Introduction

Micro cap stocks are among the investment world’s worst-kept secrets. They have been around as an asset class category since the 1980s, and research has repeatedly confirmed the advantages they offer to investors – most notably a chance to exploit numerous opportunities for greater excess returns.

Yet this remains a comparatively neglected sub-asset class, or investing niche. Micro caps typically are mentioned either in passing or not at all in investment guides and dictionaries of financial terms. As the smallest of small stocks, they scare off some investors who perceive them to be too volatile or not worth the risk.

We believe their risk has been exaggerated and their potential rewards overlooked. This widely under-followed segment of the U.S. equities landscape offers compelling opportunities for long-term investors, particularly when investments are made through skilled active managers. Micro caps over the long term have been shown to deliver strong returns and outperform all other market cap asset classes.

Micro caps’ size and role in investing have evolved over the years, and their appeal has strengthened. They remain the most structurally inefficient segment of the U.S. equity market, making them a shrewd long-term investment when access is available through good managers with reasonable fees. As we will discuss at more length below, micro caps provide opportunities to obtain growth where others are not looking or will not venture.

Today’s Micro Caps

Micro caps are the very smallest investable companies in the U.S. equity market. They are generally defined as publicly traded stocks with market capitalizations of roughly $500 million.

While technically a subset of small stocks, which are defined as having market caps of under about $3 billion, micro caps effectively are in an asset class of their own because small cap managers focus on the higher end of the capitalization range. Micro caps collectively hold less than 3 percent of the market’s total value.

The Russell Microcap Index consists of the smallest 1,000 companies in the small-stocks Russell 2000 Index plus the next 1,000 smallest eligible securities by market cap. Over-the-counter stocks and pink sheet securities are excluded, since one criterion for inclusion in the index is that the securities meet exchange listing requirements. The average weighted market cap of the micro cap index is currently $450 million.
The breakdown of stocks by sector for micro caps is not unlike that of small caps, as the pie charts for the indexes on the next page illustrate. But there are differences beyond their size.

Micro caps often are young businesses, frequently startups, with small, motivated management teams. As smaller companies, they tend to be more nimble – able to adjust better to market conditions and consumer preferences. Their size also allows greater potential for growth and makes them likelier candidates for acquisition. Earnings can be more volatile from a lack of diversification but easier to understand for a micro cap analyst who takes time to focus on the company.

Advantages
As a comparatively neglected asset class, U.S. micro cap stocks offer investors numerous appealing attributes:

• Lack of analyst coverage makes it possible to gain an informational advantage
• Outperform other asset classes over long periods
• Active micro cap managers add more value than active small cap managers
• No meaningful difference from small caps in risk or volatility

Risks
Micro caps pose some unique challenges due to their extra-small size:

• Can experience large price fluctuations because of limited liquidity
• Like small caps, historically more volatile than large caps
• Dearth of publicly available information
• May have limited track records for young companies
• Tend to underperform at times of market stress

Inefficiencies to Exploit
The micro cap space is highly inefficient, making it particularly attractive for savvy investors.

Companies on the low end of the market cap spectrum get much less research coverage from Wall Street, even compared with small stocks. About 14 percent of the stocks in the Russell Microcap Index are without analyst coverage, according to FactSet, versus just 5 percent for those in the Russell 2000. The average micro cap stock is followed by just three analysts, the average Russell 2000 stock by seven. The lack of analysts

Source: Morningstar, data as of September 30, 2014
creates an informational vacuum, which means some stocks trade inefficiently. Less-researched companies also have been shown to provide greater risk-adjusted returns.

The traditional small cap space has drawn an increasing amount of institutional and retail investor money and we believe the asset class may be bloated, making micro caps even more attractive by comparison. Small cap managers had $515 billion in total assets under management as of mid-2014, according to eVestment data, dwarfing the $16.5 billion capitalization of micro caps. Increases in asset amounts can be restrictive for managers, and performance generally declines as they grow.

