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Chris Cuesta and Steve Hall

US and international micro caps: how funds can benefit

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ANALYSIS, INVESTOR STRATEGY NEWS

What Australians call 'micro caps', of course, are not what the Americans call them. Ours are not only a lot smaller, they have different risk/return characteristics. Brookvine, an Australian manager and packager of investment strategies, is about to round out its range of micro-cap funds. They are worth a good look.

Brookvine, based in leafy Woollahra in Sydney's eastern suburbs – which is a kind-of Australian version of Connecticut – has already raised about A\$250 million for US-based micro-cap manager Thomson Horstmann & Bryant (THB). The Australian-domiciled US-invested fund is administered and advised by Brookvine, which puts its own money into its international investment strategies alongside that of its underlying managers and clients. As it turns out, THB's headquarters are in leafy Norwalk, Connecticut.

On a regular trip to Australia last week, Chris Cuesta, THB chief executive and portfolio manager, said the US micro-cap fund had delivered a return of 15.3 per cent a year since inception in September 2014, in Aussie dollar terms. The manager will launch an international ex-US version of the strategy, also Australian-domiciled, in the next month or two.

Steve Hall, Brookvine's co-founder and chief executive, told a gathering of investors in Sydney last week that when his firm embarked on the search for an international micro-cap manager, having become enamored with the asset class's characteristics, he discovered that there were not very many which had the credentials to deliver a truly international strategy. THB had its long-established US version and planned the international (ex-US) strategy. There are about 5,000 micro-cap stocks in the developed markets world, ex-US, compared with 1,500 in the US, so the selection of a 150-stock portfolio, say, requires a different approach. The US-only strategy has about 100 stocks.

Cuesta, said THB had not changed its fundamental style for the new fund but had introduced a systematic quant-based screening process to cull the investment universe. "We still do our qualitative research on the companies," he said. "We look for under-valued companies where we can see there may be a catalyst for change... We think and act like a business owner, investing alongside owner entrepreneurs who have a proven track record and a material level of outstanding shares."

The privately owned THB has been investing in the US for about 35 years, including nearly 20 years in the micro-cap market. In the US, a micro-cap is generally defined as having a market capitalization of less than US\$1 billion. THB's portfolios tend to have a bias to the smaller end of the range: from about US\$100 million – US\$500 million, which Cuesta describes as the "sweet spot".

The US is the world's largest, deepest and broadest source of micro-cap stocks. Cuesta says that over a full market cycle a well-diversified portfolio of micro-cap stocks should significantly out-perform larger-cap portfolios. There are lots of reasons for this, including:

- More than 50 per cent of all M&A activity is in the micro-cap sector
- Their balance sheets are the healthiest they've been in 20 years
- They are under-researched. About 45 per cent of US micro caps have no published earnings estimates.
- They tend to have a single product line, which makes them "pure-play" investments
- The growth in passive investments has had less impact on the sector than at the larger end
- Micro caps are currently trading at a sizeable discount to large caps and the last time this happened – in the internet boom – the THB micro-cap portfolio significantly outperformed both the Russell Micro-cap and S&P 500 benchmarks over the full market cycle
- Micro-cap management tends to have more skin in the game. There are 306 micro-cap stocks in the US with insider ownership of more than 10 per cent, compared with 24 such stocks in the S&P 500
- Private equity's "dry powder" of unused capital is at an all-time high in the US, providing further opportunities for the acquisition of US public companies, and
- Micro-cap portfolios are increasingly being used as a proxy for private equity, but they offer daily liquidity, full transparency and the portfolios come with lower fees.

Cuesta says that an under-used statistic in portfolio management is the "hit rate", of successful stock purchases. "I look at this all the time," he says. "Our hit rate is about 65-66 per cent." The thing about a hit-rate statistic is that they tend to be asymmetrical. A positive rate will yield, on average, a 30 per cent return while a negative score will yield minus 10 per cent.

Hall says the next THB fund, the international (ex-US) fund, will be investing in only developed markets, 22 out of the 23 in the MSCI Global index. It will complement the US-centric version. He says the firm aims to introduce a global (integrated) version after that.

– G.B.
