Illuminating Opportunity
in Small Capitalization Companies

Micro- and Small-Cap Stocks: the asset classes in hiding

MICRO- AND SMALL-CAPS AS ALTERNATIVE ASSET CLASSES

The micro-cap portion of the U.S. equity market, i.e. companies with market capitalization under $500 million, is considered by some to be the Wild West of the investment landscape. There are roughly 2,730 companies that fall into this category, with market capitalization between $30 million to $500 million. Another 1,600 stocks have market capitalization under $30 million. By comparison the small-cap group, i.e. market capitalization from $500 million to $2 billion, number approximately 1,100. Just 680 and 325 companies fall into the mid-cap and large-cap groups, respectively, which are delineated at $2 billion to $10 billion and $10 billion and above, respectively.

HISTORICAL PERFORMANCE

Yet smaller capitalization companies represent a significant investment opportunity for well-informed investors. Historical performance clearly demonstrates the potential in micro-cap investing. A $1.00 investment in the micro-cap asset class in 1926 would have grown to just under $7,500 by the end of 2001, compared to the same investment in small-caps ($4,569), midcaps ($3,756) or large-caps ($1,740). Furthermore, an analysis of the data indicates that micro-caps beat the overall market slightly more often than not (in 39 out of 76 years or 51% of the time).

The historical data also suggest that micro-cap stocks also have a strong tendency to out-perform immediately following recessionary periods. Based on definitions provided by the National Bureau of Economics Statistics regarding U.S. recessionary periods since 1926, returns for the micro-cap asset class in the one- and two-year periods following the official end of each recession, show that on average micro-caps had performed very well in both the one- and two-year periods. In fact, micro-caps (one year: 48.9% and two year: 40.3%) out-performed the large-cap assets classes (one-year: 26% and two-year: 30.3%). (1)

Lack of liquidity is often cited as a reason for avoiding micro-cap investments. Indeed, the micro-cap universe is about one-fourth as liquid as the small-cap universe, one-tenth as liquid as the mid-cap universe and one-thirtieth as the large-cap universe.

However, performance figures offer encouragement for reluctant investors. From 1979 to 1983 and again from 1991 to 1993, mid-caps outperformed large caps. In 1994 through 1998, large caps outperformed small- and midcap stocks. Small caps led the way in 1988, 1991 through 1993. Small caps very narrowly outperformed large caps in 1999.

HIDDEN FROM VIEW

If the smallest companies are considered the Wild West, then it is a particularly treacherous territory for having no road map. On average only 3.8 analysts covered the typical stock in the micro-cap universe in 2002. Small-caps get more attention, with an average of 7.7 analysts, mid-caps

10.6 analysts and large-caps 14.4 analysts. Of the 2,730 stocks in the microcap universe, 800 have no analyst coverage at all. (2)

We also know the research coverage universe is shrinking. Research by the large, bulge bracket firms such as Deutsche Bank, Goldman Sachs Group and Merrill Lynch are down 15% to 25% in 2003 compared to the prior year. The Nasdaq Stock Market now reports that 44% of its 3,611 companies (1,588) have no analyst coverage, while another 14% (505) are covered by just one analyst.

Our own review of Nasdaq Stock Market traded companies along with those listed on the New York Stock Exchange and American Stock Exchange revealed that at least 970 of the 2,700-plus companies with market capitalization between $25 million and $500 million do not have any analyst coverage. Our count was further corroborated by information provided by Bloomberg LP.

CAUTIOUS BUT CURIOUS

Why are these companies unable to attract investment bank or brokerage firm attention? The obvious argument is that the selection process has simply weeded out the less deserving companies and the lack of research coverage is a natural result of poor fundamental performance. We tested this theory by ranking the 970 companies that we found trading without research coverage on the NYSE, Amex and Nasdaq.

We ranked the group of 970 according to the following characteristics:

- Flat to positive sales growth in the last year compared to the prior year
- Breakeven or positive operating income in the last fiscal year
- Low or no long term debt

While a number of other measures might be used to find those companies which are good investment prospects, we believe these three basic criteria are helpful in illuminating small, but resilient companies. We believe these simple criteria show us companies with growth potential (increasing sales), the ability to generate cash (positive operating income), and financial flexibility provided by unencumbered assets (low or no long-term debt).

In our group of 970 companies, 174 (18%) met all three of these criteria. Clearly, additional analysis would be required before taking a stake and a cautious investor might use more stringent criteria, i.e. year-over-year sales growth in both of the last two years. However, we believe this result suggests that some good investment opportunities in the small company asset classes are being overlooked by traditional analysts.

CONCLUSION

We believe there are a significant number of investment opportunities in micro- and small-cap companies. Investors should be encouraged by the past performance of these assets classes. It is obvious that finding the best opportunities is a daunting task given the paucity of research coverage on small companies. However, if historical trends prove out and the small companies experience a post-recession rise, it may be very good timing for investors to roll up their sleeves and do some homework on names that have otherwise remained hidden from view.

ENDNOTES

(1) Travers, F., “Are Micro-Cap Stocks a Valid Asset Allocation Alternative,” *Institutional Investor,* Spring 2003.

(2) Chen, C.R., Chan, K. C., and Steiner, T.L., “Are All Security Analysts Equal?” *Journal of Financial Research*, Vol. 25, No. 3., Fall 2002.

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