Diamonds in the Rough

Micro-Cap Stocks Offer Opportunities for Growth

by Robert Dixon

Some of the best investments available in today's lackluster markets exist among companies whose names you've likely never heard of. Micro-caps are an asset class that get so little attention the experts can't even agree on its definition. But while fund managers may haggle over just when a micro-cap becomes a small-cap, there's one point they all agree on: There are diamonds to be found in this very rocky region.

Micro-caps have outperformed the rest of the market in 10 of the last 11 quarters, says Joe Frohna, lead portfolio manager of the First American Micro Cap Fund. And historically, it has been small-caps and micro-caps that have pulled U.S. markets out of recession, says Brian Rivel, president of Rivel Research Group.

So it should come as no surprise that institutional investors are intrigued by the sector. But they are also frustrated. It's difficult for managers of large institutional funds to put enough money to work in micro-caps to have a significant impact on their overall performance. Liquidity is a problem, and so is the lack of research.

On the positive side, size can be an advantage for small companies. Size works against big companies when it comes to seeking rapid growth. "It's much easier to grow a company from $10 million to $20 million than it is to go from $10 billion to $20 billion," says Jordan Kimmel, president of Magnet Investment Group and author of *Magnet Investing*.

WILL HISTORY REPEAT ITSELF?

The current economic environment could be ripe for growth among micro-caps, says Scott Johnston with Sterling Johnston Capital Management. The fund manager's Micro Cap Aggressive Growth Portfolio has the best performance in its asset class, according to market researcher InvestorForce's recent ranking of portfolio manager performance.

Johnston has seen it before. When the "Nifty Fifty" bull ran out of steam in the early 1980s, setting the stage for several years of relatively flat performance among large companies, the small-caps outperformed them, he recalls. Johnston, who was then just starting out in small-caps, thinks it could happen again. "You do not expunge that overvaluation of technology stocks that happened in 2000 with one bull market; it generally takes a couple bull markets to get rid of over-ownership," Johnston says. "I believe the same thing is happening now."

The small- and micro-cap universe is much larger, in terms of the number of companies, than the large- and mid-cap asset classes. There are 1,718 companies with market caps between $25 million and $750 million that trade over $2.50 per share in volume of at least 25,000 shares per day. That compares to roughly 580 mid-caps in the $2 billion to $5 billion range and fewer than 400 companies above $5 billion. Remove the trading volume limit, and there are some 2,800 companies in that range, according to Johnston.

On the other hand, stocks have declined so much that investors might be surprised at some of the names that have become micro-caps over the past couple years, however briefly. "It wasn't too long ago that American Airlines (AMR) was in the micro-cap category," says Cole Eckhardt, a private banker at C.E. Unterberg Towbin. "In fact, it was trading down at $3, with a $300 million market value — the largest airline in the country!"

Most investors would prefer stocks moving upward, but a number of well-known companies have become very inexpensive, and Bryant Riley, president of Riley Investment Management, thinks institutional investors are likely to buy into those firms first. Riley questions buying into a component manufacturer if you can get a good buy on the main manufacturer. "Why buy a [small shoemaker like] Van's (VANS) when right now, maybe I can buy a NIKE (NKE)," Riley says. "Maybe it's not going to quadruple, but a lot of the same dynamics take place in the footwear space, and it's a company where you can put more money to work."

And that factor creates a lot of what Riley likes to call "orphans" — micro-cap companies with good fundamentals that have been abandoned in favor of bigger companies or the currently popular sectors. Riley's current focus is on the out-of-favor technology sector, where his firm recently published an index of opportunities called *The Cash-Rich Tech Stock Index*. These are "companies that have incredible balance sheets, real technology and have cut their expenses such that on any improvement or continued cuts are pretty close to cash breakeven or making money," Riley says. "There are a lot of them out there."

THE ADVANTAGE OF BEING UNKNOWN

Micro-caps are the relative unknowns in the equity markets. Many companies have no analyst coverage at all, although a few popular names may have one or two analysts covering them. That compares to 12 to 15 analysts covering the average mid-cap and a few more than that tracking the biggest stocks. They tend to draw less media attention, as well.

In this era of criminal investigations and emotional, knee-jerk reactions that send prices plunging at the slightest hint of bad news, being outside the spotlight may be a blessing. "There tends to be a few less torpedoes in the smaller asset class arena," says Brian Bruce, director of global investments at institutional fund firm PanAgora Asset Management. He points out that in one recent month, four or five S&P 500 companies lost five percent of their value in one day when bad news surfaced.

Lately, those reactions have come before the true extent of a problem is fully understood. Bruce cites the example of Tenet Healthcare Corp. (THC). When Medicare announced it would cut outlier healthcare payments, Tenet's stock dropped 18% in an hour. "It turned out that only three percent of Tenet's revenues have to do with outlier payments, and how much of that was going to be cut was unclear," Bruce says. "How can the stock realistically drop 18% on that little sliver of information?"

Bruce holds micro-cap American Medical Security Group (AMZ), which provides health insurance for individuals and small employer groups. "They are currently trading at forward P/E of 7.3 with a price-to-book of 0.7. This makes them very attractively priced. Analysts expect them to grow earnings at a 20% rate and are revising estimates upward which is a positive sign."

