker and more certain way for large mining companies to expand their assets than embarking on exploration projects.

#### LITTLE RESEARCH, LARGE MISPRICING

The real difference between big and small-cap companies is that the market takes more time to find out what is happening in the smaller companies.

Professional research coverage is typically focused on large-cap stocks as these constitute the market indices, and new information on large-cap stocks is likely to be reflected in their share price very swiftly.

The majority of small companies, by contrast, receive little or no coverage. This is where large "mispricings" occur and where the significant rewards are often found.

Asia is currently growing faster than any other region in the world and this period of rapid growth is coinciding with the liberalisation of Asian stock markets.

Strong economic growth will mean the emergence of many new companies which will be able to turn to the equity markets to raise capital.

Investors in Asia are therefore being presented with a myriad of small-cap opportunities.

A key feature about Asia's economic development is that it is at the point where mass consumption is taking off. Although global brand names are enjoying some of their strongest growth in Asia, many small domestic companies have also been extremely

successful.

The long list includes supermarket chains, watch retailers, shampoo makers, lottery owners, cable television operators, Internet gaming companies and travel agencies.

Another thing to remember about Asia is its runaway success in outsourcing. China continues to be the principal workshop of the world while India and the Philippines dominate the arena for business services such as IT programming and call centres.

Contract manufacturers typically begin as small companies, but if they satisfy their multinational customers, they can grow very quickly. This is the familiar history of how successful electronic companies in South Korea, Taiwan and Singapore developed.

#### HIGH RISK IN SMALL-CAP INVESTING

The qualities which give small-cap stocks their premium value are often the very ones which make them fraught with risks.

A small company is often dependent on one customer, product or market, making it more vulnerable to the vicissitudes of demand.

When an industry is in its growth stage, competition is very intense because there are many players. Not all will survive.

The lack of research coverage for smaller companies also leads to the problem of liquidity. Shares of small companies can be difficult to obtain; they can also be difficult to sell if something goes wrong or if markets turn volatile.

Uncovering the hidden gems among small-cap stocks may ultimately be rewarding but investors need to realise that it can frequently take some time before the price of a share rises. A long holding period requires patience and nerve.

Investors also have to remember that the interests of minority shareholders are less likely to be well-protected.

#### SMALL-CAP FUNDS MITIGATE RISKS

Investing in small-cap stocks involves risks which individual investors may find daunting. An alternative for investors is to invest in a small-cap fund.

In Singapore, there are numerous Asian small-cap funds - some concentrate on one market, while others offer exposure across the region.

The key advantage of a fund is that it holds a diversified portfolio of stocks, and diversification is the single best way to reduce "unnecessary" or idiosyncratic risk. This is the risk that an investor takes without increasing the potential for higher returns.

Another advantage offered by a fund is that a professional manager would typically have more resources to conduct independent research and monitor developments in companies in the portfolio.

But even small-cap funds are high-risk investments, and it is prudent to allocate only a portion, and not all, of one's investment portfolio to small-cap stocks.

The writer is director of UOB Asset Management Ltd.

URL <http://www.todayonline.com/Business/Invest/EDC100422-0000116/Investing-in-Asias-baby-blue-chips>

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