Micro Caps + Informational Inefficiency = Active Opportunities

A small space, with lots of room to explore

By Steve Swartley

It is largely accepted that markets become less efficient as total market capitalization declines. Small-cap stocks in general and micro-cap stocks in particular provide investors with a rich pool in which to attempt to generate excess returns. The primary advantage micro-cap investors have comes from the *informational* inefficiency. While the data for a smaller company is available since all public companies listed on regulated exchanges, large or small, have to file with the Securities and Exchange Commission, it takes effort and skill to synthesize the information necessary to determine whether or not a company is mispriced.

Micro-cap stocks, generally defined as those that range between a market capitalization of $50 million and $500 million, tend to be largely ignored by Wall Street analysts, so investors have to do their own fundamental analysis. Small companies also tend to have relatively simple business models with limited products and end-markets, however, which makes the task of evaluation somewhat less burdensome. Furthermore, while a company's senior management won't disclose nonpublic information, the CEO or CFO of a smaller company is more likely to actually pick up the phone and answer questions, as they are eager for exposure and recognition from the marketplace. For an investor, the increased likelihood of contact with a key decision-maker is just one example of an opportunity to develop superior insight on a stock.

For those willing to put in the effort, there are thousands of investment opportunities in the micro-cap space. Have managers been able to take advantage of the opportunity? The short answer is yes. Money managers that invest in the micro-cap space have consistently achieved better benchmark-relative results than their larger-cap-focused peers. In seven of the past nine very volatile years, the benchmark-relative excess return for the average micro-cap manager has exceeded that of small-, mid- and large-cap managers.

It is important to keep in mind that viewing the micro-cap space as a separate investment category is a fairly recent development, and there simply aren't that many products that are categorized as micro-cap. The performance results in Figure 1 come from the "frozen" Russell universes, meaning they include only the performance of products that were actually in the universe at the time and not the backfilled results of the current members of the universe.

Since the launch of the Russell Microcap Index in 2005, approximately 30 managers have had their products included in the micro-cap manager performance universe each year, compared with only 15 in 2001. There are numerous theories as to why the market has been slow to more fully embrace the micro-cap space. For individual money managers, even if they are able to charge higher fees for a micro-cap product, it may not make economic sense for the firm to offer a product, as the available capacity should be quite limited due to the relative illiquidity of the space. Larger institutional clients, on the other hand, often find it difficult to invest enough money in the space to meaningfully impact their overall portfolio's returns. The limited number of products included in the performance universe also reflects certain restrictions such as a minimum level of assets under management and that the product is fully invested.

As has been historically the case, the market's most recent recovery has been led by micro-cap stocks. From the low of March 9, 2009, through the end of the first quarter of 2010, the Russell Microcap and small-cap Russell 2000 indexes have produced cumulative returns of 90.9 percent and 88.7 percent, respectively, and each has outperformed the large-cap Russell 1000 Index by 17.3 percent and 20.5 percent, respectively. Even in this environment, micro-cap managers have been able to add considerable value. As seen in Figure 2, there were clear longer-term advantages that could have been capitalized upon when invested in micro-cap stocks.

Of course, free lunches get eaten and there is certainly greater volatility in the Russell Microcap Index. However, the magnitude of the difference may be surprisingly small. The nine-year annualized standard deviation for the Russell Microcap Index is 26.2 compared with 23.4 for the Russell 2000 Index and 21.7 for the Russell Midcap Index. Interestingly, the longer-term risk-adjusted return is the same for the Russell Microcap and Russell 2000, and both exceed that of the Russell 1000.

What Is A Micro-Cap Stock?

While it is easy to compare the market capitalization of one stock with another's, there wasn't an objective benchmark in which to help classify micro-cap stocks as a group

