Microcap in the Age of COVID-19

March 2020

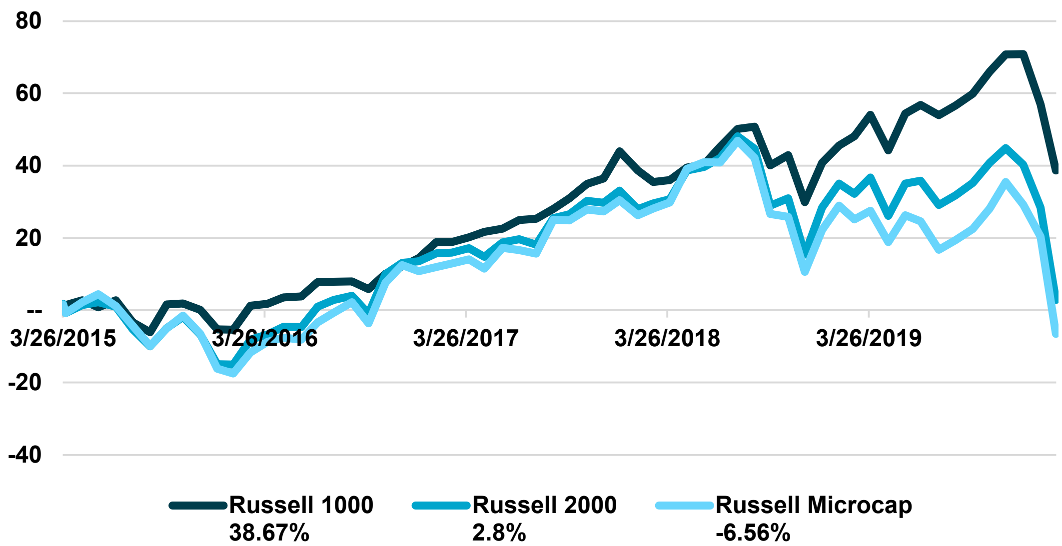
Our team has been through several economic and financial shocks, both minor and major, throughout our careers, including the dot-com bubble and the global financial crisis. Our team averages over 20 years of investment experience which has reinforced to us that now is a time to act with conviction, courage, and consistency. We continue to execute our investment process with a focus on producing returns for our clients: discussing portfolios, assessing current managers, pursuing aggressive idea generation, and looking for opportunities to improve client portfolios. While difficult to experience, economic shocks bring long-term opportunities for patient, disciplined investors. It is critical that we remain steady at the wheel while executing our investment process.

While we continue to execute on our investment process as we have historically, we realize that turbulent times introduce new dynamics and risks, creating a need for additional levels of analysis and scrutiny within our process. For example, sharp bear markets have produced additional pressure on investment management firms. Given the suddenness and severity of the decline, we have been in touch with our managers throughout the market turbulence to discuss how they are reacting to the market environment and monitoring how they are executing their processes. Additionally, we are having ongoing discussions with many of the teams we work with to stay informed of firm developments, gauge the team's focus and stability, and gain reassurance that the firm is supportive during this time. We have been very encouraged with the manner in which our managers have responded to the adversity.

Global Microcap Valuations

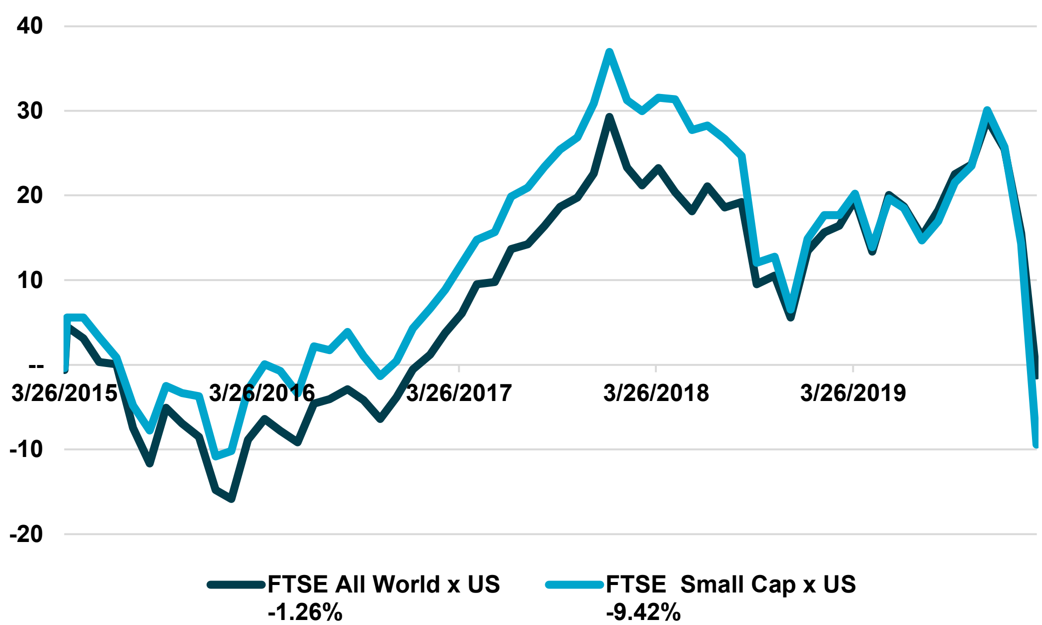
Our process is based on the active returns that can be generated in global microcap markets. For most of the last year we have been discussing the attractive valuations in microcap versus the rest of the market from a tactical perspective. The disparity has only magnified in the last month. We believed then and still believe that now is an unusually attractive time to allocate to microcap. Within the U.S. the broad market has marched to new high after new high while the Russell Microcap Index peaked in August of 2018. Since that time microcap has effectively been in a bear market. Outside the U.S. the top for small cap was even earlier, and absolute valuations have been even more attractive in the small and microcap markets. The charts below show the 5-year return history of the various market cap segments. Note – the FTSE Global ex-U.S. Microcap Index does not have five years of history.

Exhibit 1. 5-year U.S Market Return History (As of 3/26/2020)



Source: FactSet; Acuitas Investments; FTSE Russell

Exhibit 2. 5-year International Market Return History (As of 3/26/2020)



Source: FactSet; Acuitas Investments; FTSE Russell

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The turmoil of the last month has only compounded the difference in the relative attractiveness. At this point the Microcap Index is at extremely attractive valuations on both a relative and absolute basis. Below is a table that we regularly update that shows the relative valuations of various market cap tiers, in percentile terms, versus their own histories. We focus on the U.S. markets in this table because the data is more robust.

Exhibit 3. Index Valuations Relative to Historical Levels (Percentile Rank)

	P/E	P/E (FY1 Est)	P/CF	P/B	P/S
Russell 1000	63.6%	76.6%	76.6%	84.4%	89.1%
Russell 2000	4.7%	6.9%	13.8%	20.7%	46.7%
Russell Microcap	0.0%	0.0%	1.2%	12.1%	39.8%

* Source: FactSet. Dates: 12/31/2000 - 3/25/2020. Data represents month end weighted median values for the associated FTSE Russell Index. The % shown is the percentile rank of the 3/25/2020 value relative to all month end values between 12/31/2000 - 2/29/2020.

As you can see, looking at earnings-based multiples, the Russell Microcap Index is the cheapest it has been in its history, while other measures also indicate that the Index is attractively valued to varying degrees. While it is an important caveat that earnings numbers will come down significantly due to the impact of COVID-19 over the short run, we think the earnings and cash flow numbers give a reasonable picture of earnings power once the crisis is behind us. Additionally, the valuation levels on more stable measures such as book value and sales are also attractive.

Importantly, we believe the stock specific opportunities available today within microcap are more numerous and attractive than anything we have seen since the global financial crisis, and perhaps even longer. As a result, our managers are furiously assessing individual companies to identify those that will withstand the current environment. They acknowledge that the world has changed and that there is an incredible amount of uncertainty, but they are finding many company specific opportunities where the price of the stock is at a complete disconnect from the economic realities. In virtually all cases our managers are taking advantage of the volatility to upgrade their portfolios into higher quality companies trading at extreme valuations that should emerge from this crisis in a position of strength. We believe that volatile bear markets, while challenging, create tremendous opportunities to add value in both a relative and absolute context.

Global Microcap Volatility

Over the long run, global microcap markets have been less volatile than most investors expect, with the volatility of microcap being only slightly higher than small cap. That said, microcap stocks in aggregate have a higher beta. During times of market distress and extreme risk-off environments the beta in microcap can rear its head as investors rush for

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the door. These times are often marked by indiscriminate selling, driving correlations across asset classes to one. In distressed markets investors tend to raise cash in the most liquid instruments and sell perceived risk at any price. This can impact microcap in two ways:

- Rapid liquidations in equity markets can have an impact on microcap even though they aren't a great direct source of liquidity. For example, within the U.S. a meaningful number of larger microcap stocks are included within the iShares Russell 2000 Index ETF (IWM). This ETF is heavily traded and is often used as tool to rapidly increase or decrease risk. When investors are seeking to quickly lower risk the Russell 2000 ETF experiences heavy outflows. As such, a significant portion of the Russell Microcap Index gets caught up in the selling of the ETF, while the smaller microcap stocks that are not in the Russell 2000 ETF may hold up better.
- While over the long run microcap is only modestly more volatile than small cap, during market distress investors often seek to liquidate stocks that have greater perceived risk with little concern for the price impact. Given the constrained liquidity in microcap stocks a small amount of selling can have an outsized impact on stock prices.

As is shown in the return chart above, microcap has lagged both the Russell 2000 (small cap) and the Russell 1000 (large cap) during the entire 5-year period, as well as during the most recent downturn. In international markets the story has been the same. However, during the downturn the volatility in microcap has virtually matched small cap, and only been modestly higher than large cap. Below is a table showing the standard deviation of the daily returns between February 24 and March 25. The results are consistent with our long-term experience; microcap stocks tend to have similar volatility levels to small cap.

Exhibit 4. Daily Volatility During Coronavirus Bear Market

Standard Deviation of Daily Returns (2/24/20-3/25/20)			
Russell 1000 Index	5.74	FTSE All-World x US	3.54
Russell 2000 Index	6.41	FTSE Small Cap x US	3.77
Russell Microcap Index	6.46	FTSE Microcap x US	3.65

Source: Acuitas Investments, FactSet, FTSE Russell. 2/24/20-3/25/20

Importantly, none of the short-term drivers of microcap's return are tied directly to individual company fundamentals, rather they are driven by market structure and investor sentiment. As a result, there is now severe dislocation between market prices and intrinsic value for many microcap companies. As we noted above, many of our managers have been taking advantage of the market volatility to upgrade their portfolios into stocks with strong fundamentals selling at distressed prices.

The Effectiveness of Multi-Manager in Times of Stress

Extreme markets like we are experiencing today are where a multi-manager strategy can thrive, particularly in less liquid and more volatile microcap markets. By using managers with complementary investment processes, we can combine managers that are more defensive in structuring portfolios in down markets with those that will be more aggressive at repositioning their portfolios to exploit the dislocation in the market. This improves our ability to stay in the game in down markets while maximizing our ability to capture the outsized return opportunities that volatility presents.

Additionally, liquidity is at a premium when investors are running for the exits. Using multiple managers improves our ability to be meticulous in managing cash flows in times of distress. In the past two weeks we have been able to put money to work effectively for multiple clients that rebalanced their portfolios into small and microcap, while also effectively raising money for clients that needed liquidity from microcap.

Conclusion

We have been fortunate during this time in that our families are healthy, our community has been resilient, and our clients have been embracing the opportunities presented by this crisis. At the same time there are innumerable unknows and tremendous uncertainty driving volatility in the markets. Over time unknowns will become known, and uncertainties will be replaced with increased visibility, both medically and economically. We believe our portfolios are very well positioned for both the current uncertainty, while being prepared for the evolving markets as the current turmoil plays out.