Micro caps are neglected not for a lack of investment appeal but because of the constraints on institutional investors, which include large pension funds, endowments and other entities that each have billions of dollars. These investors, which comprise more than two-thirds of the market, shy away from them for several reasons: The costs of analyzing very small companies cannot be justified; micro cap managers have limited capacity; there are so many that it would require a disproportionate share of their research time, and their limited size means their price can easily be moved by bulk share purchases and sales. The absence of these large investors means less competition for those analyzing micro caps and makes it easier to find price bargains.

Outperformance Over Time

Over long periods of time, micro caps outperform equities in other capitalization ranges. A $100 investment in micro cap stocks on January 1, 1926, would have grown to $2,280,394 by August 31, 2014, with micro caps producing an annualized return of 12.0 percent over that period. The same amount would have grown to $1,708,300 in small caps (11.6 percent average annual gain), $1,647,057 (11.6 percent) in mid caps and “just” $447,057 (10.0 percent) in large caps over those 88 years.

Our separate review of returns by asset class from 1926 through September 2014 found that micro caps outperformed large caps 72 percent of the time, as measured by quarterly 10-year rolling returns. But the

Source: Center for Research in Security Prices, data as of August 31, 2014
tendency for prices to revert to the historical mean suggests they can provide an advantage to investors who buy in at a low point of their cycle. Since January 2000, micro caps have outperformed their small cap peers in 66 percent of rolling three-year periods, according to our review of returns in those asset class categories as defined by the Center for Research in Security Prices.

### Added Value

Micro cap active managers have shown the ability to pick winners over time. Even though the Russell 2000 has recently outperformed the Russell Microcap Index over the past 10 years, the managers within micro have outperformed small cap managers. The above table demonstrates how micro cap managers have generated better returns over a variety of periods than their small cap peers at the highest, median and even lowest percentile levels. The disparity is growing as small cap gets more efficient, making it more difficult for managers to find excess returns.

Only 4 percent of assets in the Russell Microcap Index are under active management. This suggests micro cap managers have a large field of mostly untapped stocks to choose from.

### Greater Growth and Acquisition Potential

Because of their size, micro caps almost by definition have a better chance to grow rapidly than larger stocks do. They also are likelier acquisition candidates, because less capital is required to buy them. About 8 percent of the Russell Microcap Index was acquired via merger or buyout during a recent one-year period (between June 2011 and June 2012), according to MergerStat. Micro caps accounted for 66.6 percent of all the merger and acquisition activity from 2003 to 2014.

### Micro Caps Account for Most M&A Activity

<table>
<thead>
<tr>
<th>Micro Cap Separate Account Managers Outperform Their Small Cap Peers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Return</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>5 Year Return (%)</td>
</tr>
<tr>
<td>10 Year Return (%)</td>
</tr>
<tr>
<td>15 Year Return (%)</td>
</tr>
</tbody>
</table>

Source: Morningstar, data as of September 30, 2014
Small/Micro Cap Rolling 3-Year Standard Deviation

No meaningful difference in volatility
June 2003 - December 2013

Small/Micro Cap Rolling 3-Year Beta

No meaningful difference in risk
June 2003 - December 2013

Small/Micro Cap Rolling 3-Year Sharpe Ratio

Comparable return per unit of risk
June 2003 - December 2013

Source: Morningstar, data as of December 31, 2013
mid-October 2014, compared with 31.9 percent for small/mid caps and 1.5 percent for large firms, a study of public merger data by Driehaus Capital Management found.

Higher Insider Ownership

Micro cap companies are unique in that senior management typically has significant equity stakes. Weighted average insider ownership for stocks in the Russell Microcap Index is 16 percent, compared with 11 percent for the Russell 2000. Greater insider equity ownership tends to create management teams whose objectives are well-aligned with those of outside shareholders. It also gives managers additional, personal incentive to take on prudent levels of risk that can potentially boost returns.

