U.S. Microcap:
The Passive-Immune Asset Class

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Summary

Record high equity markets coupled with unusually low volatility have created a challenging active environment and an explosion in popularity of low-cost passive vehicles. To put the lagging performance it in context, over 70% of active U.S. large cap equity products have lagged their benchmarks over the trailing three years, net of fees, and 63% have lagged over the last five years. Additionally, according to Morningstar, in 2017 more than $200 billion flowed into passive U.S. equity strategies while more than $200 billion flowed out of active strategies. This dynamic has increased the pressure on the active management industry, with active managers continuing to lose assets and management fees coming under ever-increasing scrutiny. We believe that this trend is part of a long-term cyclical dynamic, and that the pendulum has swung too far toward passive. In our view, the industry is heading toward an inevitable tipping point where the tides will shift and active managers will be presented with a much more favorable environment. While pinpointing that moment in time is the million-dollar question, we continue to feel that we are closer to the end of this cycle than the beginning.

Perhaps more important, as active investors focused exclusively on inefficient areas of the equity markets, we believe areas such as microcap continue to provide appealing opportunities for active management. Of course, we have analyzed, written at length about, and firmly believe in the benefits of active investing down the market cap spectrum. While passive investing has continued to grab headlines and consume the bulk of aggregate asset flows, we believe the corners of the market we focus on have been relatively immune to the potential negative effects of the recent phenomenon. In our view, this has been primarily driven by two overriding issues: the numerous inefficiencies present in microcap which greatly amplify the active opportunities in the space, and the lack of a viable passive alternative.

In this paper, we discuss the recent trends in passive asset flows as well as the causes and impacts of these flows. Additionally, we provide more insights into why we believe microcap should continued to be immune to the shifts toward passive, including the continued active manager success in microcap, as well as the lack of a viable passive alternative in microcap. Lastly, we discuss our views that the shift toward passive has a degree of cyclicality that is likely to reverse.

The Shift to Passive – Large Cap vs. Small Cap

Given the challenges active managers have had outperforming their benchmarks in recent history, money has consistently flowed out of active managers and into passive solutions. Of course, passive investors build portfolios intended to track the performance of an index, making no effort to beat the market, with a key benefit of low fees. As the number of passive vehicles available has proliferated and definitions of investment categories have become narrower, fee compression has accelerated in a race to zero (which Fidelity recently 'won' with the launch of their zero-cost funds). With that, the popularity of exchange traded funds ("ETFs") has understandably grown. Within U.S. equity, indexing has become particularly popular in the most efficient and liquid segment: large cap. This has occurred at both the retail and institutional levels, as investors have come to terms with the difficulty for active managers to add value, net of fees. Logically speaking the utilization of passive alternatives in areas where information is widely disseminated and many sophisticated investors are competing against one another makes sense.

The data clearly supports this view. Exhibit 1 shows the average excess returns for active managers over the last 10 years based on market capitalization. The 20 basis points of value that large cap managers have been able to add over the benchmark's return is understandably uninspiring considering that it is before accounting for management fees. According to eVestment, the average stated fees for active large cap separate accounts is roughly 0.68%, which puts the average manager's excess returns over the trailing 10 years well into the negative. For mutual funds (the de facto vehicle of choice for most retail investors), average fees jump to 77 basis points, which pushes net of fee returns down even further. While this data shouldn't come as a surprise to most investors, the point is that the recent explosion in passive asset flows into large cap is understandable.

Exhibit 1: Trailing Excess Returns by Mkt. Cap

10 Yr Average Annual Excess Returns in U.S. Equity	
Microcap	2.77%
Small Cap	1.36%
Mid Cap	0.53%
Large Cap	0.20%

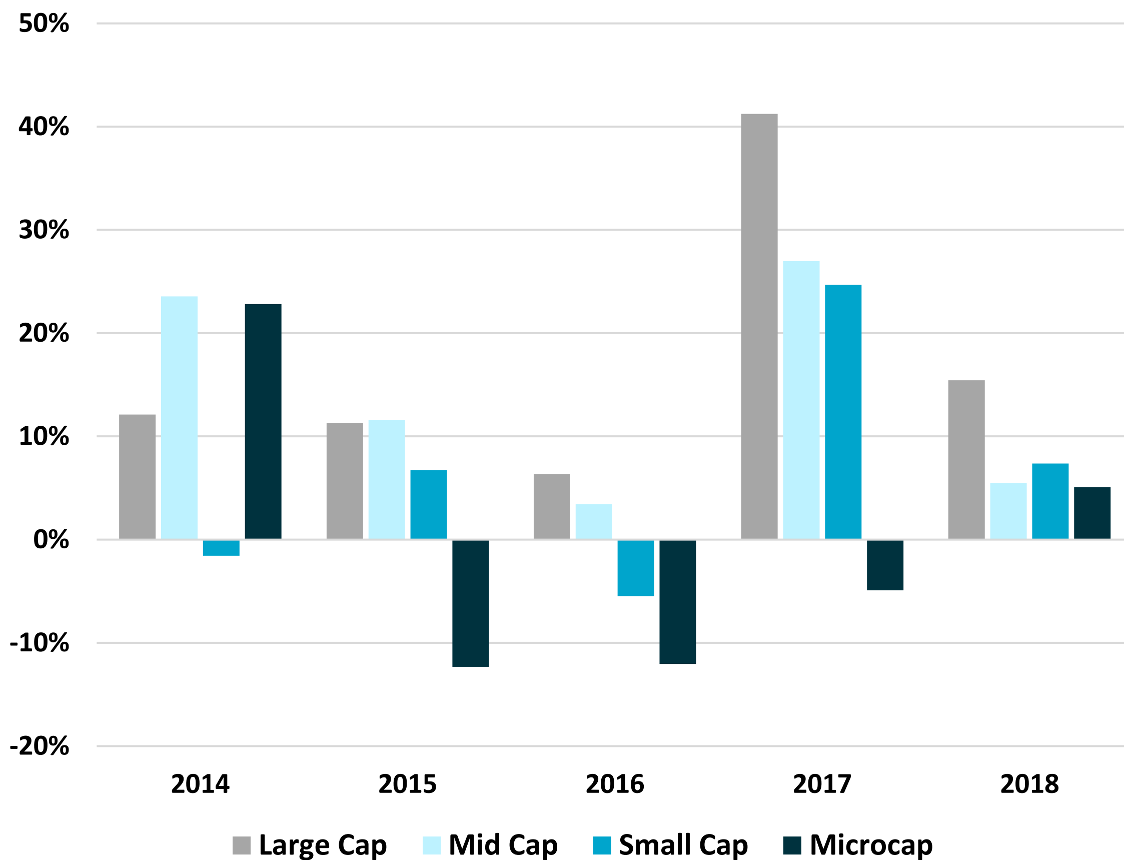
Source: Acuitas Investments, eVestment Alliance. Data represents the average annualized, gross of fee returns for the trailing 10 years ending 6/30/2018

To be clear, we still believe that there are talented large cap active investors that can add value, however the odds of success are reduced due to the market efficiencies present. Simply put, the more efficient the asset class is, the task of finding, researching, and selecting those talented managers becomes increasingly more difficult and resource-constraining for asset allocators. On the other end of the spectrum is small and microcap, where investors continue to be rewarded for investing with active managers. We expanded on this in-depth in our whitepaper "*The Case for Microcap*", which is available on our website, at www.acuitasinvestments.com. In short, the inefficiency and lack of institutional attention in the small, and particularly microcap, spaces creates opportunities for excess returns that active managers can capitalize on. For these reasons most investors agree that active management is a better solution for microcap exposure.

Recent Asset Flows

The shift to passive has caused a ripple effect across markets. One important note, however, is that the trend has been most heavily pronounced in large and mid cap. This makes sense on an absolute dollar figure basis given market-cap-weighted construction methodology for indexes (which are tracked by ETFs). However, when we look at relative percentage flows, there is significantly more to the trend than simply vehicle construction methodology.

Exhibit 2: Yearly ETF Flows as a % of beginning AUM (As of 6/30 each year)



Source: Acuitas Investments, FactSet. Data represents total net flows into the corresponding iShares ETF (IVV, IJH, IWM, and IWC) as a % of beginning AUM, measured at June 30 of each year (reconstitution date for the benchmark indexes).

Exhibit 2 shows the relative asset flows into ETFs broken out by market cap tier. The data represents the aggregate flows for the year (June 30 – June 30) relative to the starting AUM in each respective ETF. For the sake of comparing apples to apples – which admittedly is a challenge given the number of ETFs available today – we used the largest asset base iShares (BlackRock) ETF for each market cap tier for the corresponding Russell Index.

What immediately stands out is the bifurcated trajectories between passive large cap and microcap flows. Large cap has swallowed up the vast majority of aggregate passive flows over the trailing 5 years, while flows into passive microcap have actually been *negative*. Relative to the 6/30/2013 asset base, total net microcap flows over this time period represented a -11% decline. For the large, mid, and small cap ETFs, the relative percentage flows were +147%, +106%, and +40%, respectively, as shown in Exhibit 3.

Exhibit 3: 5-Year Relative U.S. Equity Asset Flows by Market Cap

	Passive	Active
Large Cap	+147.2%	-17.2%
Mid Cap	+105.7%	-2.8%
Small Cap	+40.0%	-1.8%
Microcap	-11.1%	+10.1%

Source: Acuitas, eVestment, FactSet. Data represents aggregate net flows between 6/30/13 - 6/30/18 as a % of 6/30/13 AUM.

Conversely, asset flows on the active management side have been meaningfully negative over the last five years, with large cap managers feeling the most pain on both a relative and absolute dollar basis. This shouldn't come as a surprise as this shift has received broad media coverage. However, what hasn't been discussed is that U.S. microcap has been relatively immune to the active management exodus, with *positive* active inflows over the trailing 5 years. In addition, over the last 18-24 months we have seen an increase in active searches within the microcap space in both frequency and scale. In our view, this is driven by the attractive active opportunity within U.S. microcap and the difficulty for investors to passively allocate to the space, which we address in this paper.

Has the Pendulum Swung Too Far Toward Passive?

Although the shift toward passive investing has been a sustained trend for most of the last three decades, it seems to have accelerated over the last several years as active managers have endured a particularly challenging period due to the powerful combination of rising markets and very low volatility. Associated with this trend is the dynamic where asset flows into passive have indirectly rewarded all equities, without distinguishing between those companies that are more or less effective at allocating capital. At the core of the passive versus active debate is that active managers have historically played an invaluable role in financial markets, most notably for their role in establishing a fair value for securities, i.e. price discovery. The smaller the representation of active investors vs passive investors, the less efficient the process of price discovery will be. Additionally, periods of unusually strong shifts toward passive investing will naturally support momentum-driven markets, where those stocks that have historically performed well will continue to get the largest asset flows, further inflating share prices.

This is where the 'pendulum' argument comes in: at what point does the pendulum between active and passive investing swing far enough toward passive that it lessens the

amount of capital competing for good investment ideas, thereby improving the active opportunity? At that point, we should enter a friendlier environment for active stock pickers to capitalize on. Although we believe active investing is always the best solution in microcap, we still think this is an important dynamic for active investors to understand across the market cap spectrum. As more investors have chosen a passive alternative for their equity exposure, there have been fewer active dollars competing for good investment ideas and participating in price discovery. As a result, correlations between individual stocks will continue to rise, aggregate volatility will decrease, and systematic risk will rise (which is perhaps the most underappreciated market impact). While we do not pretend to have insights on exactly when a shift toward a better active environment might occur, we strongly believe that the pendulum has in fact gone too far toward passive investing. As such, we are confident that the next 10 years will provide better active opportunities than the last 10 years.

Challenges with Passive Microcap: Expenses and Liquidity

Before we assess the difficulties that passive microcap investing presents, we first must acknowledge a few obvious headwinds to the level of interest in allocating to U.S. microcap equity. After Russell's latest index reconstitution (6/30/2018), the Russell Microcap Index's total market capitalization represented just 1.7% of the Russell 3000E Index. Given the way most investors think, this would suggest a typical allocation to microcap of roughly 2% within the U.S. equity sleeve of a portfolio (due to the lucrative nature of the space and the diversifying characteristics, we feel a much bigger allocation is warranted). Despite the low representation of microcap within the broad index, passive and active allocations to microcap are even lower than their market capitalizations would suggest. We feel this not only creates an imbalance in portfolios due to allocators being underexposed to these stocks, but they also sacrifice the absolute and excess return benefits of a microcap allocation. In our view, there are three main challenges with passive microcap solutions: expenses, liquidity and structural issues.

In terms of expenses, the largest providers of passive solutions (Vanguard, BlackRock, Fidelity, etc.) have been slashing fees to record low levels, with Fidelity recently launching zero-fee index funds. For U.S. microcap, the iShares Micro-Cap ETF (IWC) is by far the largest (currently has 85% of passive microcap assets) and is also the cheapest passive solution, with a current expense ratio of 0.60%. While still cheaper than most active microcap alternatives, an expense ratio of 0.60% in today's low-cost world is a non-starter for many passive-minded investors who simply seek out and allocate to the cheapest beta plays available.

For those investors that are willing to pay 60 bps for passive exposure, the next hurdle is liquidity and implementation. One of the attractive qualities of passive investing is the simplicity of it: investors can buy a single security (ETF) and immediately gain 'exposure' to an entire segment of the market. Unfortunately, in microcap this benefit quickly disappears for institutional investors because the microcap ETF does not have sufficient liquidity to be able to efficiently handle investments from large investors who are required to write large tickets to gain adequate exposure at their overall portfolio level. The most

recent volume statistics from BlackRock report an average trailing volume of just over $3 million per day in the IWC. While that figure is quite low, it is a somewhat minor hurdle on its own. The main challenge is the lack of liquidity in the underlying stocks that comprise the ETF. It is worth acknowledging that there are methods to help combat this issue, such as utilizing creation units (an option mainly for institutional investors, not retail). That said, the implementation complexity quickly ramps up with the size of the investment, thereby eliminating one of the main benefits of a passive allocation. A key impact that the lack of liquidity has is that it leads to a shockingly large bid-ask spread for an ETF: as of this writing, the spread has ranged from 15 to 40 cents in recent trading. At a current price of just north of $100, this spread represents anywhere from 14 to 37 basis points, which dramatically increases the costs of trading into and out of the ETF (i.e. additional implementation costs on top of the 0.60% fees). With an average full-fee of 118 basis points for active microcap separate accounts, the cost-savings typically associated with passive investing aren't nearly as pronounced in U.S. microcap.

Another liquidity-driven impact is the difference in index constituents versus the ETF constituents. There are more than 100 stocks included in the Russell Microcap Index that are not in the ETF, which causes a few noteworthy differences. One misguided assumption is that the benchmark includes significantly more low quality 'junk' stocks than the ETF. However, as of September 30, 2018, the weight of unprofitable pharmaceuticals and biotechnology (an example of what investors associate as 'junk') was effectively identical between the ETF and the Index. In reality, the most notable difference between Index and ETF constituents are banks, as many of the small regional banks that reside in microcap are quite illiquid and therefore unable to be owned within the ETF. When we create a cap-weighted portfolio of those 100+ securities that are excluded from the ETF, 44% of the portfolio is banks (compared to less than 17% for the overall Index). This large deviation within such a dynamic industry drives many of the characteristic differences between the excluded stocks relative to the Index (higher yield, lower P/B, etc.).

The key takeaway is that bank stocks also happen to be one of the most lucrative areas within microcap for active managers. Many of the inefficiencies that make microcap attractive are magnified within the banking industry, such as the lack of analyst coverage. More than 30% of banks within the Index have zero analyst coverage, which is meaningfully above the 23% figure for the overall Index. The ability to exploit the inefficiencies and illiquidity in these stocks through skillful analysis and trading provides significant opportunity for active managers. In addition, most active managers are meaningfully underweight the lowest quality, unprofitable stocks we discussed earlier. This dynamic leads to passive products holding far more 'junk' than the average active product does.

Exhibit 4: Passive Vehicle Characteristics (6/30/2018)

	iShares Russell 1000 ETF	iShares Russell Mid-Cap ETF	iShares Russell 2000 ETF	iShares Micro-Cap ETF
Net Expense Ratio	0.15	0.20	0.19	**0.60**
Tracking Error (13y ann)	0.04	0.04	0.07	**0.49**
Active Share (5y avg)	0.50	0.88	2.05	**6.04**

Source: Acuitas Investments, FactSet.

