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# The Next Big Thing Could Be Really Small:

Considerations for Integrating  
Global Micro Caps into A Portfolio



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This report will present several options for integrating GMCs into portfolios.

# The Next Big Thing Could Be Really Small: Considerations for Integrating Global Micro Caps Into A Portfolio

## Gaining Access to the Potential Global Micro Caps Offer

In the research report, “The Next Big Thing Could Be Really Small: An Introduction to Global Micro-Cap Stocks,” the Brandes Institute and Metis Global Partners explored the unique characteristics of global micro-cap (GMC) stocks<sup>1</sup> and why they represent a compelling asset class for institutional investors. Findings included GMCs’ historical returns, diversification benefits and their vast and inefficient opportunity set.

Continuing our collaboration with Metis Global Partners, we explore how investors incorporate GMCs into their portfolios.

1. Micro-cap stocks can serve as a straightforward, active component of an existing equity allocation.
2. Due to their unique characteristics, micro caps may have a role as an alternatives allocation—or as an “alternative” (or complement) to alternatives, such as private equity or hedge funds.

Of course, before adding any new asset class, due diligence efforts should investigate possible risks. Risks specific to global micro caps can include trading costs, liquidity, transparency and custody.<sup>2</sup> At the same time, misperceptions about these issues have created opportunities, and this report will present several options for integrating GMCs into portfolios.

## Adding to a Portfolio’s Existing Active Return Component

### *Extending Existing Equity Exposure with GMCs*

The most straightforward manner in which to add GMCs is to augment existing equity allocations. Investors may use GMCs as a replacement or complement to existing small-cap equity allocations; they also may invest in micro caps as a potential alpha-generating spoke in a core/satellite framework. Each approach offers compelling benefits and risks.

Investors who already have commitments to the return-enhancing potential of small-cap stocks can extend the range of their mandates further down the capitalization spectrum and across regions with micro caps.

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### INCORPORATING GMCs

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1. Extension of existing equity allocation
  2. Complement to alternatives such as private equity or hedge funds
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<sup>1</sup> There are more than 20,000 publicly traded companies around the world with a market capitalization of \$50 million or greater. More than 60% of those companies are micro caps (companies with a market capitalization between \$50 million and \$500 million).

<sup>2</sup> Stocks of micro-cap companies usually experience more volatility than small-, mid- and large-sized companies. There is often less information available about such companies, and they may operate in countries with greater economic and political risks. Companies deemed to be micro cap generally are viewed as having the liquidity risks of small market capitalization to a greater degree than other smaller capitalization companies.

**Failing to adopt a global perspective when investing in micro caps eliminates a significant portion of opportunities.**

GMC allocation may provide exposure to previously overlooked areas by offering a richer opportunity set. Current allocations to U.S. small caps, international small caps and/or emerging market equities could be reduced to create space for GMCs. (Keep in mind that only 15% of micro-cap stocks worldwide are domiciled in the United States<sup>3</sup>. Failing to adopt a global perspective when investing in micro caps eliminates a significant portion of opportunities.)

Exhibit 1 illustrates the opportunities available to investors who extend holdings down the capitalization spectrum and across geographies.

### Exhibit 1: Investors Broaden Their Opportunity Set With Exposure to Global Micro Caps

There Are Thousands of Micro-Cap Stocks, With Most Domiciled Outside the United States

	U.S. Stocks	Developed International Stocks	Emerging & Frontier Markets
Large Cap	679	798	770
Mid/Small Cap	1,523	2,466	4,165
Micro Cap	1,617	5,631	5,231

Source: CapitalIQ, as of 3/31/2015. Large Cap defined as companies >\$5B in market cap; Mid/Small Cap as companies \$500M-\$5B; Micro Cap defined as companies between \$50M-\$500M.

**GMCs may be well suited for investors who have adopted a core-satellite framework for asset allocation.**

Investors may actively deviate from cap-weighted, style-neutral asset allocation plans and seek to capture return premiums from specific market anomalies. For example, they may orient or tilt the entire portfolio to reflect a bias toward traits such as value, small caps or illiquidity,<sup>4</sup> all of which may be captured by an allocation to GMCs. In fact, GMCs have shown a more robust long-term value premium than small- and mid- to large-cap stocks.<sup>5</sup>

#### *GMCs as an Alpha Satellite*

GMCs may be well suited for investors who have adopted a core-satellite framework for asset allocation. The driving notion for this approach—using passive or tilted products in areas deemed efficient and active satellites in less-efficient regions or sectors—syncs well with GMCs’ active return potential, as well as their low correlations with a wide range of asset classes. An allocation to GMCs could complement or replace existing satellite exposures.

