



The Current Opportunity – Microcap

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Dennis Jensen

djensen@acuitasinvestments.com

Ella Thompson

ethompson@acuitasinvestments.com

The market downturn in the first quarter of 2020 was not unlike prior downturns. We saw investors aggressively flee risk, both real and perceived, which is inherent in small and microcap stocks. Larger, more well-known stocks that are viewed as more stable held up better. As in the past, this dynamic often results in the most attractive valuation opportunities in the stocks that have fallen the furthest – specifically microcap. As investors become more comfortable with the economic environment this trend often reverses, with microcap recovering more quickly and dramatically than large cap.

Below is a table that examines prior downturns with their corresponding one-year forward return. Microcap stocks underperformed during each of the six downturns that we have seen since the launch of Russell’s Microcap Index. Importantly, microcap led large cap in the subsequent year following a downturn in five out of the six periods, with an average outperformance of 7.8%.

Exhibit 1. Largest Recent Drawdowns vs. 1-Year Forward Performance – Micro vs. Large Cap

Start	Bottom	Russell Microcap Index From Peak	Russell 1000 Index From Peak	Microcap 1-Year Fwd	Large Cap 1-Year Fwd	Microcap 1-Year Outperformance vs Large Cap
10/9/2007	3/9/2009	-50.7%	-43.1%	96.8%	72.8%	24.1%
4/23/2010	7/6/2010	-20.1%	-14.9%	37.5%	35.1%	2.4%
4/29/2011	10/3/2011	-30.4%	-19.4%	36.6%	30.9%	5.7%
6/23/2015	2/11/2016	-28.3%	-14.1%	44.4%	29.0%	15.5%
8/31/2018	12/24/2018	-28.6%	-18.9%	29.1%	36.2%	-7.1%
2/19/2020	3/23/2020	-39.9%	-34.3%	*50.3%	*40.8%	*9.5%

Source: FactSet; Acuitas Investments; FTSE Russell

*Forward returns for the most recent period are through 6/5/20

The single exception was the period following the 2018 correction which contributed to the historic performance gap between microcap and large cap over the last two years. The recent selloff has only magnified the dislocation, resulting in the most extreme valuation gap between microcap and large cap since the inception of the Microcap Index. Below is a chart that we often use that shows the valuation of the respective market cap indexes relative to their own histories. Several valuation measures show microcap is

almost as cheap as it has ever been (March 31 was the low, hitting the cheapest on record for multiple measures). Stunningly, large cap remains meaningfully more expensive than average, despite having just been through one of the most rapid and extreme bear markets on record. Of course, the continued market strength in March continues to move these measures up, but even at the end of April the Russell 1000 Index was well above its historical average by these standard valuation measures, while microcap looked historically cheap.

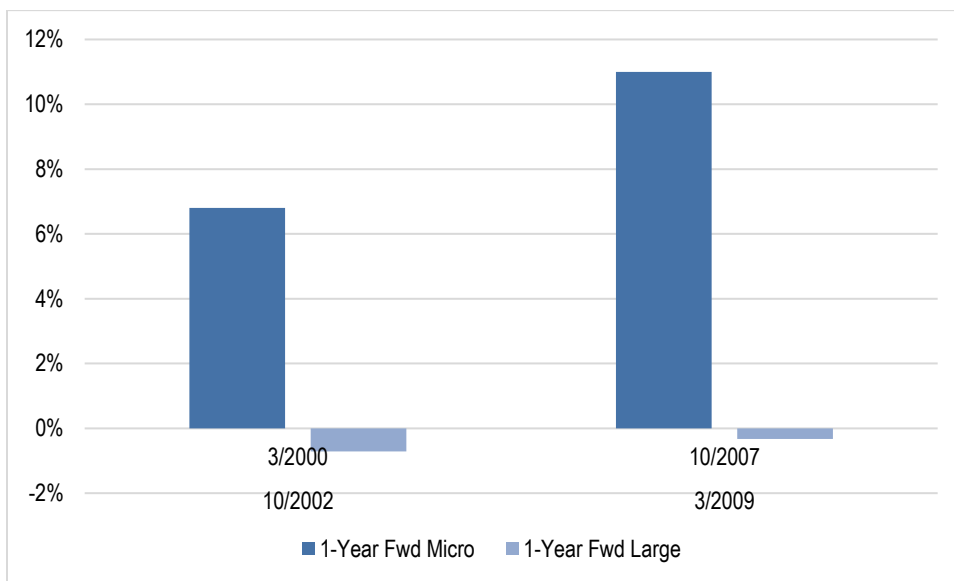
Exhibit 2. Index Valuations Relative to Historical Levels (Percentile Rank)

	P/E	P/E (FY1 Est)	P/CF	P/B	P/S
Russell 1000	92.2%	98.2%	97.8%	98.7%	100.0%
Russell 2000	45.6%	86.2%	28.0%	68.9%	75.0%
Russell Microcap	0.4%	17.2%	7.7%	41.8%	59.0%

Source: FactSet. Dates: 12/31/2000 – 4/30/2020. Data represents month end weighted median values for the associated FTSE Russell Index. The % shown is the percentile rank of the 4/30/2020 value relative to all month end values between 12/31/2000 – 4/30/2020.

We also want to highlight how active microcap managers have done during the recovery period following a bear market. In the chart below we looked at active managers' excess returns following the two most recent bear markets. Admittedly, it is a limited sample size, but microcap managers have seen robust returns during both recovery periods.

Exhibit 3. Active Management During Past Bear Market Recoveries (1-Year Forward Excess Return)



Source: Acuitas Investments; eVestment.

*The active microcap universe during 2000-2002 was approximated by using the bottom quintile of the active small cap universe (benchmarked vs. the Russell 2000 Index) due to lack of data.

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. 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.

Periods of extreme volatility and economic turmoil are the most critical times to have skilled active managers that can differentiate between companies that are truly at risk and those that are more likely to survive and thrive. Companies that have experienced severe dislocations between their stock prices and the fundamental realities become the opportunities that drive future active manager success. We are seeing exceptional opportunities for microcap managers today, and we believe these active managers will be able to capture substantial added value as markets recover.

While we acknowledge that there remains considerable economic and market uncertainty that will play out over the next few months, we remain overwhelmingly confident that microcap stocks look extremely attractive relative to the rest of the market. Additionally, given the fact that active microcap managers have historically performed very well coming out of downturns, we believe a dedicated allocation to active microcap is poised to do well over the next three to five years.

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.

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