Independent Investor

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Sizing Up Stocks: All About Market Caps

For investment purposes, companies generally can be categorized in one of three broad groups based on their size -- large-cap, midcap and small-cap. “Cap” is short for market capitalization, which is the value of a company on the open market.

To calculate a company's market capitalization, you’d multiply its stock's current price by the total number of outstanding shares. For example, if a company issues one million shares of stock trading for $50 each, its market capitalization would be $50 million ($50 times 1,000,000 shares).

Although there isn’t one set framework for defining the different market caps, one widely used source – Standard & Poor’s – currently describes each segment as follows:[1]

- Large-cap generally represents top companies in leading industries of the U.S. economy.
- Midcap generally represents a phase in the typical business life cycle in which firms have successfully navigated the challenges specific to small companies. At the same time, midcaps tend to be quite dynamic and not so large that continued growth is unattainable. Thus, the midcap segment may offer aspects of the markets not covered by the large-cap and small-cap worlds.
- Small-cap generally represents a segment of the market that is characterized by less liquidity and potentially less financial stability than that of large caps.

The Risk/Return Factor

Given these parameters, it generally follows that a stock's market cap may have a direct bearing on its risk/reward potential. Recognizing this relationship is important when making decisions about which investments to choose for your long-term portfolio.

For instance, investments in large-cap stocks may generally be considered more conservative than investments in small-cap or midcap stocks, potentially posing less risk in exchange for less aggressive growth potential. In turn, midcap stocks generally fall between large caps and small caps on the risk/return spectrum.

Small-cap companies may be vulnerable to the intense competition and uncertainties of untried markets. On the other hand, small-cap stocks may offer growth potential to long-term investors who can tolerate volatile stock price swings in the short term.

A standard method of gauging the performance of an investment is to measure its returns against those of an index representing similar investments. As with stocks, indexes come in all sizes and shapes. As their names suggest, the S&P 500®, S&P MidCap 400® and S&P SmallCap 600® indexes are commonly referenced representatives of large-cap, midcap and small-cap stocks.2

Selecting the Right Combination

So what does a company's size have to do with your investment strategy? Quite a bit. That's why some investors choose to diversify, maintaining a mix of market caps in their portfolios. When large caps are declining in value, small caps and midcaps may be on the way up and could potentially help compensate for any losses.

To build a portfolio with a proper mix of small-cap, midcap and large-cap stocks, you'll need to evaluate your financial goals, risk tolerance and time horizon. A diversified portfolio that contains a variety of market caps may help reduce investment risk in any one area and support the pursuit of your long-term financial goals. However, there is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

1Standard & Poor's, S&P Dow Jones Indices, S&P 500®, S&P MidCap 400® and S&P SmallCap 600®, as of August 31, 2017.

2The S&P 500®, S&P MidCap 400® and S&P SmallCap 600® are unmanaged. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

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