Seven Reasons to Invest in Micro Caps — and How to Do it Right

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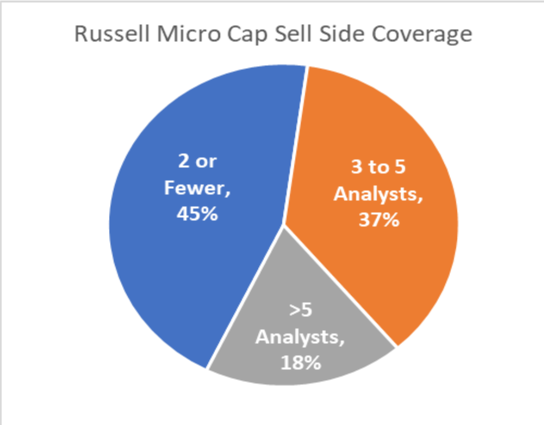
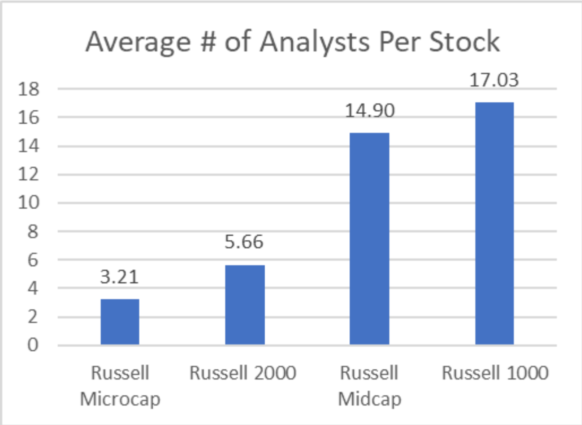
Savvy investors have long understood the benefits of small-cap stocks. They know that an allocation to a less-efficient area of the market can improve the risk/return profile of a portfolio. The same and more can be said about micro caps. It is a highly inefficient market segment where large, widespread information gaps and security mispricing can be exploited to achieve significant alpha. But the idiosyncrasies that make micro caps so compelling also underscore the need for careful stock selection and in-depth research. Active management, as well as thoughtful execution and a long-time horizon can be critical for success with a micro-cap allocation.

Micro Caps Have Much to Offer

Below are seven of the best reasons to make an allocation to micro-cap stocks.

1. **Less coverage and information inefficiencies create more opportunity.**
The micro-cap asset class is characterized by a scarcity of reliable, high-quality information that the markets generally use to accurately assess a company's business value. While all public companies need to file annual and quarterly SEC reports, micro caps often have relatively small and lean management teams that do not produce much easily digestible investor information. At the same time, micro-cap stocks are less followed, less researched, and less covered than their larger-cap counterparts. For each micro-cap stock, sell-side analysts typically generate, at most, three price estimates. That compares to 17 for the average large-cap stock. And more than 19% of micro caps have no sell side coverage at all. Specifically, a full 45% of the stocks in the Russell Micro Cap index have fewer than 2 analysts' coverage.