Illiquidity – Pros with the Cons

Due to limited liquidity, micro caps may take longer to trade and can undergo large fluctuations in price over short periods of time. However, while this factor is a concern for institutional investors, it can benefit others. For long-term, patient investors, it is return-enhancing.

Illiquidity makes prices difficult to estimate, creating the potential to buy micro caps at discounts. Research by Yale University professor Roger Ibbotson, founder of Ibbotson Associates (now a Morningstar company), concludes that less liquid stocks outperform their more liquid counterparts.

Why Now

Besides the time-tested advantages offered by micro caps, recent market analytics add other factors in their favor as timely investments.

Shift in market cap focus: The average market cap for small cap stocks has doubled in the past 12 years (see chart below), making the small cap asset class more like mid caps. With asset managers focused on a higher cap size, this leaves micro cap managers a much-expanded universe of under-researched stocks to choose from. Effectively, micro caps are the small caps of 10 to 15 years ago.

The average market cap for these stocks, as tracked by the iShares Russell 2000 investable benchmark, rose from $692 million in 2002 to $1.37 billion at the end of August 2014.

Access to nimble managers: Regardless how enticing this category may be, success is predicated on having access to top managers at a reasonable cost. Active managers have proven particularly adept in recent
years, as discussed earlier, even when the collective micro cap performance has lagged.

Active separate account managers outperformed the Russell Microcap Index by an average 2.6 percentage points per year (net of fees) over the past 10 years while charging an average management fee of 1.2 percentage point, as the table above shows. By comparison, active micro cap mutual funds outperformed by an average 1.7 percentage point while charging an average 26 percent more in annual fees.

Growing need for excess returns: Widespread expectations of more modest equity returns in the years ahead make it increasingly important to find excess returns within your investments. Unconventional monetary policies carried out by the Federal Reserve and global central banks in recent years have boosted asset prices at the expense of future returns.

Conclusions and Our Position

Micro caps offer timely potential for growth as a substitute or addition to a small cap stock allocation within a diversified portfolio. Opportunities in this category have remained compelling as many managers focus more on larger stocks than in the past.

Informational inefficiencies and other conditions make this an appealing asset class that can provide patient investors with greater excess returns, especially when pursued through top active managers. The risks are similar to those associated with small caps, but the potential rewards are greater.

For all these reasons, micro caps have been on our radar screen for some time. We have been waiting for an appropriate opportunity to gain access through top managers, which require substantial minimum investments for separate accounts. Recently we launched a fund structure that pools client assets in order to reach the required minimums. We believe that adding micro caps to portfolios is an opportunistic investment in stocks that are under-followed and overlooked.

Sources: eVestment Alliance, Morningstar, data as of September 30, 2014

*Returns prior to September 2005 proxied by the Russell Microcap Index
Altair Advisers

Altair Advisers is an independent wealth advisory firm providing investment management, financial planning and client education services. We counsel a select group of individuals, families, foundations and endowments. As a fiduciary, we serve as an advocate for our clients, providing objective advice and comprehensive guidance across all aspects of our clients’ financial lives.

Disclosures

The material shown is for informational purposes only. Past performance is not indicative of future performance, and all investments are subject to the risk of loss. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, and actual results may differ materially from those anticipated in forward-looking statements. As a practical matter, no entity is able to accurately and consistently predict future market activities. Information presented herein may incorporate Altair Advisers’ opinions as of the date of this publication, is subject to change without notice and should not be considered as a solicitation to buy or sell any security. While efforts are made to ensure information contained herein is accurate, Altair Advisers cannot guarantee the accuracy of all such information presented. Material contained in this publication should not be construed as accounting, legal, or tax advice.

Altair Advisers LLC
303 West Madison Street
Suite 600 Chicago, Illinois 60606
312.429.3000

altairadvisers.com

Connect with us: