Understanding Market Capitalization

Description:
This article discusses the process for calculating market capitalization and the significance of this dimension for understanding company performance.

Body:

If you're creating an investment strategy designed to help you pursue long-term financial goals, understanding the relationship between company size, return potential, and risk is crucial. With that knowledge, you'll be better prepared to build a balanced stock portfolio that comprises a mix of "market caps."

Market cap -- or market capitalization -- refers to the total value of all a company's shares of stock. It is calculated by multiplying the price of a stock by its total number of outstanding shares. For example, a company with 20 million shares selling at $50 a share would have a market cap of $1 billion.

Why is market capitalization such an important concept? It allows investors to understand the relative size of one company versus another. Market cap measures what a company is worth on the open market, as well as the market's perception of its future prospects, because it reflects what investors are willing to pay for its stock.

- **Large-cap** companies are typically firms with a market value of $10 billion or more. Large-cap firms often have a reputation for producing quality goods and services, a history of consistent dividend payments, and steady growth. They are often dominant players within established industries, and their brand names may be familiar to a national consumer audience. As a result, investments in large-cap stocks may be considered more conservative than investments in midcap or small-cap stocks, potentially posing less risk in exchange for less aggressive growth potential.

- **Midcap** companies are typically businesses with a market value between $2 billion and $10 billion. Typically, these are established companies in industries experiencing or expected to experience rapid growth. These medium-sized companies may be in the process of increasing market share and improving overall competitiveness. This stage of growth is likely to determine whether a company eventually lives up to its full potential. Midcap stocks generally fall between large caps and small caps on the risk/return spectrum. Midcaps may offer more growth potential than large caps, and possibly less risk than small caps.

- **Small-cap** companies are typically those with a market value of $300 million to $2 billion. Generally, these are young companies that serve niche markets or emerging industries. Small caps are considered the most aggressive and risky of the three categories. The relatively limited resources of small companies can potentially make them more susceptible to a business or economic downturn. They may also be vulnerable to the intense competition and uncertainties characteristic of untried, burgeoning markets. On the other hand, small-cap stocks may offer significant growth potential to long-term investors who can tolerate volatile stock price swings in the short term.
Market Cap vs. Free-Float Market Cap

Market cap is based on the total value of all a company's shares of stock. Float is the number of outstanding shares for trading by the general public. The free-float method of calculating market cap excludes locked-in shares, such as those held by company executives and governments. Free-float methodology has been adopted by most of the world's major indexes, including the Dow Jones Industrial Average and the S&P 500.

What Could Impact a Company's Market Cap?

There are several factors that could impact a company's market cap. Significant changes in the value of the shares -- either up or down -- could impact it, as could changes in the number of shares issued. Any exercise of warrants on a company's stock will increase the number of outstanding shares, thereby diluting its existing value. As the exercise of the warrants is typically done below the market price of the shares, it could potentially impact its market cap.

But market cap typically is not altered as the result of a stock split or a dividend. After a split, the stock price will be reduced since the number of shares outstanding has increased. For example, in a 2-for-1 split, the share price will be halved. Although the number of outstanding shares and the stock price change, a company's market cap remains constant. The same applies for a dividend. If a company issues a dividend -- thus increasing the number of shares held -- its price usually drops.

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.¹

Source/Disclaimer:

¹Diversification does not assure a profit or protect against a loss.

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