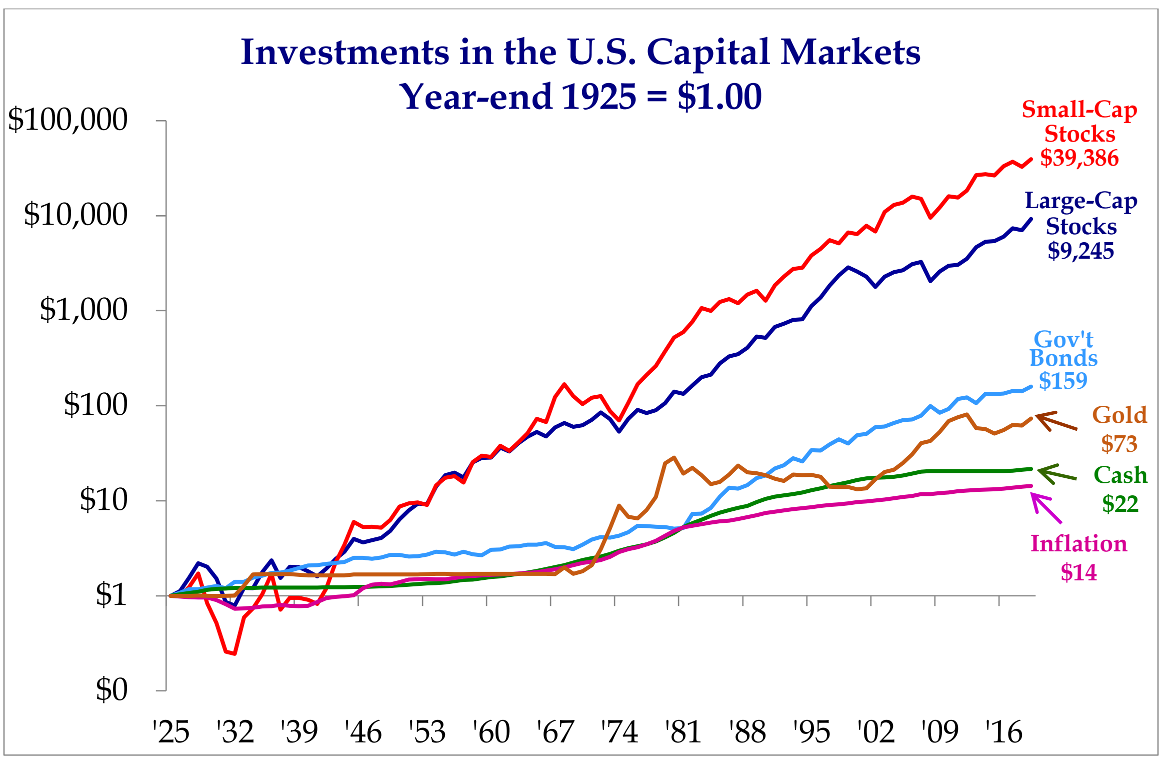


Source – Essex, Bloomberg (as of 9/18/2020). Average of the total number of analysts contributing recommendations to Bloomberg for each security in the stated Index.

In practical terms, sparse analyst coverage means that there's often no clear market consensus about the value of a change — such as a management decision to expand a product line, enter a new market or cut costs — that may be a meaningful growth catalyst. That inefficiency provides a wide window of opportunity to uncover undervalued stocks well before they have been recognized and fully valued by the broader market.

2. Smaller stocks generate higher risk-adjusted long-term returns.

Empirical evidence shows that both small and micro caps have provided higher risk-adjusted long-term returns than large-cap stocks. The reason may be what has been coined the "small firm effect." In an efficient market, stock prices reflect their inherent risk: the higher the systematic risk of a portfolio, the higher the potential returns. But multiple studies using various methods have confirmed an anomaly to this rule: portfolios of the smallest companies provide investors with higher returns for the same level of risk.

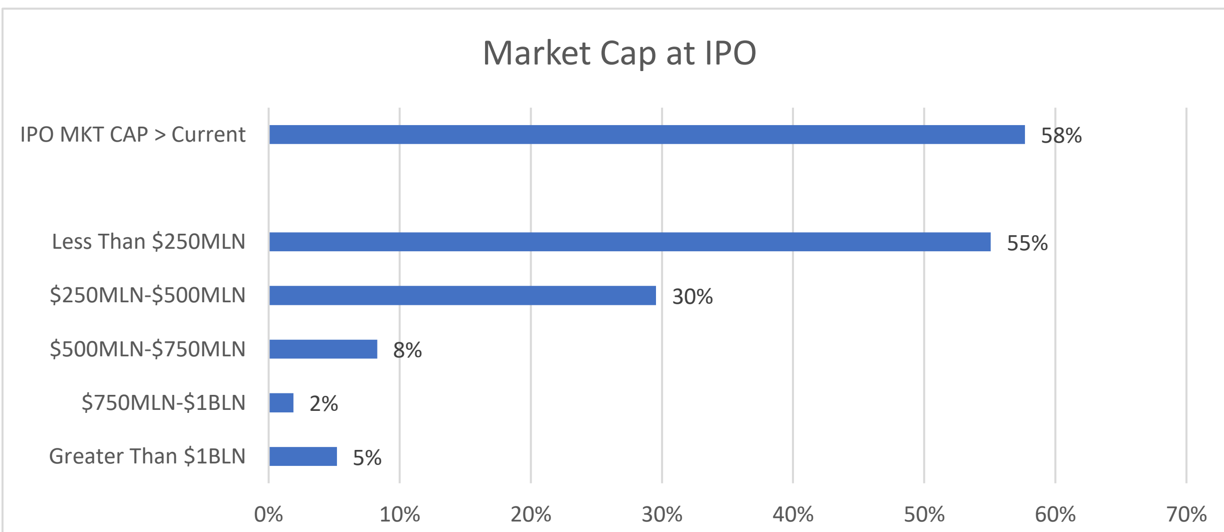


Source – Essex, Strategas (01/01/1926 – 12/31/2019).

