A MOTLEY FOOL SPECIAL REPORT

THE MICRO-CAP HANDBOOK

A PRACTICAL GUIDE TO INVESTING IN THE MARKET'S SMALLEST COMPANIES

The Motley Fool®

To Educate, Amuse & Enrich™

Contents

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This report is intended to be read as a companion guide to *The Motley Fool's Micro-Cap Report*. Investing in small and micro-cap shares carries a higher level of risk and therefore may not be suitable for everyone. Please see the back cover for the full Risk Warning.

The Micro-Cap Handbook

A Practical Guide to Investing in The Market's Smallest Companies

by The Motley Fool UK Analyst Team

Dear fellow Fool,

Thanks for joining us on our micro-cap investing adventure!

Here at The Motley Fool, we believe that smaller companies are more likely to fly under the City's radar, and as a result, we think they often provide greater returns potential than investing in large companies.

To put it another way: ***"elephants don't gallop"***.

If you want to invest in the "next big thing", investing in the "current big thing" probably won't work. It's the companies that are small today that have the potential to become the elephants of tomorrow — and reward investors with massive returns along the way.

But investing in small and micro-cap shares is very different than investing in your typical blue-chip. If you don't go about it the right way, it can be hazardous to your wealth — something we want to avoid!

That's because these tiny companies are often based on a single product or revenue stream, and an unexpected bump in the road ahead can potentially spell disaster. By comparison a larger, more diversified enterprise can more readily absorb the impact of an unexpected hiccup or two.

Ultimately it boils down to this: by choosing to invest in small or micro-cap shares, you're effectively accepting a higher level of investing risk, in exchange for potentially outsized returns.

And when used as part of a diversified investing strategy, small and micro-caps can be both an exciting and potentially lucrative addition to your portfolio.

In this report (or "instruction manual" if you prefer), we point out some of the classic pitfalls of investing in small and micro-cap companies that often catch people out, and suggest a few ways you can avoid these common mistakes.

The information gap

Flip through the pages of the *Financial Times* and what do you see? On any given day if I were to guess Barclays, BP, Lloyds Banking Group or Sainsbury's I'd probably get at least one right.

Giant companies are very well covered by the media. They also typically have large press and investor relations departments whose jobs are based on sharing information with investors, the press, and the wider public.

This is usually *not* the case with micro-cap companies.

You're unlikely to find them on the front page of the *FT* — or even the middle pages for that matter — and their public and investor relations teams are normally much smaller and put out far less content.

That means that as an investor in micro-caps, you have to do a bit more work to make sure that you're informed. Visiting the company's website regularly should ensure that you're up to date on what's going on, as can making sure you're familiar with the dates when the company normally reports earnings. Doing general-purpose research on micro-cap companies is also better done directly through the company's website and in regulatory filings, since there's likely less media coverage to be found.

Of course that's also what we're here for. In ***The Motley Fool's Micro-Cap Report*** that you now have in your hands, you have the distilled analysis and countless hours of research that we've done on the five companies we've recommended you buy. We believe that this can provide you a great basis for immediately understanding the opportunity and potential — as well as some of the risks! — of these small and often overlooked companies.

(You may have already thought about this, but this information gap is also good news for us: It's part of the reason why small-cap shares often deliver better returns than larger companies!)

Liquidity

Liquidity is an investing concept that's often made out to be more complicated than it really is. What liquidity boils down to is how quickly you can turn an investment into cash.

Premium Bonds are very liquid.

Your house (assuming you own one) is not liquid.

When we consider the stock market, the shares of **GlaxoSmithKline** (LSE: GSK) and **Royal Dutch Shell** (LSE: RDSB) are very liquid. But the shares of specialist software provider **Craneware** (LSE: CRW), for example, are far less liquid.

Let's talk a bit about how this works in practice.

If you decide you want to buy **Lloyds Banking Group** (LSE: LLOY) shares, it'll likely be easy. According to data from *S&P Capital IQ* as of 16th February 2017, the average daily trading volume for Lloyds is around 150 million shares, which equates to a daily value of some £100 million. If you wanted to invest £50,000, there's plenty of liquidity (there's that word again) to allow you to do that. Your investment would only represent 0.05% of Lloyd's average daily trading value.