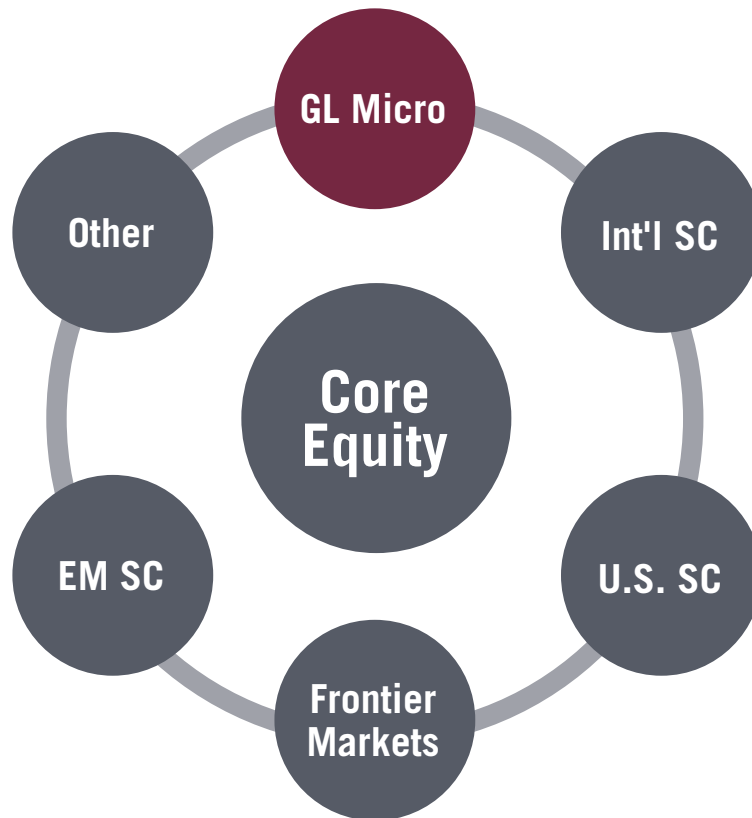
Exhibit 2, on page 4, shows where a GMC satellite allocation may fit within an equity core/satellite configuration.

<sup>3</sup> According to data from Worldscope and CapitalIQ via Clarifi as of 4/30/2014.

<sup>4</sup> Ibbotson, Roger G., Zhiwu Chen, Daniel Y. J. Kim and Wendy Y. Hu. “Liquidity as an Investment Style.” *Financial Analysts Journal*. 69:3, 2013.

<sup>5</sup> See the Brandes Institute paper, “The Next Big Thing Could Be Really Small: An Introduction to Global Micro Cap Stocks.” <http://www.brandes.com/docs/default-source/brandes-institute/the-next-big-thing-could-be-really-small.pdf>

**Exhibit 2: Global Micro-Cap Stocks Can Be an Attractive Component of an Equity Core/Satellite Plan**



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**The return patterns of active micro-cap managers tend to be highly correlated to those of private equity managers.**

### GMCs Offer Benefits Similar to Private Equity and Hedge Funds

Allocations to alternative asset classes, such as private equity and hedge funds (often funded by reductions to existing equity exposure), seek to fulfill a range of investment objectives and portfolio needs, especially diversification and return enhancement. GMCs may offer many of the same benefits—and a number of unique advantages.

#### *Comparing and Contrasting GMCs with Private Equity*

Investing in private companies via an allocation to private equity captures an illiquidity premium, yields an uncorrelated return source and provides exposure to otherwise difficult-to-access companies. GMCs can deliver similar benefits, as “the return patterns of active micro-cap managers tend to be highly correlated to those of private equity managers.”<sup>6</sup>

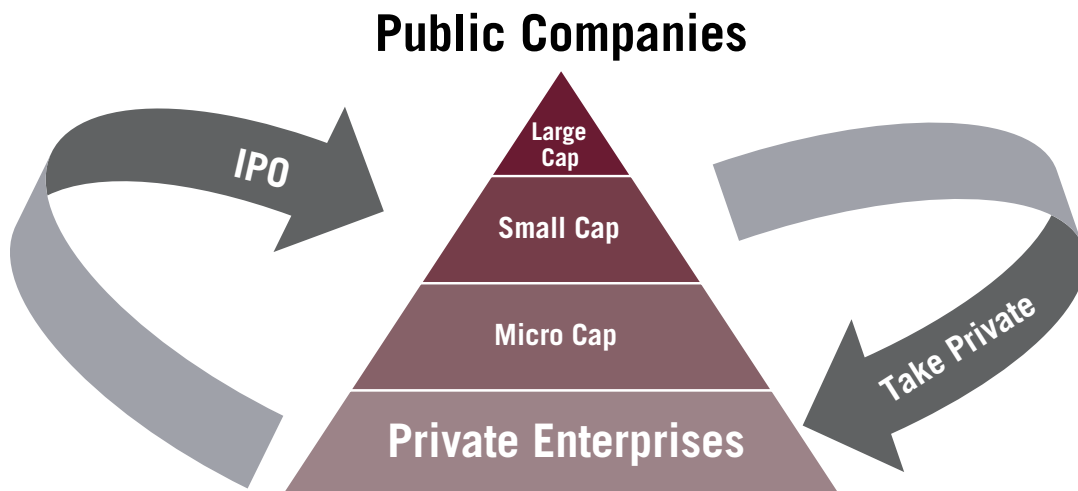
Micro caps and private equity also share a similar structural alignment because micro-cap *public* equity tends to represent the next logical corporate progression for many privately financed or family-owned businesses.