3. **Many micro-cap companies have a track record of success.**

Although each micro-cap company is unique, a common storyline shared by many includes time as a successful business. Many micro caps had an initial public offering that was in the high end of the small-cap or even mid-cap range. But then they faltered. They may have missed a product cycle, or the market shifted, or the original owners were not equipped to effectively manage cash flows. Whatever the reason, the companies stopped meeting Wall Street expectations. Their investors lost faith and sold off, driving down stock prices and market capitalizations.

For much of Wall Street, that is where the stories end. But some of these stocks will have a second life. Some companies will fix their problems. For example, they might reform the management team, address operational inefficiencies, or discover an untapped market for their technology.

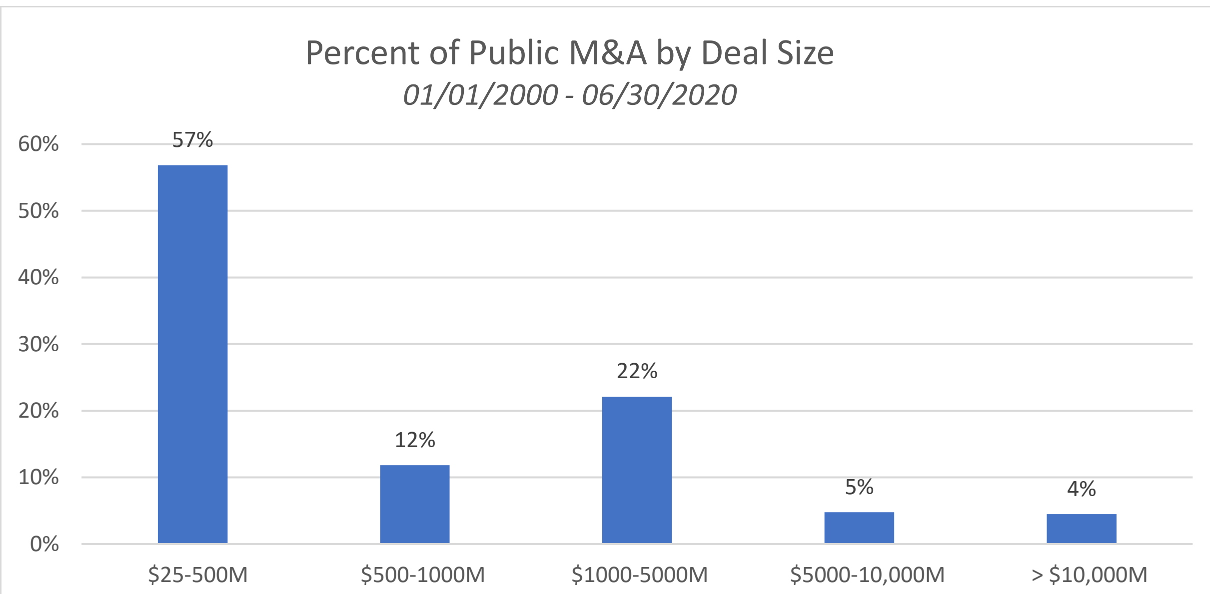


Source – Essex, Bloomberg, Data Set = RMICRO stocks w/ current market cap <$500 that had IPO post 10/01/2000-06/30/2020. Average current Market Cap as of 9/14/2020 is $213mln. Average IPO Market Cap was $320mln.

4. Micro caps offer a cost-effective, more liquid alternative to private equity.

Many pension funds and other institutions struggling to meet liabilities are choosing a micro-cap allocation over private equity or venture capital to achieve similar investment objectives. Successful micro-cap stocks often exhibit the J-shaped growth curves that make private equity and venture capital so compelling, but with lower fees and without the multi-year lock-up requirements.

