ROBECO

Micro Cap Stocks:
Gaining a Competitive Advantage

October 2013

Executive Summary

Small and micro cap stocks – securities with a market capitalization below $3 billion - offer investors a number of sustainable advantages when compared to other market cap segments. Consequently, they allow active asset managers focused on these stocks the potential to outperform over long periods of time. This is especially true of micro caps, which are typically valued at less than $1 billion.

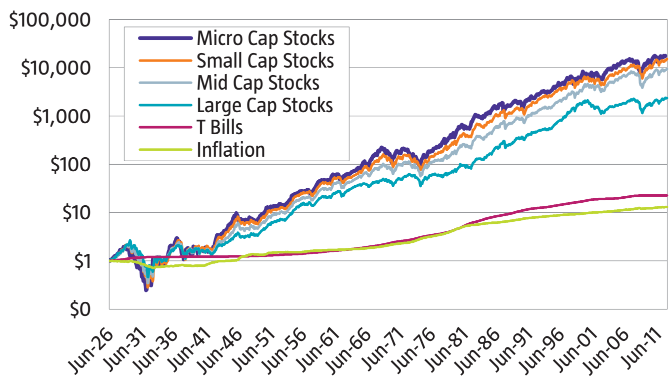
Among these competitive advantages:

- Empirical evidence over any statistically significant time frame shows above average returns for the smaller market cap segments of the U.S. market.
- These stocks are often overlooked by institutional investors – who now own more than 70% of the U.S. equity market – and some large institutions limit, or even prohibit, investment in small and micro cap equities.
- Lack of coverage by Wall Street sell-side analysts creates inefficiencies in the pricing and valuation of the micro cap universe. This can benefit those managers who have extensive experience in this universe.
- The senior management of smaller companies often includes founders who retain a significant ownership stake, creating an alignment of interest between managers and outside investors.

The performance factor

The Center for Research in Security Prices shows the hypothetical return of $1 invested in each capitalization range from 1926 through 2012. Micro caps have clearly outperformed. (see Figure 1)

Figure 1: Asset Class Returns



Source: Federal Reserve, Prof. Kenneth R. French, CRSP Database
Past performance is not an indication of future results.
Market capitalization identifications are defined as quintiles of all NYSE, AMEX, and NASDAQ stocks beginning in July 1926. Each fifth is defined as either Large, Mid, Small, Micro or Nano-capitalization. The portfolios designated by the capitalization definitions are reconstructed each year in June using the current market capitalization.

> Overall lack of appetite for smaller stocks **creates a void that opens up opportunities** for dedicated small and micro cap managers.

An analysis of annual returns by decade since 1930 shows the outperformance of both small and micro cap stocks in every period, except during the 1990s, when they lagged by a small margin as shown in Figure 2. This particular advantage has endured throughout a variety of market conditions and economic cycles.

Figure 2: Annual Returns by Decade (%)

	Micro	Small	Mid	Large
1930s	3.9	2.8	1.6	-0.3
1940s	16.5	14.5	12.6	8.7
1950s	19.3	19.1	18.4	18.2
1960s	13.6	11.4	10.3	7.3
1970s	9.3	8.7	7.9	5.1
1980s	16.9	17.4	17.5	17.2
1990s	13.8	15.5	16.1	18.8
2000s	5.6	5.1	4.7	-1.3
2010s[1]	12.5	15.0	13.9	10.5
Median[2]	**13.7**	**13.0**	**11.4**	**8.0**

[1] 2010s reflects results through December 31, 2012.
[2] Median data does not include 2010s
Source: Prof. Kenneth R. French, CRSP Database.

Being overlooked brings opportunity

An analysis of equity mutual funds in the U.S shows the majority of assets are focused on large cap stocks. The data shown in Figure 3 highlight the neglect and ultimate inefficiencies in micro-cap investing. Furthermore, institutions own more than 70% of U.S. stocks compared to less than 10% in the 1950s. The neglect and lack of public participation (natural holders of micro-cap issues) creates wonderful opportunities for dedicated micro-cap managers.

Figure 3: # of Analyst Recommendations

Total Universe of Companies	5,707
$10B+	20
$3B-$10B	15
$750M - $3B	10
<$750M	3

Source: Bloomberg

At the same time, the lack of coverage by Wall Street researchers creates a disconnect between the price and the intrinsic value of these micro stocks. The average number of analysts covering large cap stocks is around 20+, mid caps is about fifteen, yet few, if any, analysts cover the micro universe (see Figure 4).

