



Fisher Funds

Investor Education Centre

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Small stocks can give small investors an advantage

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It is not often that small investors have an advantage over large investors, but when investing in small, illiquid stocks, individuals can find opportunities that the big guys just can't touch.

It's all about liquidity, or the ability to buy and sell something quickly without moving the market price significantly. If an asset is illiquid, it means it cannot be sold quickly; whereas the market for a liquid asset is generally large, with plenty of buyers and sellers.

For example, a large company like Telecom is very liquid. On average, about 8 million shares change hands every day, or about \$21 million worth of stock. So it's possible to buy a large amount of Telecom stock without affecting the share price. By contrast, a stock like Abano Healthcare is illiquid. The stock of this healthcare and medical services company trades only about 50,000 shares worth \$250,000, per day.

Abano is a profitable company and its share price has lifted 37% over the last two years, but its total size (measured by market capitalisation) of just \$119 million, is too small for most professional fund managers to look at.

Therefore smaller company stocks like Abano, and there are lots of them, are effectively "off limits" to large investors, and this is a good thing for small investors and those prepared to accept illiquidity. Since liquidity is valued highly by the 'big money' it often gets overpriced in the market. Conversely, illiquid or smaller companies are more likely to fall through the cracks and be discounted or ignored.

Over the long term, small illiquid stocks tend to produce higher returns than big, liquid stocks. Individual investors with a long term focus and without the constraints of a large money manager, can dig around and explore small stocks to take advantage of possible discounts. Illiquidity does come at a cost. For illiquid stocks, there is less demand and no ready market to sell. It may take a week or more before a buyer appears.

If you need to raise cash quickly, you may need to offer your shares at a lower price than the market price in order to entice buyers. Similarly, if you are very eager to buy shares in an illiquid company, you may find you need to bid a higher price than the current share price in order to encourage sellers to come out of the woodwork.

In twenty years of investing, I have never needed to pay a significant premium or accept a large discount when trading in smaller company shares, even though our funds have often been large shareholders in these companies. Mind you, we've never had to buy or sell in a hurry, as our investors generally have the same long investment timeframe as us.

The problems associated with illiquidity can often be overstated. You wouldn't avoid buying a house just because you knew it could take months to sell. Ditto with good companies – the inability to sell quickly should not blind you to its investment merits.

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