Other comparisons also favor micro caps. Unconscious bias may skew the valuations of both private equity and micro caps, but in opposite directions. With little reliable information about a micro-cap stock, public market participants tend to err on the side of undervaluing these securities. On the other hand, the unlisted companies that make up private-equity portfolios are generally assigned values by the firms that own them — and that have a vested interest in higher valuations. In addition, the holdings in private-equity funds are generally more highly leveraged than those of micro-cap portfolios.



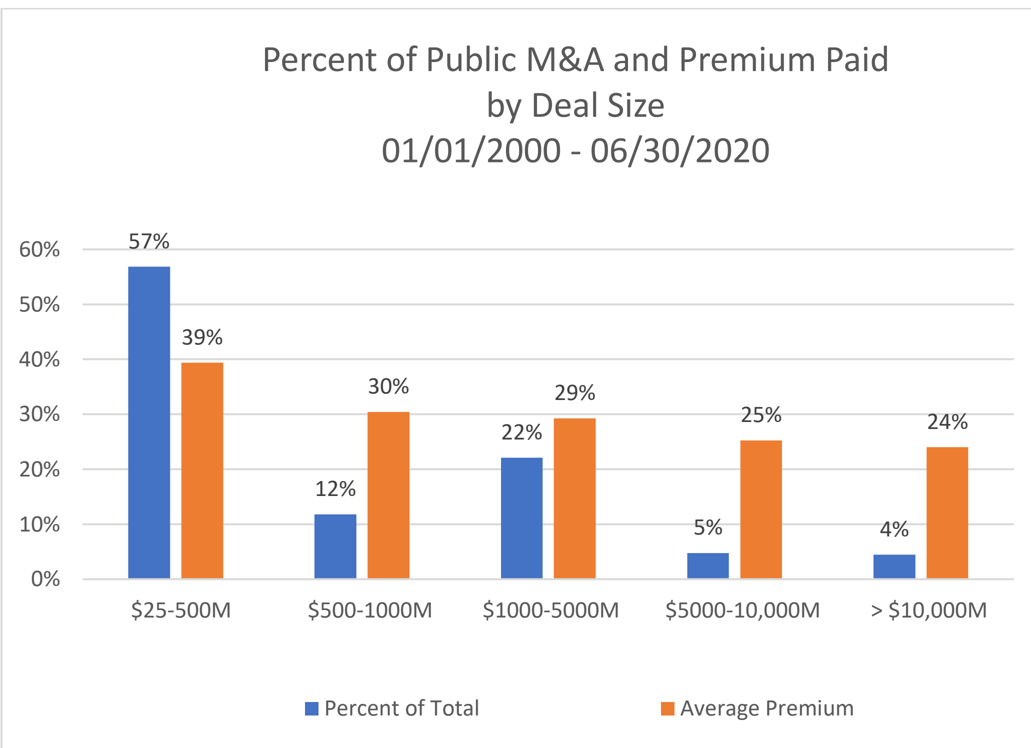
Source – Essex, Bloomberg (01/01/2000 – 06/30/2020).

5. Micro-cap stocks can have explosive growth.

Many micro-cap companies produce the critical components that feed companies higher up the market-cap food chain, including today's technology giants — industry leaders that are adept at leveraging disruption to find previously untapped markets for their products and services. That expansion often directly translates into growth for their smaller suppliers.

At the same time, with small balance sheets, micro-cap companies can achieve dramatic margin improvements through only modest revenue gains or cost reductions. For that reason, it's not unheard of for a micro-cap stock to double or triple in value over a single year.

In addition, healthy and growing micro-cap companies often become targets for acquisition by larger companies or competitors that understand their business value better than the broader market. The result can be a sales price that brings an immediate and significant boost to shareholder value. A Furey Research Partners 2019 study found that more than half of all public M&A transactions since 1993 have involved micro-cap equities with the average acquisition premium paid for micro-cap companies more than double that paid for large-cap companies.



Source – Essex, Bloomberg (01/01/2000 – 06/30/2020).