Figure 4: # of Analyst Recommendations

Total US Focused Equity Mutual Fund Assets	$4,912,961	
		% of Total
AUM ($10 B+ Avg. Mkt. Cap)	$4,139,012	84.2%
AUM ($3 B - $10 B Avg. Mkt. Cap)	$411,649	8.4%
AUM ($750 M - $3 B Avg. Mkt. Cap)	$352,341	7.2%
AUM (Sub $750 M Avg. Mkt. Cap)	$9,959	0.2%

Source: Mutual Fund Data - Bloomberg
Criteria: U.S. Focused, Equity Mutual Funds

This mismatch is likely to persist because of the lower trading volumes and the concomitant lower commissions generated by small and micro stocks. Analysts are often incentivized to cover securities that generate higher trading volumes since their compensation structure is often tied to brokerage commissions.

Further disconnects between price and value arise from the lack of media attention given to small and micro companies. Media outlets devote more time to reporting results and news from large, well-known companies that are more likely to be immediately familiar to investors. Finally, smaller companies have fewer available resources to assemble and disseminate information to the investment community. This confluence of factors makes the micro cap universe an extremely attractive investment class where managers can generate high risk-adjusted rates of return.

An alignment of interests

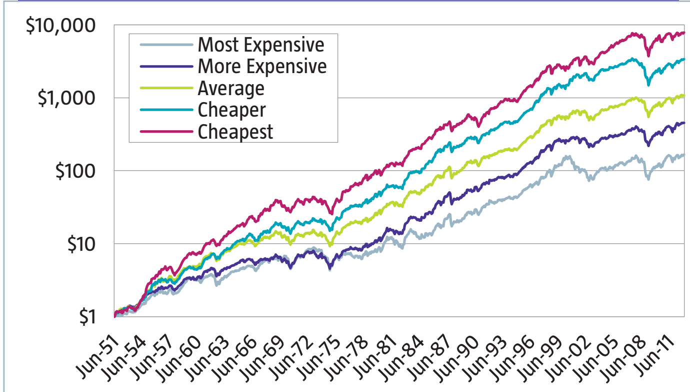
Frequently, senior management and board members of micro caps include founders who retain a significant ownership stake. These holdings often represent a large portion of the founder's net worth, forming common interest with outside investors. Insiders are generally dedicated to their companies, and highly knowledgeable about products and markets, providing valuable insights to the investor. It is particularly important, when investing in a passive role, to have interests and incentives closely aligned between both parties.

Price sensitivity is critical

All of the above-mentioned factors should favor active managers who have gained an intimate knowledge of the small and micro cap sectors by conducting primary research and developing long-standing relationships with companies, including frequent visits and discussions with management.

However, a major determinant of investment performance is the price paid for individual securities. The intelligent investor leaves himself an ample margin of safety by purchasing stocks at a discount to fair value. By being sensitive to price when purchasing assets, the active manager can sharply reduce the risk of permanent capital loss and may generate outstanding compounded returns over long periods. As shown in Figure 5, cheaper securities have outperformed more expensive stocks over time.

Figure 5: Return on Equity P/E



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Key investment criteria

Robeco Weiss, Peck & Greer (RWPG) takes a bottom up approach to small and micro caps that blends quantitative screens with rigorous fundamental analysis. There are four key elements:

1. Return on invested capital, which should be higher than the cost of that capital. The management track record should demonstrate a sensible allocation of funds.
2. Cash flow generation in the form of a high free cash flow yield.
3. Balance sheet strength. In particular, interest coverage should be at least two for one.
4. Catalyst for change. What catalyst (new management, for example) is likely to generate an increase in the stock price?

If a company meets all these criteria, RWPG will wait until the stock price reaches its target buying level. The price of a security is a key factor in the final buy decision. The target price is generally two to three standard deviations below a normalized average.

Volatility can create opportunity

In conclusion, investors should recognize that micro caps are traditionally vulnerable in periods of fear and uncertainty. But these periods produce exceptionally favorable circumstances for small and micro caps as market participants run for safety in the form of blue chip stocks, regardless of the fundamentals. Micro cap stocks tend to be overlooked in this situation and those that meet the necessary investment criteria may prove to be a sound, long-term investment.

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