MORE ON MARKET CAPITALIZATION

Market Cap and Investment Strategy

The market cap can be a helpful metric in determining which stocks you are interested in, and how to diversify your portfolio with companies of different sizes.

Large-cap companies typically have a market capitalization of $10 billion or more. These companies have usually been around for a long time, and they are major players in well-established industries.

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Investing in large-cap companies does not necessarily bring in huge returns in a short time. Still, over the long run, these companies generally reward investors with a consistent increase in share value and dividend payments.

Examples of large-cap companies—and keep in mind that this is an ever-changing sample—are Apple Inc., Microsoft Corp., and Google parent Alphabet Inc.

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Mid-cap companies generally have a market capitalization of between $2 billion and $10 billion. Mid-cap companies are established companies that operate in an industry expected to experience rapid growth.

Mid-cap companies are in the process of expanding. They carry an inherently higher risk than large-cap companies because they are not as established, but they are attractive for their growth potential.

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Companies that have a market capitalization of between $300 million to $2 billion are generally classified as small-cap companies. These small companies could be younger and/or they could serve niche markets and new industries.

These companies are considered higher-risk investments due to their age, the markets they serve, and their size. Smaller companies with fewer resources are more sensitive to economic slowdowns.

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As a result, small-cap share prices tend to be more volatile and less liquid than more mature and larger companies. At the same time, small companies often provide greater growth opportunities than large caps. Even smaller companies are known as micro-cap, with values between approximately $50 million and $300 million.

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Diluted Market Cap

A security's market capitalization may change over time due to the outstanding number of shares. This is especially prevalent in cryptocurrency where new tokens or coins are issued or minted frequently.

Because new offerings will theoretically thin the value of existing coins, tokens, or shares, a different market cap formula can be used to calculate what the potential market cap will be.

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This concept is referred to the diluted market cap, and the formula is:

Diluted Market Cap = Current Share Price * Total Number of Shares Authorized

For example, consider Bitcoin trading at roughly $24,000 per coin as of mid-August 2022. At this time, there are also approximately 19.1 million Bitcoin issued. However, the total number of potential Bitcoin that may eventually be minted is 21 million.

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Therefore, Bitcoin's market cap calculations are:

Market Cap = $24,000 * 19.1 million = $458.4 billion

Diluted Market Cap = $24,000 * 21 million = $504 billion

Analysts use the diluted market cap to better understand potential changes to security, token, or coin price. For example, imagine if all 21 million Bitcoin were minted tomorrow.

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If it were to retain the same market cap of $458.4 billion, the price would have to drop to roughly $21,828 ($458.4 billion / 21 million).

Therefore, companies with large inventories of unissued securities or coins are at greater risk to face price decreases if investors wish to keep their market cap the same regardless of outstanding tokens.

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Misconceptions About Market Caps

Although it is used often to describe a company, the market cap does not measure the equity value of a company. Only a thorough analysis of a company's fundamentals can do that.

It is inadequate to value a company because the market price on which it is based does not necessarily reflect how much a piece of the business is worth.

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Shares are often over- or undervalued by the market, meaning the market price determines only how much the market is willing to pay for its shares.

Although it measures the cost of buying all of a company's shares, the market cap does not determine the amount the company would cost to acquire in a merger transaction. A better method of calculating the price of acquiring a business outright is the enterprise value.

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Changes in Market Cap

Two main factors can alter a company's market cap: significant changes in the price of a stock or when a company issues or repurchases shares.

An investor who exercises a large number of warrants can also increase the number of shares on the market and negatively affect shareholders in a process known as dilution.

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