Institutional Investor

VOL. XVII, NO. 10 / October 2014

Your Exclusive Pipeline to Managing Investments for Nonprofits

Foundation & Endowment Money Management

The monthly issue from Foundation & Endowment Intelligence www.foundationendowment.com

ASSET CLASS

Int'l Micro-Caps An Attractive, Overlooked Market?

The size and relative inefficiency of the international micro-cap marketplace make it a compelling bet for nonprofits, according to industry experts **Bhanu Singh**, a v.p. and portfolio manager at Austin, Texas-based **Dimensional Fund Advisors**; **Marco Priani**, a portfolio manager at **Advisory Research** in Chicago; **Machel Allen**, president and ceo at San Diego, Calif.-based **Metis Global Partners**; **Joshua Moss** and **John Scripp**, directors and portfolio managers at **EAM Investors** in Cardiff-by-the-Sea, Calif.; and **Marcel Houtzager** and **Peter Zaldivar**, principals and co-portfolio managers at Chicago-based **Kabouter Management**. Companies with a market capitalization less than $750 million are generally considered micro-cap.

***FEMM:* Why would an endowment or foundation seek to invest in international micro-cap?**


Bhanu Singh

Singh: The small-cap premium is well documented in both developed and emerging markets throughout the world. This premium can be even stronger in the micro-cap space, so it is a good idea to consider including these companies in a portfolio.

Priani: Temporary inefficiencies are more readily present (limited sell-side coverage, smaller number of investor eyeballs compared to the larger-market-cap equity classes), and diversification benefits are higher compared to large-cap international investing. Increased diversification results from the fact that micro-cap companies are usually more locally oriented, whereas the larger market caps tend to be subject to global trends. Another reason is that the long-term investment horizon of endowments and foundations help mitigate a key micro-cap risk: liquidity.

Allen: We actually refer to global micro-caps as the "alternative to alternatives," as they tend to reflect many of the attractive attributes of an alternative investment, such as private equity, but without the high fee costs or liquidity lock ups. Historically, global micro-caps have offered low correlations to other equities and even negative correlations to U.S. fixed income. The value premium in the micro-cap universe is significant, at three times larger than that seen in U.S. large-cap stocks.

Scripp: The international micro-cap opportunity set represents what we consider to be the inefficient frontier of emerging and developed markets, characterized by an extremely large selection universe that is relatively less followed by analysts. According to our research, the universe of potential investments in international micro-cap (companies with market caps between $110-750 million) consists of approximately 8,000 companies in both developed and emerging markets (excluding mainland China and frontier markets). This is roughly two-and-a-half times the size of the U.S. small- and micro-cap universe. In addition, the average international micro-cap company isn't well followed. On average, only 1.6 analysts follow the typical micro-cap company and only about 56% of the universe is followed by even one analyst. This compares to the average ex-U.S. large-cap company with 15.3 analysts following the company and about 88% of the universe followed by at least one analyst.


Marcel Houtzager

Houtzager: The international small- and micro-cap space is where companies are not as staffed up with MBAs and consultants, particularly in the area of investor relations. As a result, friendly activism is more effective than with well-advised U.S. large-caps, which allows further outperformance. It is a large asset class where it is possible to gain exposure to industries, sectors, or themes that are not well-represented in the large-cap universe.

***FEMM*: What are the risks in micro-cap investing?**

Allen: One of the biggest myths concerning the risk of investing in global micro-caps is that they are young, "start-up" companies. In fact, the average age of a global micro-cap company is 31 years. The actual risks are similar to other global small-cap companies, but perhaps a little more magnified in some areas. The quality of financials and fundamental information for micro-cap companies can be challenging, particularly in non-developed markets (about 35% of the global micro-cap universe is domiciled in emerging- and frontier-market countries). Price volatility can be higher than larger caps, in spite of the meaningful correlation benefits micro-caps offer. And, some of those desirable correlation benefits actually come from lower liquidity in micro-caps.


Peter Zaldivar

Zaldivar: Liquidity in international micro- and small-caps can dry up in times of crisis. Fortunately, the universe of international micro- and small-caps is huge with over 14,000 investable stocks with market caps between $100 million and $3 billion. There is plenty of scope to build portfolios of companies with reasonable free floats. In addition, there are usually block-trading opportunities where even if volumes appear low in a given stock, a large block of stock can usually be placed without difficulty. If speed is desired, block trades at discounts are generally possible.


