Market Capitalization Defined

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You often hear companies or different mutual funds being categorized as small cap, mid cap or large cap. But what do these terms really mean? The "cap" part of these terms is short for capitalization, which is a measure by which we can classify a company's size. Although the criteria for the different classifications are not strictly bound, it is important for investors to understand these terms, which are not only ubiquitous but also useful for gauging a company's size and riskiness.

Calculating Market Cap

Market capitalization is just a fancy name for a straightforward concept: it is the market value of a company's outstanding shares. This figure is found by taking the stock price and multiplying it by the total number of shares outstanding. For example, if Cory's Tequila Corporation (CTC) was trading at $20 per share and had a million shares outstanding, then the market capitalization would be $20 million ($20 x 1 million shares). It's that simple.

Why It's Important

A common misconception is that the higher the stock price, the larger the company. Stock price, however, may misrepresent a company's actual worth. If we look at two fairly large companies, IBM (NYSE:IBM) and Microsoft (Nasdaq:MSFT), we see that at as of March 18, 2009 stock prices were $91.75 and $16.75 respectively. Although IBM's stock price is higher, it has about 1.34 billion shares outstanding, while MSFT has 8.89 billion. As a result of this difference, we can see that MSFT's market cap of $148.91 billion is actually larger than IBM's $122.95 billion. If we compared the two companies by solely looking at their stock prices, we would not be comparing their true values, which are affected by the number of outstanding shares each company has. (*The Basics Of Outstanding Shares And The Float*).

The classification of companies into different caps also allows investors to gauge the growth versus risk potential. Historically, large caps have experienced slower growth with lower risk. Meanwhile, small caps have experienced higher growth potential, but with higher risk.

Different Types of Capitalization

While there isn't one set framework for defining the different market caps, here are the widely published standards for each capitalization:

- *Mega cap* - This group includes companies that have a market cap of $200 billion and greater. They are the largest publicly traded companies such as Exxon (NYSE:XOM). Not many companies will fit in this category, and those that do are typically the leaders of their industries.

- *Big/large cap* - These companies have a market cap between $10 billion to $200 billion. Many well-known companies fall into this category, including companies like Microsoft, Wal-Mart (NYSE:WMT) and General Electric (NYSE:GE), and IBM. Typically, large-cap stocks are considered to be relatively stable and secure. Both mega and large cap stocks are often referred to as blue chips.

- *Mid cap* - Ranging from $2 billion to $10 billion, this group of companies is considered to be more volatile than the large- and mega-cap companies. Growth stocks represent a significant portion of the mid caps. Some of the companies might not be industry leaders, but they are well on their way to becoming one.

- *Small cap* - Typically new or relatively young companies, small caps have a market cap between $300 million to $2 billion. Although their track records won't be as lengthy as those of the mid to mega caps, small caps do present the possibility of greater capital appreciation - but at the cost of greater risk.

- *Micro cap* - Mainly consisting of penny stocks, this category denotes market capitalizations between $50 million to $300 million fall into this category. The upward potential of these companies is similar to the downside potential, so they do not offer the safest investment, and a great deal of research should be done before entering into such a position.

- *Nano cap* - Companies having market caps below $50 million are nano caps. These companies are the most risky, and the potential for gain is often relatively small. These stocks typically trade on the pink sheets or OTCBB

Remember, these ranges are not set in stone, and they are known to fluctuate depending on how the market as a whole is performing.

Conclusion
Understanding the market cap is not just important if you're investing directly in stocks. It is also useful for mutual fund investors, as many funds will list the 'average' or 'median' market capitalization of its holdings. As the name suggests, this gives the middle ground of the fund's equity investments, letting investors know if the fund primarily invests in large-, mid- or small-cap stocks.

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