<sup>6</sup>“Active Micro Cap: A Private Equity Alternative.” Acuitas Investments. 4th Quarter 2013. [http://www.acuitasinvestments.com/insights/Acuitas\\_MicrocapAndPrivateEquity\\_update.pdf](http://www.acuitasinvestments.com/insights/Acuitas_MicrocapAndPrivateEquity_update.pdf)

**A substantial portion of micro caps have historically been acquired over time, many times via private deal.**

As illustrated in Exhibit 3, the barrier between micro- and small-cap companies and privately held businesses may be bridged more frequently and easily than for larger caps.<sup>7</sup> In fact, as noted in research by Acuitas Investments, a substantial portion of micro caps have historically been acquired over time, many times via private deals.<sup>8</sup>

**Exhibit 3: Small- and Micro-Cap Companies May Migrate Between Public and Private Status**



Attractively valued businesses tend to be the preferred buyout targets for private equity firms. Ninety-five percent of buyouts occurred among companies with enterprise values below \$1.1 billion, placing such companies in the realm of micro caps.<sup>9</sup> Acquired companies also had an average P/B ratio of 0.5x. Given the size of the micro-cap universe, there are far more buyout candidates here versus other market cap segments.

Evaluating recent buyout opportunities, there was a relatively high number of attractively valued micro-cap stocks versus small and large caps. Adopting Prof. Ludovic Phalippou's 0.5x P/B threshold for acquired securities, Exhibit 4 illustrates the potential field of buyout candidates. There were 979 micro-cap companies worldwide trading below that threshold as of March 31, 2015—an opportunity set nearly six times as large as global small caps and over 50x larger than large caps globally.

<sup>7</sup> Roughly 8% of the Russell Microcap Index was acquired, via buyout or merger, between June 30, 2010 and May 31, 2011, according to "Active Micro Cap: A Private Equity Alternative." Acuitas Investments. 4th Quarter 2013. [http://www.acuitasinvestments.com/insights/Acuitas\\_MicrocapAndPrivate-Equity\\_update.pdf](http://www.acuitasinvestments.com/insights/Acuitas_MicrocapAndPrivate-Equity_update.pdf)

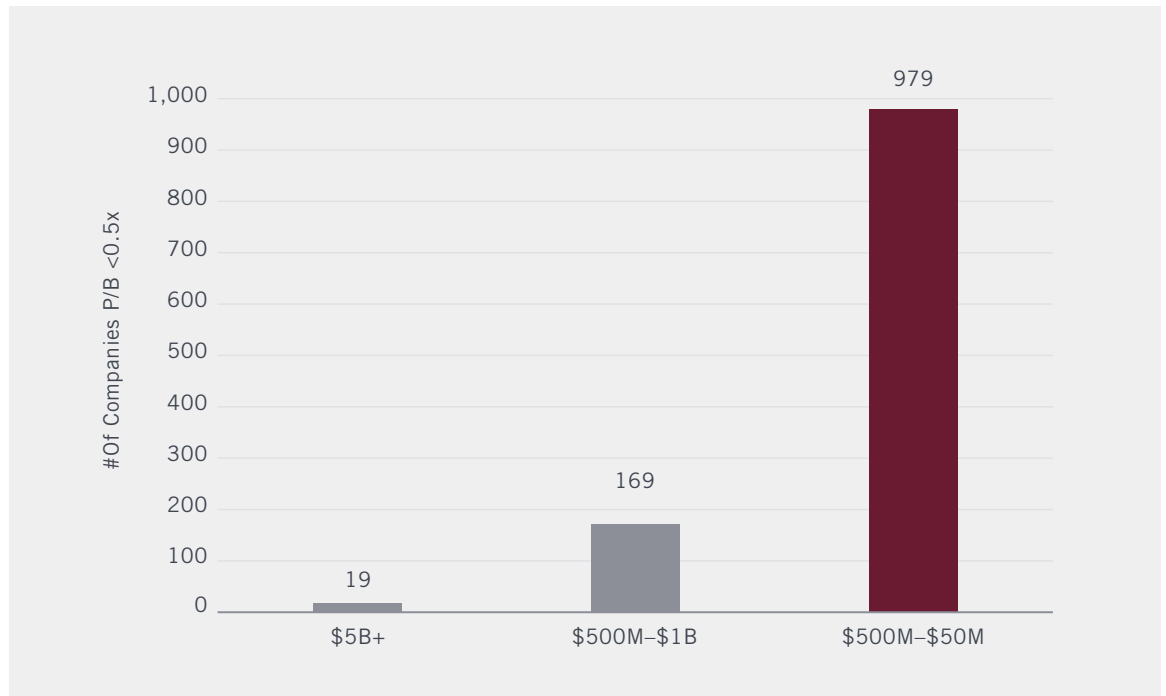
<sup>8</sup> "Active Micro Cap: A Private Equity Alternative." Acuitas Investments. 4th Quarter 2013. [http://www.acuitasinvestments.com/insights/Acuitas\\_MicrocapAndPrivateEquity\\_update.pdf](http://www.acuitasinvestments.com/insights/Acuitas_MicrocapAndPrivateEquity_update.pdf)