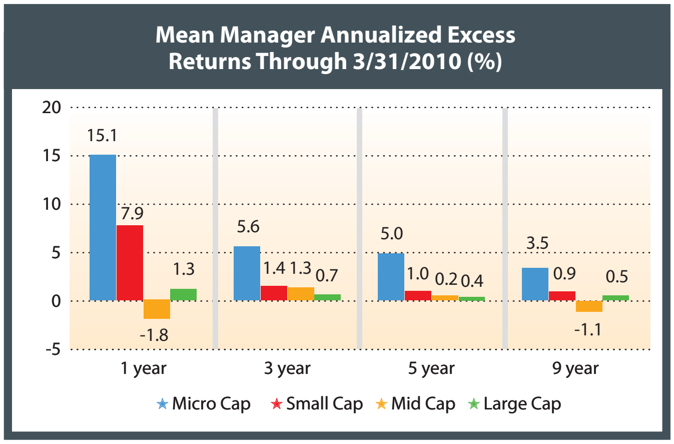
Figure 1

Mean Benchmark-Relative Excess Return For Active Managers

Russell Manager Universes: U.S. Equity	2009	2008	2007	2006	2005	2004	2003	2002	2001
Micro Cap	**15.08**	-2.05	**10.14**	**-0.60**	**7.89**	**3.66**	-6.76	**1.15**	**4.96**
Small Cap	7.86	-4.02	4.82	-3.35	3.55	-1.01	**0.78**	**1.15**	1.62
Mid Cap	-1.83	**0.85**	4.07	-1.87	-1.31	-2.00	-0.57	-4.22	-3.08
Large Cap	1.30	-0.50	2.14	-1.47	1.06	0.44	0.66	-0.40	1.63

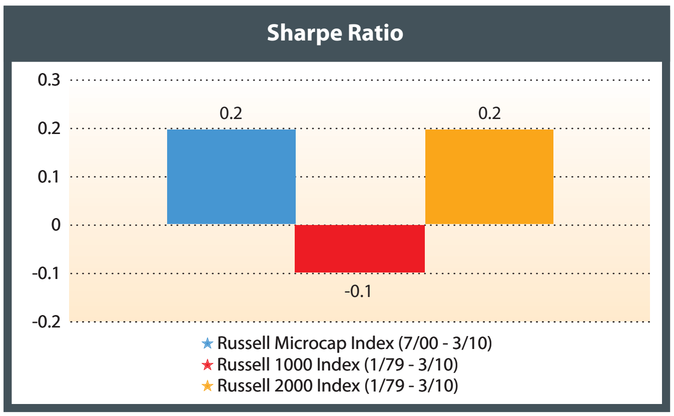
Source: Russell Manager Universes
Indexes and universes are unmanaged and cannot be invested in directly. Returns shown here and in subsequent figures represent past performance, are not a guarantee of future performance and are not indicative of any specific investment.
Note: Data are based on Russell Manager Universes. The benchmark for micro-cap equity is the Russell Microcap Index; for small-cap equity, the Russell 2000 Index; for mid-cap equity, the Russell Midcap Index; for large-cap equity, the Russell 1000 Index.

Figure 2



Source: Russell Microcap Universe

Figure 3



Sources: Russell Index Group and MPI Stylus

until 2005, when Russell launched its index to help define this market-cap space. (At the time of the launch, Russell used the same construction methodology to reconstruct five additional years of performance for the Microcap index, which is why the unusual nine-year numbers are being referred to throughout this piece.) The microcap index comprises the smallest 1,000 stocks in the small-cap Russell 2000 Index plus an additional 1,000 smaller companies.

Following the market's meltdown in 2008, the overall valuation of the market declined sharply and, for the first time in the history of the micro-cap index, there weren't enough stocks that passed the construction methodology rules to reach 2,000 index members. At the time of the annual 2009 index reconstitution in June of 2009, the market cap for the smallest position was $30 million, the largest was $375 million and the weighted average was $193 million. As of March 31, 2010, with the recovery of the market, the weighted average market cap for the micro-cap index had grown to $260 million.

Over 50 managers are currently providing Russell with their portfolio holdings, which allow our research analysts to see where the managers are positioned relative to the benchmark. On average, the managers' largest over-weighted sectors are energy services and producer durables, while they are underweight health care and financial services as of the end of March 2010 (see Figure 4). Valuation metrics are largely similar except for the manager's greater avoidance of negative earnings and willingness to pay up for companies with stronger cash flows. Managers are also showing a preference for greater forecasted growth and higher return on equity.

