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Improving Economy, Strong Dollar Put Micro-Cap Equities In The Spotlight

Investors could soon turn to U.S. micro-cap stocks to take advantage of an improving economy, the rising dollar and possibly increasing interest rates. U.S. **Federal Reserve Board** Chair **Janet Yellen** has recently dropped her "patience pledge" in her talks on raising interest rates, and the industry is looking at a possible hike in rates as soon as June. Separately, the U.S. dollar is very strong right now, which means investments in other currencies could struggle. Both of these factors matter to the micro-cap market—when the economy is doing well and interest rates rise, small- and micro-cap investments are better able to take advantage, according to industry experts.

Richard Shuster

"Right now would be a better time than normal to buy these stocks," **Richard Shuster**, senior portfolio manager at **WPG Partners**, said. "The most obvious reason to invest is for the returns, but it is also offering investors a way to own things they just normally would not own. Your average private equity deal has 40 people biding at once, but in micro-cap we are investing in things that hardly anyone bids on." WPG focuses on domestic micro-cap equities. Shuster added that when the dollar is strong, it is better for smaller companies because not as much of their earnings come from abroad compared to large-cap companies.

The micro-cap universe is valued at around $10 billion, according to Shuster. WPG's Micro-Cap Opportunities fund returned 45% for the one-year period ending on Dec. 31, 2013 compared to 21% for **Cambridge Associates**' U.S. Private Equity index. Data from 2013 was the most up-to-date information WPG provided. The **Russell** Microcap index had an annualized return of 18.9% for the three year period ending Feb. 28. Public micro-cap stocks are often comparable to venture-capital private equity investments, since they both focus on small, less-established companies. Compared to domestic large-cap equities, which returned 15.6% on average since 2010, micro-cap returned 16.2%.

Machel Allen

"Generally speaking, smart money and smart investors want to be somewhere before everyone else is," **Machel Allen**, cio at **Metis Global Partners**, said. "For value investors, this is truly a dream space. But the main question we hear is 'If I'm an institutional investor how should I be thinking about implementing this in my portfolio?'" Metis focuses on global micro-cap.

Plan sponsors have been slow to answer that question, despite a couple of notable investments in the past year. The **Oregon Public Employees Retirement System** earmarked $550 million for international micro-cap strategies last March and committed $150 million to **Dimensional Fund Advisors** and $100 million to **EAM Investors** (MMI*,* 3/14); the **Florida State Board of Administration** committed $125 million to a domestic micro-cap strategy run by **Acuitas Investments** in October; and the **Los Angeles Fire & Police Pension System** is currently evaluating small- and micro-cap managers for a $25 million mandate.

"The micro-cap [mandate] was added because the board felt with a small allocation it would be a worthwhile investment, the space can be inefficient and a good active manager can achieve positive returns," said **Ray Ciranna**, general manager at the Los Angles Fire & Police Pension System.

Some plan sponsors do not allocate to micro-cap simply because their consultants do not research or recommend the sector. "The consultants are key to allocations becoming more common place," Allen said. "We have spoken with a few consultants who have done some research on the global micro-cap space, but largely this space remains undiscovered and unused by them. I think the consultants who become knowledgeable of the benefits of this space first and develop approaches to successfully implementing it have the most to gain on behalf of their institutional clients."

However, many consultants are not fully on board just yet. "Because of the market capitalization of micro-caps, active managers in this space are restricted in terms of fund size," **Ian Toner**, director of strategic research at **Wurts & Associates**, said. "The institutions that have complex enough portfolios to justify considering allocating specifically to micro-cap assets are often larger in size. Taking the size of potential allocation into account, larger institutions might reasonably decide that micro-caps will find it hard to move the needle on total portfolio performance, at least on a cost-benefit basis. Similarly consultants will generally focus their time and resources on areas which can have significant impact on client portfolios."

Ian Toner

Even so, there have been signs of increased interest over the last couple of years. MMI previously reported that micro-cap product views, as measured by **eVestment**, averaged about 10 views per month in November of 2013 (MMI, 12/19). This was measured on a rolling six-month average. By November of 2014, on a rolling three-month basis, product views had increased to an average of 20. For the three-month period ending this past February, there was a slight decline to 18.

"Slowly, we are starting to see more consultants bring in micro-cap research," Shuster said. "And over time, as people get frustrated with low rates of return in [other] market-caps, they will look at micro-cap."