<sup>9</sup> Phalippou, Ludovic. "Performance of Buyout Funds Revisited?" *Review of Finance*. March, 2013.

**GMCs Have Provided Hedge Fund-Like Benefits, With Better Upside Participation.**

#### Exhibit 4: Buyout Funds May Find Attractive Acquisition Candidates Among GMCs

Number of Companies With Price-to-Book Ratios Less Than 0.5x as of 3/31/15



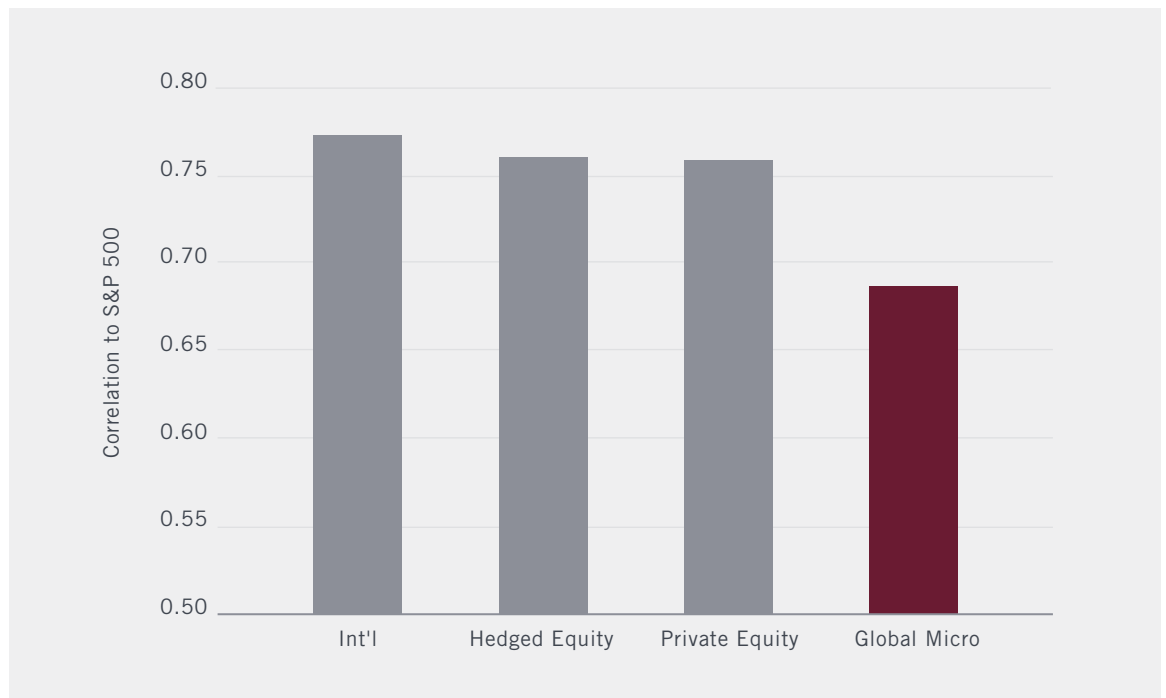
#### *GMCs Have Provided Hedge Fund-Like Benefits, With Better Upside Participation*

Some investors have turned to hedge funds and their goal of exploiting various market inefficiencies to deliver diverse return sources and correlation benefits; micro caps are among the most potentially *inefficient* areas of the global markets. But hedge funds cannot readily access and exploit this market segment due to the lack of lendable inventory among micro caps. And while correlations to the S&P 500 Index have been low for hedge funds, they have been even lower for global micro caps, as shown in Exhibit 5.

**GMCs have offered a compelling and complementary return profile when compared to hedge funds.**

### Exhibit 5: GMCs Have Had Low Correlations to Other Asset Classes<sup>10</sup>

Correlations of Various Indices to the S&P 500 Index, Jan. 1990 to Dec. 2014



Source: S&P, HFRI, Cambridge, as of 12/31/2014. Defined as correlations of calendar year returns to the S&P 500 Index. Past performance is not a guarantee of future results.