Perhaps most important in the passive vs. active microcap discussion is the structural challenges that passive vehicles face due to the very nature of U.S. microcap equity. In a vacuum, the perfect passive vehicle would have, among other items, zero fees, zero tracking error and zero active share relative to the index it is attempting to replicate. However, there is a reason the disclosure “You cannot invest directly into an index” is found on nearly every mutual fund’s fact sheet. In theory, terms such as tracking error (a measurement of risk) and active share (a measurement of deviation from a benchmark) shouldn’t be associated with ETFs. Nonetheless, over the same time period that we analyzed above (five years ending 6/30/18), the microcap ETF has had an average month-end active share above 6% (which is 12 times greater than the large cap ETF). Looking further back to the ETF’s inception, the annualized tracking error of monthly returns between the IWC and the Russell Microcap Index has been 0.49%, which is also more than 12 times greater than the 0.04% tracking error for the large cap ETF. Simply put, the ‘passive’ solutions for U.S. microcap provide a much more active exposure than many investors would consider acceptable. For those seeking to invest in microcap equity, we feel an active solution makes far more sense, not only due to our belief that active managers should be able to deliver better returns, but also because the expenses and tracking error in passive microcap vehicles are not representative of what passive investors typically expect.

Where Do We Stand Now?

Coming out of the 2008 financial crisis, the U.S. economy has been riding the wave of an unusually long economic expansion along with abnormally accommodative monetary and fiscal stimulus. This has driven a historically long and powerful bull market, with new all-time highs seemingly being set on a regular basis. In addition, aggregate market volatility has been at historic lows for much of the last several years. This type of environment often results in a heavily momentum-driven market, with lack of volatility or trend shifts to shake up managers’ views. This typically presents challenges for active stock pickers who have historically done well in periods of higher volatility (especially high cross-sectional volatility) and less trending markets. Conversely, active managers tend to struggle in the late stages of long, momentum-oriented bull markets and periods of unusually low volatility. Economic recessions with elevated stock market volatility allow opportunistic stock picking, giving active managers the chance to capitalize on perceived mispricing while passive investors are stuck with their beta exposure. For example, in 2000 through

2002, the percentage of U.S. large cap equity products that outperformed net of fees was 88%, 73%, and 67%, respectively, which is far better than what has occurred over the last three years (70% have underperformed). Despite the challenging environment, active microcap managers continue to hold up well versus both the benchmark and other active products focused up the cap spectrum.

Long periods of stable relationships lead to stretched valuations and extreme experiences. While we aren't predicting another tech-bubble-like market crash, the sustained flows into passive vehicles discussed above have certainly contributed to the current market environment. We remain confident that at some point the pendulum will broadly swing back in favor of active managers.

The recent outflows from active products in favor of passive alternatives coupled with fee compression in the space has, and will most likely continue to, cause underperforming active managers to go out of business. In a sense, it is a self-regulating, mean-reverting relationship: decreased competition in the active world will exacerbate the cycle, but potentially accelerate the reversal of the pendulum. Less competition among active investors who survive will result in less money competing for good investment ideas, making it easier for the remaining participants to add excess returns over their benchmarks. In the interim, we are even seeing active strategies opportunistically capitalize on the ETF phenomenon, particularly quantitatively-driven strategies that attempt to take advantage of ETF and index rebalancing schedules.

Even as we find ourselves in a unique market environment with record highs, an unsustainably strong economy, and a rush to passive investments, we feel confident in our abilities to add value for clients. Investors who have been willing to allocate to U.S. microcap have been rewarded, however the space continues to be underrepresented in most U.S. equity portfolios. For those investors considering a microcap allocation, an active management solution should be heavily considered, even if the rest of their equity exposure is passive. One of our founding principles was to remain focused on the lucrative, inefficient corners of equity markets where active management continues to be rewarded even in the face of stiff headwinds. In summary, we feel that we are uniquely positioned in the industry: we remain somewhat immune to the negative effects of the passive craze but are also confident we will be able to capitalize when markets turn, volatility spikes, and active management thrives.

Disclosures

Performance

Past performance is not a guarantee of future returns. Investing in securities involves risk of loss that investors should be prepared to bear. Investments in small and microcap companies may be less liquid and prices may fluctuate more than those of larger, more established companies.

Investment Strategy

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Index Descriptions

Russell Microcap Index is the stocks ranked from 2,001-4,000 in the Russell indexing universe, consisting of capitalizations ranging from about $50 million to $2.5 billion.

Russell 2000 Index is a small-cap benchmark index of the bottom 2,000 stocks in the Russell 3000 Index.

Russell 1000 Index is a large-cap index of the top 1,000 stocks in the Russell 3000 Index.

Russell Midcap Index is the bottom 800 stocks in the Russell 1000 Index.

Russell 3000 Index is an unmanaged index that consists of 3,000 of the largest U.S. companies based on total market capitalization.

Russell 3000E Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Index returns do not reflect any fees or expenses and are not directly available for investment.

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