Marco Priani

Priani: Although recent academic research seems to contradict conventional wisdom to some extent, the generally accepted view is that liquidity risk is higher in micro-cap investing. For an investor with a longer-term view, such as a foundation or an endowment, this could be a source of opportunity rather than a risk. For example, investors with a long-term time horizon can buy stocks in depressed markets when shorter-term oriented investors are selling. Another risk for micro-caps is that in a credit crisis or an economic downturn weaker companies are more likely to suffer under credit access limitations compared to larger caps. Another source of risk is that corporate governance might not be as strong and developed as in large public companies, with potentially lower regulatory oversight.

***FEMM*: Which micro-cap sectors are most appealing currently? Which countries or regions are most appealing?**


John Scripp

Scripp: EAM operates a bottom-up investment process with no top-down sector, region or country biases. Our process looks for the best micro-cap, company-specific ideas across all markets and sectors outside of the United States. Currently, within our international micro-cap portfolio, we have an overweight posture to South Korea and Taiwan, and have seen a significant increase to Japan more recently.

Zaldivar: We currently like health care, business services, niche manufacturers and specialty finance companies. We typically avoid banks, commodity-related companies, and deep cyclicals. Regionally, we look everywhere, and our weightings typically reflect the relative size of company inventories that meet our criteria in each region. We are a tad underweight in Japan and slightly overweight in the United Kingdom and Europe in general.

Allen: Our global micro-cap portfolio is currently heavily positioned in cyclical industries like chemicals, metals and mining, oil and gas, and auto components. Many of these businesses operate out of Asia, including Japan, so our portfolio has significant allocations there as well.

***FEMM*: What should one look for in an international micro-cap manager?**

Priani: In this space, the most effective asset manager takes advantage of all the tools of fundamental research and does not pick stocks blindly from screens. A qualitative dialogue with management as part of the investment process is key in micro-cap investing—usually the smaller the company, the more candidly an asset manager can engage with key company personnel regarding their conviction in strategies and judge whether they are capable of executing them. An unwillingness by the company to engage in dialogue with a potential investor is usually a red flag. Another way in which micro-caps are well suited for fundamental research is that they are usually engaged in a single line of business, allowing the investor to have a deep and detailed knowledge of the operation.

Houtzager: Clearly it helps if the manager is experienced in international markets. We would also evaluate the ratio of investment professionals to the number of stocks in the portfolios (lower may be better up to a point). Given the inefficiencies in the asset class, we have found that friendly activism can pay dividends. A manager with an activist bent should have an edge. We believe that trading costs and the labor intensity of the due diligence process argue against any strategy that relies on trading alone.


Machel Allen

Allen: There are several key attributes I believe increase the probability of successful investing in global/international micro-caps. First, a deep knowledge of global financial data and its sources. It is messy, not uniform, and requires meaningful experience with global financial data to address the quality issues that often present themselves in the micro-cap space. Second, robust global trading capabilities. Companies of this size can be illiquid. Finally, active management. This is the dream universe for active value investors: huge opportunity set, lack of information flow, substantial mispricing, and limited penetration by other institutional investors.

Singh: Managing international small-caps is not the same as managing U.S. large-caps. It is worth finding managers with a lot of experience in international small-caps and who have lived through many market conditions. Since some of these countries are more prone to instability than the U.S., managers with integrated portfolio management and trading processes who have a presence in the time zones where the securities are being traded should be considered. This helps ensure recent news is incorporated into buy and sell decisions as these companies' prices can move a lot in a short period.

Moss: Like any investment strategy, we believe it always comes down to people, philosophy, and process. However, international micro-cap investing has some important idiosyncrasies that we feel need to be considered. First, due to the vast number of companies across 45 different countries, we believe it is essential to have an objective and systematic process to identify potential investment candidates. Furthermore, once a potential candidate is identified, we believe an efficient and focused research process is paramount to transform ideas into alpha in a universe where timing is absolutely critical due to the volatile fundamentals of micro-cap companies. In addition, because micro-cap companies are more fundamentally volatile than larger companies, we believe a thoughtful approach to risk management and portfolio construction is necessary to optimize risk and return.


Joshua Moss

http://www.foundationendowment.com/Article/3386958/Search/Intl-Micro-Caps-An-Attractive-Overlooked-Market.html