Beyond correlation benefits, GMCs have offered a compelling and complementary return profile when compared to hedge funds. After underperforming the average hedged equity manager during the 1990s, GMCs have outperformed in the 2000s and the first five years of the current decade. See Exhibit 6, which uses the same indices as proxies for asset classes described in footnote 10. The S&P 500 Index was used as a proxy for U.S. stocks. (For a more detailed discussion of hedge funds and how many have failed to realize their potential, please see the Brandes Institute research report, "[The Hedge Fund Mirage: Q&A With Simon Lack](#).")

<sup>10</sup> International stocks represented by the S&P Developed LargeMid ex-U.S. Index. Global micro-cap stocks represented by the S&P Global <\$500M Index. Hedged equity represented by the HFRI Equity Hedge Index. Private equity represented by the Cambridge Associates U.S. Private Equity Index. See disclosure section for more details on these indices.

Hedge funds have tended to protect capital on the downside, but have not delivered much upside, especially since 2000.

### Exhibit 6: GMCs Have Outpaced Hedged Equity Managers in the Decades Since 2000

Annualized Returns

	U.S.	Int'l	Hedged Equity	Global Micro
1/1990 – 12/2014	7.3%	5.3%	12.3%	7.8%
1990s	15.3%	8.2%	23.7%	8.4%
2000s	-2.7%	2.2%	5.4%	6.9%
1/2010 – 12/2014	13.0%	5.7%	4.8%	8.1%

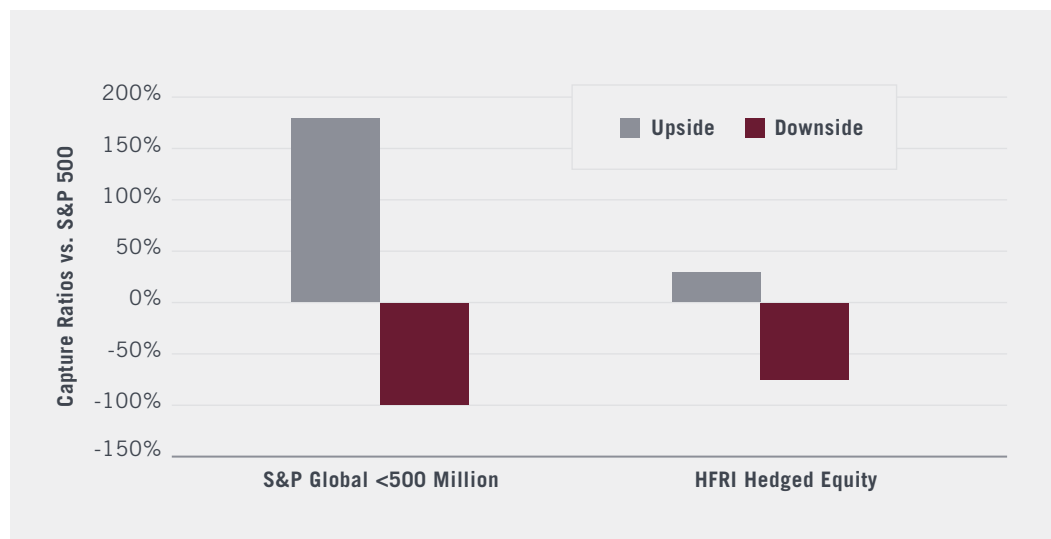
Source: S&P, HFRI as of 12/31/2014. Past performance is not a guarantee of future results. One cannot invest directly in an index.

Examining returns for GMCs and hedge funds in more detail reveals that hedge funds have tended to protect capital on the downside, but have not delivered much upside, especially since 2000. This may reflect hedge funds' long bias and variable, but positive, market beta. See Exhibit 7.

Pairing an allocation to GMCs with hedged equity strategies has historically delivered lower volatility than the market.

### Exhibit 7: Relative to Hedge Funds, GMCs Have Had an Attractive Upside/Downside Combination Since 2000

Capture Ratios of GMCs and Hedge Funds vs. S&P 500, Jan. 2000 to December 2014



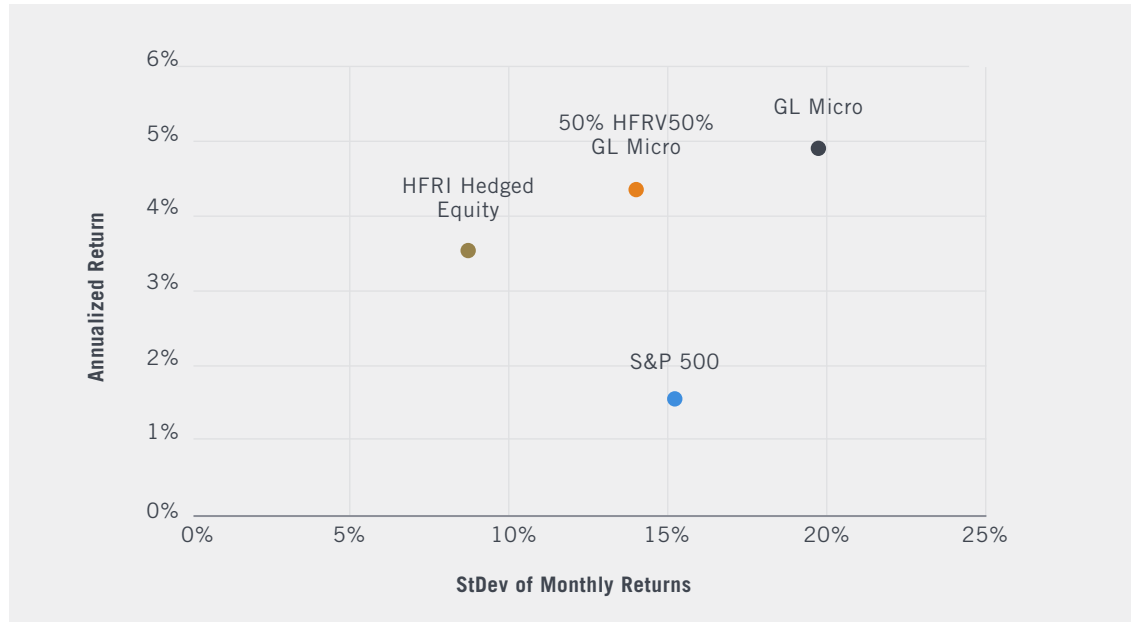
Source: S&P, HFRI as of 12/31/2014. Past performance is not a guarantee of future results. One cannot invest directly in an index.

With GMCs having delivered multiples of market gains, and hedge funds offering greater downside protection, we believe the two asset classes may complement one another. Pairing an allocation to GMCs with hedged equity strategies has historically delivered lower volatility than the market and substantially better-than-market returns. Exhibit 8 compares the risk/reward profile for a 50/50 allocation (50% GMCs and 50% hedged equity) versus the S&P 500 Index between December 31, 1999 and Dec. 31, 2014.



**Exhibit 8: Pairing GMCs With Hedged Equity Delivered Greater Returns With Less Volatility since 2000**

50-50 Allocation vs. S&P 500, December 31, 1999 to December 31, 2014



Source: S&P, HFRI as of 12/31/2014. Assumes a 50/50 weighted portfolio between the S&P Global <\$500M Index and HFRI Equity Hedge Index, rebalanced monthly. Past performance is not a guarantee of future results. One cannot invest directly in an index.

**GMCs have shown attractive benefits relative to private equity and hedge funds.**

GMCs have shown attractive benefits relative to private equity and hedge funds. Additionally, there are important differences that may enhance GMCs’ appeal, including lower fees and potentially greater liquidity. See Exhibit 9. Investing in GMCs also offers greater, real-time transparency on holdings (rather than aggregate or lagged disclosure) when compared to many hedge funds and private equity funds.

**Exhibit 9: GMCs Have Offered Advantages vs. Private Equity and Hedge Funds**

	Avg. Hedge Fund*	Avg. Private Equity Fund*	Avg. Global/Int'l Micro Cap Portfolio
Management Fee	1.60%	1.59%	1.13%
Incentive/Carry Fee	18.87%	19.62%	0.00%
Liquidity	Every 1.5 Months	Secondary Market	Monthly
Redemption	1 Month	None, Secondary Market	1 Month
Lock-Up Term	5.8 Months	Varies, Indefinite	Varies

Sources: Preqin. Average hedge fund data includes all long/short hedge funds as of December 2012 report. Private equity data includes all funds over \$2 billion in assets.\*Does not include fund-of-funds fees, if accessed through this vehicle. A second layer of similarly structured fees would be paid to the fund-of-funds manager in such a case. Evestment as of 12/31/14, defined as products whose primary equity capitalization was “micro cap” and used a non-U.S. benchmark.

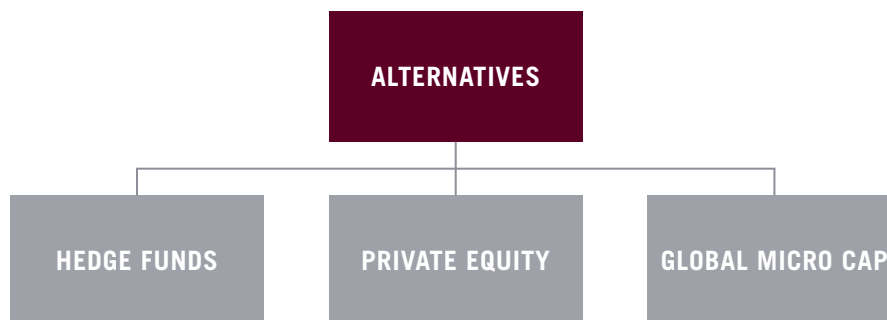
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Investors may wish to consider GMCs as a component *within* an existing allocation to alternatives.

