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Investor Education Centre

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Large or small – does company size really matter? – 10/05/09

Perceptions about size can be very personal. Some people feel that bigger is better - in cars, houses, body parts and almost everything else.

Most investors tend to equate large companies with safety. But it is not always true that large companies will give you better investment returns than small companies.

Smaller companies have some appealing investment characteristics that their larger counterparts don't have and there have been many periods when smaller companies have outperformed larger ones. The current economic crisis (that we are hopefully near the end of) has turned the common wisdom about big being better, completely on its head. We've seen that some of the largest companies, banks and car makers, have been the most vulnerable to the economic slowdown while smaller companies have proven more resilient.

Some of the factors that have left large companies vulnerable are the very things that make small companies appealing. The main one is flexibility.

At turning points in the economic cycle, businesses sometimes have to change the way they do things in order to win or even keep customers. Think about how you have reacted to the slowdown over the last year or so – you've probably looked a bit closer at prices than you used to, and you might now focus on the things that you *need* rather than the things that you *want*. Smaller companies are able to change their business direction quickly to meet changing customer demands, whereas larger companies often struggle to reinvent themselves because they are set up to do things 'the way they've always been done'.

Smaller companies also sometimes struggle to get access to capital which means they typically keep their businesses lean, with conservative financial management and healthy levels of cash. This gives them a buffer during bad times and a springboard for growth when times get better. I have always preferred smaller companies as I believe it's easier to have an information advantage with smaller businesses, and information is vital when investing.

As investors tend to prefer larger companies, smaller companies are often not as well researched and their share prices can be overlooked. It can also be easier to research smaller companies because they typically do just one thing, rather than having a number of diverse business activities (Telecom has seven business units, so researching their mobile phone business tells you just a fraction about the company).

As with all potentially rewarding investments, there is risk associated with small companies.

The biggest risk is failure, and there is no doubt that more small companies go broke than large companies. This risk can be managed to some extent through research, and also by ensuring that you choose a small company that has a moat around its business. By a moat I mean something that ensures its products and services are competitive and will be demanded by customers. A small business that is the best in its field can potentially be less risky than a large undifferentiated business.

Size matters, but so does quality.

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