Now if you wanted to invest the same amount in Craneware, it'd be a different story. On average, only about 10,000 shares of Craneware trade per day. That makes the daily value of trading in Craneware's stock less than £150,000. Your £50,000 investment would represent more than a third of Craneware's total daily trading value.

The impact of this lower liquidity is three-fold:

- First, it makes it more difficult to make such a large trade all at once, as there needs to be other investors in the market that can provide the number of shares you're looking for.
- Second, when you add such a large amount of trading volume to a thinly traded company, your trade can actually push up the share price. Just think about the basic economics of supply and demand — you've just shoved demand way up.
- Third, less liquid shares tend to have wider dealing spreads, which are often your largest cost when executing trades. (We'll discuss these in more detail, just ahead.)

It's also worth pointing here that lower levels of liquidity can also make it trickier to sell your small or micro-cap shares quickly (and to achieve a fair price for them) — particularly in the event of some sort of market shock.

Now as Fools, we're long-term investors and not likely to panic whenever the market hits a bumpy patch and hit the sell button! But it's important to be aware that lower liquidity can make it trickier for your to realise your investment, compared to selling your typical big 'blue-chip' share.

Here are three strategies to help you deal with trading lower-liquidity shares:

1. **Study the liquidity before you place your trade.** Many micro-caps have low liquidity, but not all of them. Check out the average trading volume before you place your trade, so you can make sure you're making a trade that can be "digested" in the company's normal trading volume. (Trading volume information should be readily available via your broker's website.)
2. **Be patient.** Foolish investors know that patience can pay off. That's usually in the form of owning stocks over the long term, but when it comes to small stocks, patience can also pay off when you're buying. If you want to buy more shares than the normal trading volume can handle, buying in smaller portions over time can work out better. Lower volume can also create volatility in smaller shares — both upward and downward — so if you see shares of a small, illiquid company spiking, it can often be a good idea to wait on the sidelines, as the price may "settle down" in the coming days.
3. **Use limit orders.** Limit orders allow you to specify to your broker the maximum price you're willing to pay for shares. This helps make sure you don't overpay for shares if increased volume pushes up the price before your order is completed. Placing a limit order may mean that your trade won't get completed right away, but in that case… remember point number two!

Volatility

I already touched on volatility above, but it's worth covering in a bit more detail.

Thanks in part to the lower trading volume that we just talked about, small shares can be particularly volatile. That means that it's more likely that you'll see shares of a small company spike up (or down!) 10% or more in the course of a single day.

This again makes patience important. If shares are up a significant amount in a day, it's often a bad idea to try to "chase" them. The shares may settle down in the coming trading days and offer a better buying price.

Your best friend here is the "buy up to" price guidance that we've provided for each of the five micro-cap share recommendations in The Motley Fool's Micro-Cap Report.

For each share in this report, we've used financial analysis and modeling to determine a price at which we believe investors are best positioned to earn an attractive long-term profit. That is to say, as much as we admire the companies that we've recommended, at a certain price we think they are a less attractive investment opportunity.

These "buy up to" prices are not set in stone forever. Over the coming quarters and years, changes in the businesses and the economy may change the intrinsic value of the shares. But you should view them as a guidepost for making purchases right now. If the prices remain below the **"buy up to" price**, you should feel comfortable buying. If they run beyond that price, your best bet may be waiting for them to fall back below.

While volatility can cause shares to spike, it can also cause unexpected plunges. When you see a micro-cap share plunging, don't panic. Find out if there's something company-related — something fundamental like an earnings miss, a write-down, or a management change — that's causing the drop. In that case, you may want to reevaluate the investment. Our **"risks and when we'd sell"** section of ***The Motley Fool's Micro-Cap Report*** could help you here.

If there's nothing fundamental to the company that's driving the share price down, it could also be that an investor is simply trying to sell too many shares at once, and the low liquidity is causing the stock price to plunge. In these cases, most of the time your best action is inaction. Sometimes though, it may be an opportunity to buy more shares at a discounted price.

Bid-offer spreads

When investing in smaller shares, we also need to be mindful of the "bid-offer spread". This is the difference between what buyers ("bidders") are offering to pay for shares and what price sellers ("offers") are willing to offer at any given time.