## GMCs Within an Alternatives Allocation

Given their features and benefits, investors may wish to consider GMCs as a component within an existing allocation to alternatives, as illustrated in Exhibit 10.

**Exhibit 10: Hypothetical Asset Mix with GMCs as an Alternatives Allocation**



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Investors may wish to weigh other important questions about a commitment to global micro-cap stocks.

## GMCs: Implementation Considerations

In addition to tactical considerations at the portfolio level, investors may wish to weigh other important questions about a commitment to global micro-cap stocks, including how internal staffing resources and levels of knowledge may affect implementation. If allocating with an external manager, investors may wish to investigate how much attention the manager pays to environmental, social and governance (ESG) factors and the manager's desire and/or ability to influence governance practices of the underlying companies. We believe managers with concentrated portfolios (perhaps fewer than 50 stocks) are better positioned to devote more time and attention to such considerations. However, even managers with more diversified portfolios may have active and deliberate proxy voting policies to provide a meaningful voice in governance issues. Overall, investors who focus on holdings' sustainability and ethical practices, for example, may be better able to effect meaningful change among micro-cap holdings vs. holdings in larger-cap companies.

Separately, investing in micro caps is inherently capacity-constrained. Depending on the number of stocks in the portfolio and individual liquidity of those stocks, it is not unreasonable to expect a manager investing in this segment of the global equity markets to keep assets under management below approximately \$1 billion. Thus, investors in GMCs may face two capital constraints:

1. Can they carve out sufficient assets to make a worthwhile investment?
2. Or is the allocation so large as to make implementation problematic?

As a result of these potential capital constraints, investors should give considerable thought to the size of their GMC allocation and its percentage of total portfolio assets. Liquidity is a related consideration, and liquidity preferences span the spectrum. At one end are investors who are willing to accept *lock-up periods* of five years or longer to capture GMCs' liquidity premium. At the other end are those who want the flexibility to completely exit the asset class in a matter of days. Regardless of needs and preferences, there are various avenues available to accommodate GMC investment.

**What are the potential benefits of investing in GMCs?**

When thinking about an allocation to GMCs, investors may wish to consider:

1. What are the potential benefits of investing in GMCs?
2. What are the biggest risks and concerns?
3. How much of plan assets are being considered for an allocation to GMCs? What percentage of total assets would this allocation represent?
4. What is the illiquidity tolerance?
5. How will internal staffing resources affect implementation, if at all? Would an investment in managers directly or use of an external manager of managers be better?
6. What are the pros and cons of various types of allocations: multi-manager approach, fund of funds, direct investment, etc.?

Once the decision to add GMCs to a portfolio has been made, a variety of implementation options remain to be evaluated. The hypothetical illustration in Exhibit 11 is designed to help investors assess aspects of their situation and how they may best align with GMC investment opportunities. The illustration is not comprehensive, but may serve as a starting point for meaningful dialogue on a number of important considerations.

**Exhibit 11: Potential Considerations When Implementing an Allocation to GMCs**

SIZE OF PLAN/ ALLOCATION	LIQUIDITY TOLERANCE	STAFFING	LEVEL OF KNOWLEDGE	IMPLEMENTATION OPTIONS
<ul style="list-style-type: none"> <li>• Small</li> <li>• Medium</li> <li>• Large</li> </ul>	<ul style="list-style-type: none"> <li>• High Liquidity (30-day exit)</li> <li>• Low Liquidity (multi-year lock-up)</li> </ul>	<ul style="list-style-type: none"> <li>• Under Staffed</li> <li>• Well Staffed</li> </ul>	<ul style="list-style-type: none"> <li>• Less</li> <li>• Moderate</li> <li>• High</li> </ul>	<ul style="list-style-type: none"> <li>• Direct               <ul style="list-style-type: none"> <li>-Single Manager</li> <li>-Multiple Mgrs.</li> </ul> </li> <li>• External               <ul style="list-style-type: none"> <li>-Fund of Funds</li> </ul> </li> </ul>

In Exhibit 11, we highlight considerations for hypothetical investors with different traits who may choose among a few different implementation options for executing a GMC allocation. As an example, a small plan with high liquidity needs, relatively small staff, and lower investment acumen might find accessing GMCs through direct investments to be too onerous given the plan’s limited resources. In such a case, an external fund-of-funds might be the optimal implementation solution. Conversely, a large plan with lower liquidity requirements overseen by a large and relatively sophisticated staff might have the capacity to make direct investments in GMCs with one or multiple investment managers. These are illustrative, of course. No option fits all situations so each plan must weigh which implementation route is best suited for their circumstance.