Financial service provider Sterling Financial Corporation (STSA) is another holding of Bruce's. "They attract deposits from the general public through 77 retail banking branches located primarily in rural and suburban communities in Washington, Oregon, Idaho and Montana," he says. "The firm is currently trading at a forward P/E of 9.2 with earnings growth over 10%. In October, they had a positive earnings surprise of 15.38% and analysts are revising earnings estimates upward for the firm."

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> *–Scott Johnston, Portfolio Manager, Sterling Johnston Capital Management's Micro Cap Aggressive Growth Portfolio*

PREPARE TO DO SOME HOMEWORK

The downside to the lack of analyst coverage among micro-caps is that investors have to do their own research — a time consuming and costly process. For institutional investors, the answer most likely lies among funds that do their own research and forecasting for the micro-cap universe. That, of course, leads to higher fees, the managers say. PanAgora researches and forecasts a universe of some 3,500 small-cap and micro-cap companies, so they analyze firms as small as $75 million, Bruce says.

Johnston says his firm's micro-cap fund started out as an "incubator" for Sterling Johnston's Small Cap Fund. "We do a lot of bottom-up work to identify these new, emerging industries. It might be in the small-cap area that you've defined a new industry, but you've got to thoroughly research all the competitors so you have to analyze the micro-caps as well," Johnston says. "We didn't want to lose the value of that research, so we started the micro-cap as an extension of the small-cap." Companies in the micro-cap fund include the same themes, earnings profiles and buy and sell criteria as the small-cap fund.

"If you roll up your sleeves, do your homework, kick the tires and do the due diligence necessary to understand the firm; and, if it's a good company that's growing but is under the radar screens of most brokerage firms and fund managers, then you've really got an opportunity to make a lot of money," says Johnston.

CHALLENGES FOR LARGE INSTITUTIONS

The micro-cap world can be frustrating for large institutional investors. While the opportunities are there, the numbers often just don't add up for institutions that need to put money to work in very large chunks. Liquidity is the most often-mentioned problem. Institutions need to be able to get in and get out of investments quickly, something not easily done in firms where the daily trading volume may only be a few thousand shares.

Joe Dancy, manager of the LSGI Technology Value Fund and a member of the board of Michigan Tech's endowment fund tells of a recent call from an institutional investor interested in placing $10 million in his relatively small micro-cap fund. He told them he'd have to take it in pieces of perhaps $1 million a month, and that they would have to agree not to take it out any faster than that. "All these folks, they chase performance. They run in there with all the money, then six months later, large-caps are hot and they want to get out [of small-caps]," he says. "As a fund manager, that will normally kill you in small-caps; in a micro-cap, that will just devastate you."

Fund managers close micro-cap funds before they get too large, fearing they won't be as nimble as they need to be in dealing with small companies. Fremont Investment Advisors announced plans at the end of October to close its U.S. micro-cap funds when they reach $400 million "to avoid too much exposure to individual securities." At that time, the public fund was nearly topped out at $394.5 million; the institutional fund, with $247.8 million, had a bit more room. Existing investors will be able to add to their positions. The average micro-cap fund is about $400 million, Fremont said. Sterling Johnston will likely close its micro-cap fund to new investors when it reaches the $350 to $500 million range, Johnston said.

WHAT TO LOOK FOR IN A MICRO-CAP STOCK

Management is key to the ultimate success or failure of companies of all sizes, but it is crucial to the growth of micro-cap firms. Executives with significant ownership in their firms are more responsive to shareholder concerns. "We like to know that these guys are feeling the same thing we are," Riley says. He worries about entrenched management with strong ties to the board, people who are more interested in keeping cushy salaries than worrying about the stock price.

The pros also watch insider trading closely. "It's a cliché," says Eckhardt, "but insiders sell for many reasons; they only buy because they think the stock is going up."

A strong balance sheet is high on everyone's list, too. Is the company managing its assets well? Investors also need to look behind the balance sheet. "There are a lot of good balance sheets out there, but some of them have lost their products," Eckhardt says. "It's no longer relevant, or buyers aren't interested in that technology any more." There are opportunities in energy, too, Eckhardt says, but it requires a great deal of digging to really understand those often very highly-leveraged companies, he warns. Call it the Enron factor.

Liquidity is always an issue; more so for large institutional investors, as noted above, perhaps less so for those who are more likely to buy and hang on for a while. Funds, too, help to spread the risk around; Sterling Johnson has 80 companies in each of its micro-cap funds, so the positions in an individual company are never more than one or two percent.

Eckhardt looks for "catalysts" — the reasons a company is likely to grow or outperform its peers and competitors. High barriers to entry by competitors, sector leadership and cutting-edge products or services are among those issues.

Kimmel likes to follow hot market sectors, then look at the peripheral companies likely to ride along with that growth. He cites the example of investors who bought Cisco Systems (CSCO) during the Internet bubble because the company supplies key hardware for the Internet. More recently, when investors were excited about the gambling industry, Kimmel found an attractive micro-cap company that makes most of the poker chips, dice, and other paraphernalia necessary to day-to-day casino operations.

Clearly, opportunities to earn better-than-average returns exist among micro-caps for those who are willing to do the homework. They may not be for everyone, but there are ways for nearly all investors to participate in this sector that could be at the forefront of the next market rebound. After all, Microsoft was a micro-cap once, too.