For large companies, the bid-offer spread is often very small. For Lloyds Banking Group, the difference between the bid and offer is as little as 0.02p.

The spread on a share like Craneware, on the other hand, is likely to be much higher — at the time of this writing, it was 20p !

And remember, the "price" of a share is simply the last price that it successfully traded. It doesn't mean that anyone is currently willing to sell at that price.

Remember what I mentioned about limit orders? This is another good reason to use them.

If you place a market order to buy a share, rather than a limit order, you're instructing your broker to "take the offer" — that is, buy at the best offer price they can find. That's not that big of a deal if we're talking about buying Lloyds Banking Group with its teeny-tiny spread. But for smaller shares, taking the offer may mean paying a price that's 1% or 2% higher than the last price — or in some cases much more.

Because of the low liquidity of some micro-caps, you may have to take the offer price in order to complete a trade. If that offer price is still below our "buy up to" price, you should be in good shape. But, it's important to be aware of that up front, rather than being surprised by a higher price after your broker has already executed the trade.

Micro-cap scams

It's saddening that we have to address this here, but as you get comfortable in the world of micro-cap shares, it's important to remember that this is also an area of the market where scammers like to hang out.

The shares that we recommend in our micro-cap report are not get-rich-quick shares. These are real businesses that in our view offer great products and services and have strong management teams. We have done rigorous research into these companies to reach the conclusion that they are good investments. And while we cannot guarantee that any of them will work out as great investments, we have done our utmost to determine that these are solid, high-quality investment opportunities.

On the other hand, spam emails, "boiler room" scams, and the like seek to get investors excited about micro-cap shares that often have little or no real business behind them. In most of these cases, the perpetrators of the scam are looking to profit by buying small shares, exploiting their low liquidity to create a price spike, and then sell their own shares at a big profit before the shares crash back to earth.

For this reason, it's very important that you do your research on any companies that you plan to invest in. That goes for blue-chip shares, and doubly-so for small-cap and micro-cap shares. By confirming through your own research that what you're investing in is a real company, with real products, and true future business prospects, you can avoid getting sucked into micro-cap scams.

Let's go!

This certainly isn't all there is to say about the world of micro-cap investing. But we hope that it should serve to help you get started in this exciting and potentially very profitable niche of the market… and to avoid some of the common pitfalls too.

We hope you enjoy both reading about and investing in all five of the high conviction buy recommendations that we've presented to you in ***The Motley Fool's Micro-Cap Report***, and we look forward to helping you continue investing Foolishly in the future!

Here's to better micro-cap investing!

The Motley Fool UK team.

Disclosure: The Motley Fool UK has recommended Barclays, BP, Royal Dutch Shell and Craneware shares and owns GlaxoSmithKline shares.

Risk Warning

- The articles in *The Motley Fool's Micro-Cap Report* and *The Motley Fool's Micro-Cap Handbook* reflect the opinions of the individual writers and give general advice only.
- The shares mentioned may not be suitable for any individual.
- You should make your own investment decisions, or consult an authorised financial adviser.
- The prices of all shares, and the income from them, can fall as well as rise.
- You run an extra risk of losing money when you buy shares in certain smaller companies including "penny shares".
- Investment in the securities of smaller companies can involve greater risk than for larger, more established companies. Price movements may be more volatile, and they can react strongly to news or recommendations. You should always check the price before you deal. The market for smaller company shares may be less liquid, meaning they may be harder to trade.
- There may be a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up and you may not get back the full amount invested. It may be difficult to sell or realize the investment.
- You should not speculate using money you cannot afford to lose, or rely on dividend income for non-discretionary living expenses.
- Some securities may be traded in currencies other than sterling, and may also pay dividends in other currencies.
- Changes in rates of exchange may have an adverse effect on the value of these investments in sterling terms. You should also consult your stockbroker about any additional dealing or administrative charges.
- We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material aspects.
- Investors should seek appropriate professional advice from their stockbroker or other adviser if any points are unclear.

About The Motley Fool's Micro-Cap Handbook

For all queries please email The Motley Fool at **CustomerServices@Fool.co.uk** or alternatively you can call us on **020 7462 4300**.

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