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**GMCs have provided many of the same benefits as private equity and hedge funds—but typically with lower fees, often better liquidity and greater transparency.**

Here is an example of how one large pension investor chose to invest in GMCs: The \$70 billion Oregon Public Employee Retirement Fund (OPERF) originally made allocations to U.S. micro-cap strategies as part of its objective to capture the small-cap premium.<sup>11</sup> These allocations were dispersed across multiple managers and totaled approximately \$480 million as of September 30, 2014. In 2014, the plan expanded into the international micro-cap markets, committing up to \$750 million<sup>12</sup> between two managers. At full commitment, micro caps (U.S. and international) could exceed 1.5% of total plan assets.

## Conclusion: Making Room for Global Micro Caps

As introduced in the research report, “[The Next Big Thing Could Be Really Small: An Introduction to Global Micro-Cap Stocks](#),” or explored in this paper, GMCs can offer a variety of potential benefits:

- **Broad Opportunity Set:** There are thousands of micro-cap stocks, with most domiciled outside the United States.
- **Upside Participation:** GMCs have provided hedge fund-like benefits, with better upside participation.
- **Low Correlations:** GMCs have had low correlations to other asset classes.
- **Performance Potential:** GMCs have outpaced hedged equity managers in the decades since 2000.
- **Reduced Volatility:** Pairing GMCs with hedged equity can provide greater-than-market returns with less volatility.

There are simple and innovative ways in which investors have overcome the perception of capacity constraints typically associated with GMCs and are using them as a complement to existing small-cap equity allocations or as part of a core/satellite framework. GMCs also have provided attractive benefits as a component within an allocation to alternatives. GMCs have provided many of the same benefits as private equity and hedge funds—but typically with lower fees, often better liquidity and greater transparency.

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<sup>11</sup> <http://www.oregon.gov/treasury/Divisions/Investment/Audio/Public%20Meeting%20Materials%20-%20Regular%20Meeting%20December%203,%202014.pdf>

<sup>12</sup> <http://www.oregon.gov/treasury/Divisions/Investment/Documents/OIC/OIC%20Minutes/2014/Public%20Meeting%20Materials%20-%20Regular%20Meeting%20March%205,%202014.pdf>, page 14

**Stocks of micro-cap companies usually experience more volatility than small-, mid- and large-sized companies. There is often less information available about such companies, and they may operate in countries with greater economic and political risks. Companies deemed to be micro cap generally are viewed as having the liquidity risks of small market capitalization to a greater degree than other smaller capitalization companies.**

**The Russell Microcap® Index** measures the performance of the micro-cap segment of the U.S. equity market. Micro-cap stocks make up less than 3% of the U.S. equity market (by market cap) and consist of the smallest 1,000 securities in the small-cap Russell 2000® Index, plus the next 1,000 smallest eligible securities by market cap.

**The S&P 500 Index** with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.

**S&P Developed LargeMid ex-U.S. Index** is a comprehensive, rules-based index measuring stock market performance of mid to large capitalization companies from developed markets excluding the United States.

**S&P Global <\$500M Index** with net dividends is a comprehensive, rules-based index measuring stock market performance of micro and small capitalization companies from developed and emerging nations. It represents all issues in the S&P Global Broad Market Index whose market capitalization at time of index constitution is less than \$500 million (USD).

**The HFRI Equity Hedge Index** is a fund-weighted index meant to represent the performance of a cross-section of Hedged Equity managers. Equity Hedge strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity Hedge managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short. EH is further subdivided into 7 sub-strategies.

**The Cambridge Associates LLC U.S. Private Equity Index®** is an end-to-end calculation based on data compiled from 1,171 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2014. Pooled end-to-end return, net of fees, expenses, and carried interest. Historic quarterly returns are updated in each year-end report to adjust for changes in the index sample.

Price to Book Ratio: Price per share divided by book value.

Correlation is a measure of how a security's (or a portfolio's) price moves relative to another; it is expressed as a correlation coefficient with a range between 1.0 and -1.0. A correlation coefficient of 1.0 suggests prices move in lockstep; -1.0 suggests moves that are completely opposite. Zero suggests no relationship.

**Past performance is not a guarantee of future results. No investment strategy can assure a profit or protect against loss.**

**Diversification does not assure a profit or protect against a loss in a declining market.**

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The performance results presented were achieved in particular market conditions which may be repeated. Moreover, the current market volatility and uncertain regulatory environment may have a negative impact on future performance.

International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; differences in financial reporting standards and less stringent regulation of securities markets which may result in greater share price volatility; such risks are increased when investing in emerging markets. Additional risks associated with emerging markets investing include smaller-sized markets, liquidity risks, and less established legal, political, social, and business systems to support securities markets. Some emerging markets countries may have fixed or managed currencies that are not free-floating against the U.S. dollar. Certain of these currencies have experienced, and may experience in the future, substantial fluctuations or a steady devaluation relative to the U.S. dollar.

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