Figure 4

1Q10: Active Managers Vs. Microcap Index

	Manager Average	Microcap Index
Market Cap ($ Wtd Avg $billion)	0.25	0.26
Technology	18.5%	17.7%
Health Care	11.7%	16.6%
Cons. Disc. and Services	16.9%	15.4%
Consumer Staples	3.2%	2.4%
Energy Services	7.4%	3.3%
Materials and Processing	7.3%	6.3%
Producer Durables	18.7%	12.1%
Financial Services	14.0%	23.9%
Utilities	2.2%	2.3%
Portfolio P/E	54.8	-239.5
Portfolio P/E Excluding Neg. Earnings	17.6	18.9
Portfolio P/E - I/B/E/S 1Yr Forecast EPS	16.2	16.8
Portfolio Price/Book	1.5	1.6
Price/Cash Flow	15.6	33.0
Portfolio Price/Sales	0.9	1.0
L.T. Growth Forecast - I/B/E/S Medians	15.0	14.3
1 Year EPS Forecast - I/B/E/S Medians	13.7	11.9
Return on Equity - 5 Year Avg	9.1	5.0
EPS Growth - 5 Years	6.0	0.6
EPS Variability - 5 Years	71.1	79.9
EPS Variability - 10 Years	117.2	112.9
Beta (vs. R3000)	1.3	1.4

Source: Russell profiles

The sector exposures of the Russell Microcap Index are similar to that of the Russell 2000 Index, with financial services, technology, health care, consumer discretionary and services, and producer durables accounting for more than 85 percent of the index's weighting. Likewise, the two indexes are largely similar in terms of valuation, with the exception being the large proportion of micro-cap stocks that have negative earnings, which significantly impacts the P/E ratio. Compared with the Russell 2000, the Russell Microcap has a lower return on equity and assets (often proxies for quality), higher earnings variability and, with less access to capital, lower debt levels.

The Challenge And The Opportunity

Two of the greatest challenges when trying to invest in a micro-cap stock are often the liquidity and trading costs. While the challenges posed by investing in more illiquid

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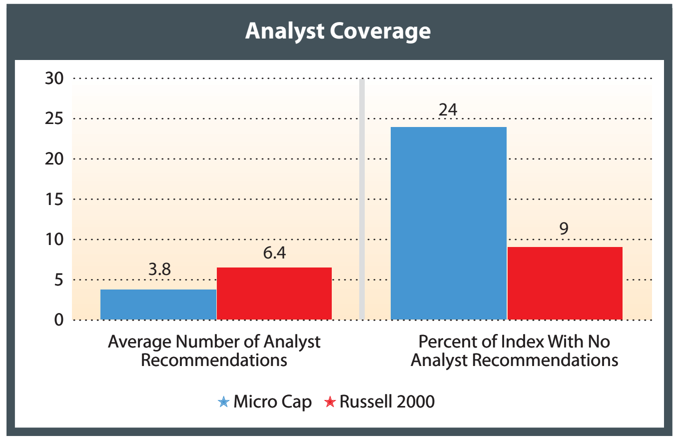
stocks can't be completely eliminated, active managers can choose which stocks they want to hold and can avoid the most illiquid. In fact, within a benchmark that contains 2,000 stocks, micro-cap managers will typically hold only 100 individual names. Likewise, with the increased use of electronic crossing networks—especially for managers that are liquidity providers as opposed to demanders—transaction costs can be managed to a certain degree.

An interesting development to watch going forward will be the growth and adoption of micro-cap exchange-traded funds. The obvious benefit ETFs provide is a relatively inexpensive means to capture micro-cap exposure. While active managers have shown the ability to add value in the space over longer periods, manager performance patterns tend to be cyclical, leading to specific periods where passive exposure to the micro-cap space would have been preferred. For active managers, ETFs can be seen as another source of liquidity. One double-edged sword, however, is that ETFs hold a considerably larger number of stocks, including a large portion of stocks not widely held by active managers. Large fund flows, then, could significantly impact benchmark-relative performance. For example, significant inflows in passive micro-cap funds would drive up prices in general, including benchmark holdings not widely held by active managers, negatively impacting the relative performance.

Figure 5



Source: Bloomberg, as of 3/31/2010.

Investors across the market-capitalization spectrum are seeking to identify mispriced securities. One advantage the micro-cap space offers is that the lack of Wall Street coverage provides a greater opportunity to develop insights not yet identified by the broad marketplace. If the investor has in fact identified a mispriced stock, and if the company is able to operate effectively, the stock should benefit from the discovery effect as others begin to recognize this formerly unknown company and help drive the price up.

Disclosures

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