# Mortality Risk in Small-cap Investing

Expert Take

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There is no sure thing when it comes to investing. Investing is a game of probability and in any game of probability there is always a possibility of adverse payoffs and the probability of such adverse payoff is much more in case of small caps.

Statisticians use the Bell Curve to explain the probability distribution of an event. The same Bell Curve can be effectively used to demonstrate the risk-reward equation of an investment hypothesis. The curve is completely lopsided when it comes to small-cap investing, which effectively means that if you get a small-cap company investment hypothesis right, then the payoffs are huge (mind-boggling), but the probability of getting that hypothesis right is very low. Thus, daydreaming about a payoff can be fun but understanding risk is critical. Small-cap investing is about testing hypothesis and eliminating mortality risk.

All small-caps are experiments. The founders are testing whether their hypothesis about a business idea is true, and if so, they (and their investors) can potentially achieve great success. The most important aspect of due diligence in case of small-cap investing is to understand the key hypotheses a small-cap business is testing, is there a proof of concept — even somewhat, and whether the right plans are in place to test those hypotheses more rigorously — quickly.

I think there is a single, universal question to ask every entrepreneur before investing: "What does the success of your company fundamentally depend upon?"

Asking this question should be a "golden rule" for small-cap investors. An entrepreneur must be able to clearly articulate what their success uniquely depends upon, not a generic set of factors. Of course, it's likely that the key factors are in the "buckets" we all know: management team, product-market fit, market size, supply chain, business model, etc. But it's on the unique set of two or three specific factors that the small-cap's success depends upon. The answers to this question can help investors evaluate whether the entrepreneur has thought deeply about their business and if they are on the right track. For investors, it decreases risk and increases the likelihood of success.

The payoffs in case of successful small cap investing are huge. But, the probability of success is low. An investment in 100 shares of Infosys in 1993 (when it was a small cap company) for a sum of ₹9,500 would have been today worth ₹7.68 crore, excluding dividends. Many large successful companies that exist today were small-caps at some point in their journey. But these high returns come with very high associated risks. Therefore, a successful small cap investor has to do an incredible job in risk mitigation.

I have always enunciated the biggest risk with small-cap investing is Mortality Risk — risk that the company will not survive.

Due their small size, lack of experienced management teams and inadequate risk management and foresight in managing the affairs of the business, small-cap companies are extremely vulnerable to economic slowdown and external shocks; leave aside the issues around corporate governance. Experience shows that over 50% of small-cap companies do not survive a single economic slowdown/crisis and die their natural death. This is the biggest risk facing investors because in case of mortality of investee companies, investors lose 100% of their capital. And that risk is significant when it comes to small-cap investing.

For example, in the aftermath of the technology meltdown in 2001, 90% of the IT companies did not survive the next recession. Likewise, the best performing sector of the 2003-07 bull market was infrastructure and real estate but many of the infrastructure and real estate companies could not survive the Global Financial Crisis of 2008 and ceased to exist or are struggling with huge pile of debts leading to significant loss of capital for investors.

There is a high probability that if a small-cap company emerges from crisis either unharmed or with minor bruises, than it is likely to create significant wealth for its shareholders over a period of time.

Thus, despite the sharp selloff in small cap companies over the last year and the high level of disdain, investors should not give up on them; instead they should make their process fool-proof with rigorous testing of investment hypothesis and elimination of mortality risks. For in small-caps, lies the key to multi-bagger returns.

*(The author is founder, Renaissance Investment Managers)*