MICROCAP MYTHS

Over the years, numerous academic studies have concluded that significantly above average returns have been achieved in the MicroCap-Value arena.

One of the most powerful of these studies is the Fama and French work entitled "*The Cross-Section of Expected Stock Returns*." Originally published in 1992, it is updated annually and now spans a period of over 50 years (1963-2013). As can be seen in the table below, by far the best returns over the 50+ year study period were achieved when the smallest market cap decile is combined with value as represented by the lowest price/book decile. (+23.45% per year).

Market Cap Deciles

1963 - 2013 Annual Investment Returns for Low Vs. High Price/Book Stocks According to Market Capitalization

		Ratio of Price to Book Value Decile									
		(Lowest Price/Book Value)							(Highest Price/Book Value)		
Market Cap Decile		1	2	3	4	5	6	7	8	9	10
(Smallest Market Cap)	1	**23.45%**	**20.55%**	19.17%	18.31%	17.56%	16.27%	16.35%	13.41%	9.57%	6.05%
	2	**17.03%**	**17.51%**	14.31%	17.48%	13.92%	13.66%	11.38%	11.72%	9.80%	2.26%
	3	17.77%	18.14%	16.08%	14.37%	17.86%	14.42%	11.70%	12.12%	11.75%	3.37%
	4	10.61%	16.95%	16.58%	15.15%	16.16%	14.40%	13.07%	10.49%	10.13%	5.71%
	5	15.65%	18.88%	15.19%	15.48%	16.20%	13.15%	16.43%	12.26%	10.55%	5.95%
	6	18.88%	16.56%	14.34%	15.90%	12.61%	13.55%	13.14%	12.38%	10.97%	5.93%
	7	15.54%	14.64%	15.99%	15.81%	13.72%	11.76%	11.00%	11.92%	11.06%	10.09%
	8	16.19%	13.54%	14.48%	14.04%	12.37%	13.79%	9.14%	10.68%	10.44%	8.87%
	9	13.02%	13.37%	11.97%	12.87%	11.11%	12.95%	11.86%	10.92%	10.61%	8.20%
(Largest Market Cap)	10	9.77%	9.54%	8.92%	10.53%	10.77%	9.01%	11.61%	10.19%	10.16%	9.61%

Source: 100 Portfolios Formed on Size and Book-to-Market (10 x 0)
http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#BookEquity

Even expanding to the lowest two deciles of market cap in conjunction with the lowest two deciles of price/book would have produced returns substantially above the market average.

Other studies coming to similar conclusions include one by *Morningstar* covering the period 1926-2009 which showed tenth decile capitalization stocks gaining 13.1% per year versus a 9.1% return for the top decile (largest) stocks. Another analysis by James O'Shaughnessy showed a 16.4% return from 1952-2003 for stocks with capitalizations between $100 million and $250 million versus 13.1% for those with capitalizations over $1 billion.

In our opinion, the primary reason why this excess return persists over time has to do with the inefficiencies created by institutional size and research coverage constraints. In addition, MicroCap stocks benefit disproportionately more from positive developments such as new products as well as the potential for premium takeover bids by larger companies. The relative return advantages of MicroCaps are in fact often compared to those of private equity funds, but with considerably more liquidity.

MICROCAP MYTHS

The MicroCap sector also tends to have low correlation to other capitalizations, providing true portfolio diversification benefits. Since 1967 the correlation of annual returns between capitalization deciles 1 and 10 has only been 0.60. Due to the low correlation and higher return profile overall, portfolio returns can be enhanced by an allocation of up to 10-20% in MicroCaps without any meaningful increase in overall portfolio risk.

Given such compelling data the obvious question must be asked, "Why don't all investors with a long term time horizon utilize MicroCap managers to invest a portion of their portfolio in the MicroCap-Value sector?" The answer to that question revolves around several myths which have been associated with the MicroCap universe. Below we explore and dispel these myths.

Myth #1: MicroCaps are equivalent to "Penny Stocks"

Many investors equate the term MicroCap to "Fly by Night" companies, start-ups, frauds, or other so-called "Penny Stocks". They see them as exceptionally risky and subject to a high rate of volatility and ultimate failure. While such stocks may well comprise a small portion of the MicroCap space, not all MicroCaps should be lumped into this category, especially those which meet the MicroCap-Value definition.

