



DOWNSIDE: Smaller company investments can fall by significantly more than the market average

Worth dipping toe into smaller stocks

Investment: Higher returns might justify risk

BY BARRY O'NEILL

Investing in ordinary shares of a company exposes you to the highest level of risk in that firm's capital structure.

Shareholders rank below HM Revenue and Customs and bond holders in the event of liquidation.

It is therefore vital to make sure you are properly compensated for the risks you choose to take.

The first step is to realise that not all companies are built the same.

Most people buy into businesses they are familiar with. This often means the large ones at or near the top of the FTSE 100 index.

Although you may feel

more comfortable investing in these firms because you engage with many of them in one form or another on a daily basis, academic research and real-life experience highlights the benefits of investing in smaller companies.

These businesses, usually defined as the bottom 10% of the listed market in any country in terms of size, are often cited as the growth engine of the

economy. Smaller companies have a higher expected return than the broader market due at least in part to their higher cost of capital; they have to offer the prospect of higher returns to entice investment into them to compensate for the higher level of risk.

Investing in stocks at this end of the market does not necessarily mean that you won't be familiar with any of the companies as they are still sizeable organisations.

It is important to note that although investing in smaller companies

could provide you with greater rewards than the broader market over the long term, such investments can fall by significantly more than the broader market in years where the general direction of travel is down.

Ultimately, some investment risks are worth taking while others are not.

Trusting a portion of your money to smaller companies is a risk that has academic support and helps to diversify portfolios that are overly concentrated in a tiny number of extremely large companies.

■ Barry O'Neill is investment director at Carbon Financial Partners and can be contacted on 01224 619215

Barry O'Neill: portion

