

US micro cap: Thomson Horstmann & Bryant, Inc. (THB)

Investor roadshow FAQs

**This paper outlines the key themes and common questions raised by investors at recent meetings across Australia and New Zealand with Chris Cuesta, CEO and Portfolio Manager of THB, a dedicated micro cap specialist manager celebrating 20 years of US micro cap investing this month. Chris reiterated that US tax reform, deregulation and the valuation gap vs large cap stocks combine to make a very compelling and timely investment thesis for US micro caps.**

## Introduction

The US is the world's largest source of micro cap stocks. Over a full market cycle, a well-diversified portfolio of high quality US micro cap companies run by top calibre management teams should significantly outperform larger cap portfolios.

To capitalise on that opportunity, Brookvine and THB launched the THB US Micro Cap Fund in Australia in 2014. The Fund currently has A\$265 million under management and has returned 16.8% p.a. since inception to 31 May 2018.

### 1. What is the definition by market cap of micro cap stocks in the US?

In the US, micro cap stocks range from \$50 million to \$1.5 billion market cap. The weighted average market cap of companies in the THB US Micro Cap Fund is \$550 million.

### 2. What does THB expect will close the valuation gap between large US stocks and micro caps?

The valuation gap between large and micro cap US stocks is at its highest level in 20 years<sup>1</sup>. The gap tends to be cyclical. Nonetheless, some very powerful forces are expected to disproportionately benefit micro cap companies:

- Tax reform: THB's micro cap companies are currently paying an average of 34% tax, this will drop to 21%.
- Deregulation: The number of pages of new regulation being published has dropped to lowest levels since the 1980's. With less resources tied up dealing with the regulatory burden in running their business, owners can refocus on growth and efficiency.
- Optimism: Significant recent improvements in consumer sentiment, small business confidence and CEO confidence also augur well for the performance of the general economy and its flow on to micro cap stocks.
- US economy: Small businesses (micro cap sized companies) form the 'base of the pyramid', generating 60% of GDP. These businesses are now feeling optimistic and are confident they are in the early stages of the business cycle. Micro cap stocks are also domestic focused and largely driven by the US economy and thus more immune to global trade-related issues.
- Interest in micro caps: There is growing recognition of the merits of micro cap investment by US institutional investors and consultants.

### 3. Why might investors view US micro cap as an alternative to private equity (PE)?

About 40% of THB's client base view micro caps as a complement or alternative to PE.

The drivers of return are similar:

- PE managers often target small, niche companies similar to those found in the micro cap segment.
- Both strategies can provide direct and meaningful exposure to 'mega trends' in infrastructure, e-commerce, green

1. As measured by price/sales of large cap stocks (S&P 500) and micro cap stocks (bottom 1000 stocks in Russell 2000)

## RESEARCH NOTE

- energy, health and activity, connectivity, cyber security and data analytics.
- Like PE, THB favours companies with strong cash generation and stable business fundamentals. It also favours companies with aligned and entrepreneurial management teams.
- THB engages valuation disciplines akin to PE managers; a keen interest in metrics such as EV/EBITDA and a private markets valuation approach based on recent trade sales.

THB's US Micro Cap strategy has:

- Shown stronger performance, with the THB US Micro Cap Composite outperforming widely available PE indices (since the Strategy's inception date of 30 June 1998);
- Provided daily liquidity, and allowed investors the opportunity to allocate their full investment at once;
- Lower fees, and no performance fee, commitment fee or carried interest; and
- High levels of transparency.

Interestingly, THB's microcap stocks are often a target of PE investment and about 30% of acquisitions of THB's portfolio companies have been by PE. Once invested, underlying PE companies typically also carry far more leverage.

It should be noted that PE (being illiquid) does display less variability in returns than the THB US Micro Cap Fund, where the price is daily marked to market.

#### **4. Chris has spoken of the resilience of the US Micro Cap strategy. What makes it resilient?**

THB utilises a proprietary Quality Assessment and Risk Grading methodology:

- Multi-factor Quality Assessment skews the Fund towards companies with stronger balance sheets, little debt, high tangible assets ratios, stable profitability and strong corporate governance.
- Risk Grading focuses the Fund on less risky stocks (from a price and earnings standpoint) and ensures an adequate premium is captured if and when the Fund accepts heightened price and earnings risk.

The best example of resilience was the peak to trough experienced during the internet-led era. Between 3 March 2000 and 30 September 2002, the S&P and Russell Microcap® annualised returns were -20.5% and -13.9% respectively, while THB Micro Cap held steady over the same period at 1.5%.

#### **5. What is the biggest risk to the strategy at present?**

Everyone is looking for the 'new monster in the closet', for triggers that might lead to a widespread collapse of equity market valuations. Interestingly, there isn't much THB hasn't seen before; it has managed money through many business cycles and recognises that investors will always have something to worry about.

A 100bp sharp lift in rates could affect micro caps. There is talk about 'wage inflation' which would have a lesser impact on micro caps that don't typically have large populations of low paid employees. In terms of a risk to the tax and regulatory reform tail winds, impeachment of the current President wouldn't affect tax reform (already passed through US Congress) or deregulation (managed by individual agencies and doesn't require Congress).

#### **6. Is there a shift of interest to micro caps and what is the driver of that?**

There is growing recognition by investors of the benefits of an allocation to micro caps in their portfolios. This reflects their concern with large cap stock valuations, the impact of ETF trading volume on large cap stock prices and a search for opportunities to capture higher returns.

Small to mid-sized private wealth groups and institutions are best placed to exploit this opportunity given capacity limitations, however mainstream US pension funds have begun to explore the opportunity.

### 7. What is the impact of ETFs on US micro cap?

Passive trading flows have really snowballed. On any given day, approximately 20-30% of trading volume in large cap stocks is driven by ETFs, compared to less than 0.1% for micro caps.

### 8. Why do you hold 100 stocks? Why not be more concentrated?

Micro cap stocks are typically single line businesses, and may have a geographic focus, whereas large cap companies often have multiple divisions and a broad geographic focus. There is too much event specific risk in micro caps to run a highly concentrated portfolio. A single factory fire, for example, would likely have a much greater impact on the stock price. THB believes a 100-120 stock micro cap portfolio equates to a 30-40 stock large cap portfolio.

### 9. How does THB factor ESG considerations into its process?

ESG analysis is integrated into fundamental analysis. The research team assesses the ESG related factors using various datasets, best in class third party providers as well as company filings and presentations. A rating is assigned to each company through an internally developed rating system. The ESG rating is then blended into fundamental analysis through THB's proprietary Quality Assessment which adjusts the price target of the stock and its expected return. To remain current and improve their knowledge, THB analysts frequently engage in training opportunities in ESG.

For more information about US micro caps or the THB US Micro Cap Fund please contact:

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