The most common definition of MicroCaps corresponds to the smallest 2 deciles of capitalization and generally includes companies up to approximately $500 million of market capitalization. It is not uncommon for MicroCap companies fitting this capitalization parameter to have several hundreds of millions, and sometimes over a billion, of annual sales volumes. Many of them have long histories, well known brand names and leading market shares in their niche categories.

Recent examples would include:

Company Name	Annual Sales	Market Cap
Invacare	$1.3BIL	$372MIL
Ruby Tuesday	$1.2BIL	$367MIL
Leap Frog Ent	$553MIL	$424MIL
Heidrick & Struggles	$502MIL	$370MIL
Lubys	$390MIL	$147MIL

Source: Factset

While it is true that due to their size and breadth of product line, many MicroCaps individually may have a higher risk profile than a larger cap stock, most of that risk can be diversified away by assembling a well-selected portfolio.

Myth # 2: MicroCaps are a Homogeneous Group

While in most capitalization ranges investors make a clear distinction between value and growth stocks, for some reason many investors try to lump all MicroCap stocks together. In fact, the Value/Growth distinction is at least as, if not more, important for small stocks. There is a vast difference in both risk profile and analytical approach between a $500 million revenue company which has a $300 million market cap and a start up company with $5 million in revenue and a $100 million market cap even though both may be classified as MicroCap. Referring again to the Fama and French study in Table 1, note the long term return differential between the two lowest price/book deciles of MicroCap stocks which average 20% per year and the two highest price/book deciles of MicroCap stocks which average a little over 4% per year over the last fifty years.

Myth # 3: Exposure to MicroCaps can be achieved through SmallCap exposure

Many investors view asset allocation only in terms of the "Nine Style Boxes" shown below:

	Value	Core	Growth
Large			
Mid			
Small			

Using this model, the only option to address the MicroCap universe is through the "Small" portion of the box. Thus, many believe that they are achieving MicroCap exposure via their SmallCap allocation. This approach provides less than optimum results for two main reasons:

- First, most SmallCap money managers have a very small allocation to MicroCap. Due to the size of their assets under management, it is often difficult for them to purchase MicroCaps without taking unwieldy large positions. Take for example a SmallCap manager with a one hundred stock portfolio managing a billion dollars. Even a one half of a one percent position, that would have minimal impact on performance, would require them to buy a $5 million position which would be quite difficult, particularly in the lower end of a MicroCap universe.
- Second, the skills and focus necessary to be successful in the MicroCap arena can be very different from those required of a SmallCap manager. As indicated earlier, many MicroCaps have little or no Wall Street analyst coverage which a manager can rely on.

According to *Morningstar* data, the average exposure that SmallCap value funds have to MicroCaps is only 3.7%. Therefore an investor who has even as much as a 20% allocation to SmallCap value funds may in fact have only three quarters of one percent invested in MicroCaps. This is hardly sufficient exposure to a sector which has such compelling historical returns.

Perhaps asset allocation should be considered utilizing the "Twelve Box" approach shown below:

	Value	Core	Growth
Large			
Mid			
Small			
Micro			

Myth # 4: It is okay to utilize index funds for MicroCap exposure

Here again most academic studies have concluded that while passive indexing may work in the efficient LargeCap universe, it does not work well in the inefficiently followed and less liquid MicroCap arena. Quoting a 2010 study published in *The Journal of Indexes,* "Money managers that invest in the MicroCap space have consistently achieved better benchmark relative results than their Larger-Cap focused peers." This makes logical sense: the

reason why indexing works for LargeCaps is that the information on those stocks is efficient because of the large number of analysts and investors that are researching them. Most MicroCaps are followed by only a few, if any, Wall Street analysts. The result is a level of inefficiency that can be exploited to provide excess return potential versus the benchmark. In fact, it has been estimated that the average MicroCap stock has fewer than three analysts covering it, with 25% having no analyst coverage at all.

In conclusion, the perpetuation of the above myths has prevented many investors from participating effectively in a market sector that has provided superior long term results. Also, even though they recognize the return advantage, some investors managing extremely large sums may shy away from MicroCaps feeling that they cannot invest enough to move the dial for their large asset base. This applies to both institutional fund sponsors as well as large asset managers. It is for these reasons that MicroCaps remain fertile ground for those who are also willing and able to incur somewhat more short term volatility to obtain superior long term results.

The final requirement is being able to identify a MicroCap experienced money manager who has a proven record of success and the capacity to manage additional dollars.

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