6. Most institutional portfolios are under-allocated to micro caps

Even if you have a small-cap allocation, chances are that you do not have meaningful exposure to the opportunity set offered by a true micro-cap strategy. Many portfolio managers simply ignore the smallest of the small caps. In fact, of the 300 active small cap strategies in the eVestment database, 75% exceed the weighted average market capitalization of the small-cap benchmark Russell 2000. While the average excess was 36%, the larger the manager, the larger the market cap bias.

7. Low correlations reduce portfolio risk.

Although interest rates and other macro-economic factors may impact the stock market as a whole, micro caps typically do not move in lockstep with large caps or even small caps. And since each micro-cap company's path to success is unique, their turnarounds generally do not coincide with those of other stocks, including those in similar sectors or industries. These low correlations provide some measure of diversification to a broad equity portfolio, as a decline in one stock or group of stocks may be offset by gains in another.

Micro Caps can provide Diversification benefits

Market Cap Correlation 06/01/2005 - 06/30/2020 (Monthly)

Color scale highlights lowest correlation

Asset Class	S&P 500	Barclays US Treasury Index	Barclays US Treasury Bill Index	iBoxx USD Liquid Corp. Investment Grade Index	iBoxx USD Liquid High Yield Index	Refinitiv Core Commodity CRB(R) Index
Russell Microcap Index	0.879	-0.428	-0.186	0.277	0.693	0.492
Russell 2000	0.914	-0.398	-0.152	0.294	0.710	0.502
Russell Midcap Index	0.964	-0.358	-0.166	0.393	0.776	0.564
Russell 1000	0.999	-0.349	-0.148	0.361	0.734	0.530

Source – Essex, Bloomberg (06/01/2005 – 06/30/2020).

Thoughtful Execution Helps Ensure Success

Arguably, there is a right and a wrong way to invest in micro caps. With a thoughtful implementation process, even large investors can leverage the micro-cap opportunity set.

Allocate strategically.

Given the high long-term reward potential, an allocation to micro caps makes sense for many investors, including large institutions with significant funds to invest. These larger investors run the risk that their purchases and sales through a single micro-cap strategy might impact share prices. However, they can still achieve meaningful exposure to the micro-cap opportunity set through a multi-manager structure. Alternatively, investors can expand an existing small-cap allocation to include a small-cap manager that offers exposure to micro caps. Regardless of the approach, it is important to find managers with the experience, expertise, and a proven track record in the micro-cap space.

Leverage active management.

Skilled active management is the key to unlocking value in micro caps. More than in any other capitalization range, the opportunities and risks of micro-cap stocks are highly company specific. Some of these businesses will effectively position themselves for future success, and some will not. In contrast to a data-rich, efficient market where a well-crafted algorithm generates useful results, in the micro-cap space, artificial intelligence cannot uncover the needed, but hard-to-find information that tells the real story of a company's value. Rigorous, bottom-up fundamental research is the only reliable way to find the stocks that are poised for growth.

For example, while the quality of company management is an important factor across the capitalization spectrum, particularly close scrutiny is needed for micro caps. The leadership team may need to manage unique risks associated with narrow sets of products, services, or geographies, as well as higher costs of financing. Yet because micro-cap leadership teams may have fewer resources to dedicate to managing Wall Street expectations, they may not be able to put a positive spin on information that is negative or neutral. A micro-cap portfolio manager needs to dig deep into the data to separate signs of weaknesses from what sounds bad only because the management team is more focused on running the business than on pleasing Wall Street.

But there is another reason passive investing in micro caps does not make a lot of sense: the indexes that serve as the benchmarks present a distorted reflection of the micro-cap universe. If you were to invest in a strategy that tracks the Russell Microcap Index, more than half of your portfolio would be companies in the health care and financial sectors. More than 50% of the Russell Microcap Growth Index is health-care stocks and more than 40% of the Russell Microcap

Value Index is financials. What's more, the average market capitalization of these micro-cap benchmarks has risen over the past several years as the U.S. equity investment universe as a whole has shrunk. Simply put, these indexes do not offer a well-diversified representative mix of micro-cap stocks.

Be patient.

While market timing is always difficult, it is practically impossible to predict when a micro-cap stock's time will come. The best approach is to do the work to find a variety of well-positioned, but mispriced securities and then exercise patience. Long holding periods that allow for variable entry times can help maximize the power of micro caps to deliver exceptional returns over the long term.

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