Historically, many asset owners haven’t created separate allocations for microcap. However, that seems to be changing as asset owners recognize the compelling case for microcap investing, both as a standalone asset class and for the role it can play in asset allocations.

Microcap investing: A definition
Microcap investing is generally defined as the smallest public companies in the U.S. equity market. One of the most common definitions is the Russell Microcap Index, which is defined as the bottom half of the Russell 2000® Index (small cap) plus the next eligible securities down to $30 million market cap. Currently, the majority of companies in this index have a market capitalization between $30MM and $800MM.

Historical lack of microcap investing
From our conversations with prospects and clients, we’ve heard four main reasons that asset owners historically haven’t allocated to microcap:

• Lack of a dedicated style box
• Microcap may be considered a subset of small cap, not requiring a separate allocation
• Large plans struggle to make meaningful allocations due to limited capacity
• Small plans choose not to go that granular in their allocations

However, that sentiment seems to be changing.

In this paper, we discuss the main arguments for microcap investing as well as our preferred approach. In addition, we cover the key concepts to consider when selecting a microcap manager.
The case for microcaps

Asset owners appear to be warming to the benefits of microcap investing. In our view, the case for microcaps breaks into two main categories.

Benefit #1: Higher potential returns

We expect microcap to offer higher returns over the long run due to the high-returning nature of the asset class in combination with greater alpha potential:

- **Higher returning asset class:** According to the well-documented\(^1\) size premium, smaller companies tend to outperform larger companies over the long-term. Since 1973, microcap stocks have outperformed large cap stocks by more than 1% on an annualized basis.

- **Higher alpha:** In addition, microcap tends to be the least efficient area of the U.S. equity market due to less investor attention (e.g., lower institutional ownership, lower analyst coverage). This leads to greater opportunities to identify quality, growing microcap companies before they have been recognized (and fully valued) by the market. In fact, we expect these inefficiencies to become more pronounced as pressures on both the buy-side and sell-side lead to decreased fundamental coverage of microcap companies.

<table>
<thead>
<tr>
<th>Median institutional ownership</th>
<th>Median number of analyst estimates</th>
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Issues with liquidity steer institutional investors away from microcap names.

Microcaps are overlooked in favor of larger, more liquid names by Wall Street analysts.

Benefit #2: Improved asset allocation

Microcap can play a number of powerful roles in an investor’s asset allocation.

- **Liquid, transparent alternative to private equity:** Microcap offers many of the same benefits as private equity (e.g., access to early-stage, high-growth companies) but does so with greater liquidity and transparency into the manager’s process. In addition, significant dollars chasing limited private equity opportunities may lead to expensive valuations and lack of available deal flow, which does not appear to be an issue with microcaps.

- **Small cap completion:** Many small cap managers “cheat” into the larger half of small cap and even into mid-cap, particularly as their AUM grows. The result is that many small cap managers neglect the bottom (and less liquid) half of the small cap universe. In that sense, microcap can act as a completion strategy that fills out the remainder of an investor’s U.S. equity allocation.

Historically higher returning asset class

Annualized returns 1973-2017\(^2\)

<table>
<thead>
<tr>
<th>Percent</th>
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<td>Source: Kenneth French website, BMO Asset Management analysis</td>
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Microcap has historically harvested the small cap premium and delivered higher returns than other segments of the U.S. equity market.

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\(^{2}\) Analysis based on “Portfolios Formed On Size” from Kenneth French website and covers 7/1973-12/2017 based on data availability. Stock universe includes all NYSE, AMEX, and NASDAQ stocks with market equity data as of each June month-end. "Large" defined as Deciles 1-5 of market cap, "Small" defined as Deciles 6-8 of market cap, and "Micro" defined as Deciles 9-10 of market cap. This equates to ~1000 names in large cap, ~1000 names in small cap, and 2000-4500 names in Micro-Cap. Returns are equal-weighted and each category’s value is the equal-weighted return of the relevant deciles. Past performance does not guarantee future results.
The case for microcap investing

U.S. Equities Insights

The case for microcap investing

**Fills gap in small caps**

Median portfolio market cap (in $ millions)\(^3\)

![Chart](chart.png)

Many small cap managers are overexposed to larger companies, and microcap helps restore a balanced small cap exposure.

As a result of the above arguments, we believe microcap offers compelling return potential along with a meaningful benefit in asset allocation plans.

**Picking a microcap manager**

For investors that are interested in hiring a microcap manager, the selection process may involve a tradeoff between performance, length of track record and available capacity. Due to the liquidity limits in microcap, many managers with long and attractive track records have limited remaining capacity. Therefore, prospective investors need to balance:

- Their evaluation of an investor's process (how well suited is it for microcap and how repeatable will it be?)
- The quality and length of track record (how has the manager performed in a variety of market environments?)
- The manager's remaining capacity (how were capacity limits set and how much is left?)
- The firm's commitment to the strategy (in the event a manager has limited AUM, is the firm committed to supporting the strategy long-term?)

Building on these points, we believe key concepts in manager selection include:

**Quantitative tools are highly effective within microcap**

We believe there’s a misconception that microcap investing needs to be primarily fundamentally driven. In fact, we think there are a few characteristics of the microcap universe that make it ideally suited for utilizing quantitative tools in both stock selection and portfolio construction.

- **Universe breadth:** Today, the microcap universe contains over 1,500 publicly traded companies. Quantitative approaches typically outperform fundamental approaches in larger universes, as quantitative models have the ability to draw comparisons across the entire investable universe while fundamental approaches have limitations due to the labor intensive nature of fundamental research. Ultimately, quantitative processes can identify high-quality companies with strong growth potential that may otherwise be undiscovered by fundamental managers.

- **Portfolio construction:** Portfolio construction becomes more important in microcap, as managers need to consider factors such as optimal position sizes based on liquidity, transaction costs, and risk, as well as the optimal level of turnover. Quant managers are able to explicitly incorporate liquidity into their portfolio construction and position sizing, leading to significantly more implementation-conscious processes.

- **Risk management:** Risk tends to be higher in microcap, so risk management becomes more of a priority. This is a traditional strength of quantitative managers.

- **Data clarity:** Data is surprisingly cleaner in microcap than large cap. Because all the companies are public, they still produce the same regulatory filings as large cap companies, meaning earnings and cash flow data is available for all companies. Moreover, these companies typically have more straightforward businesses with fewer product lines, little-to-no off balance sheet financing and overall less complex businesses. As a result, we believe the data may be more reflective of underlying business trends than in other parts of the market.

- **Lack of required analyst coverage:** Quantitative managers typically do not require analyst coverage in order to evaluate the entire microcap universe — moreover they may add the most value in companies that lack analyst coverage. We expect this advantage for quant will only grow as buy- and sell-side firms decrease analyst coverage due to growing economic and regulatory pressures (e.g., MiFID II).

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\(^3\) A Small Cap Core Equity and Micro Cap Core Equity manager universes used to calculate median market cap figures for each respective asset class shown above.
**Fundamental analysis is also important in microcap investing**

In our view, the main downside of quantitative approaches in microcap is that much of the risk tends to be stock-specific, with the potential for large stock-specific losses. As a result, it’s important to have fundamental knowledge of the companies. A purely automated quantitative process without any fundamental oversight might run into blind spots in microcap. We believe the optimal process would also include some level of fundamental analysis, including researching companies fundamentally to avoid model error.

- Understand drivers of company business models
- Identify company-specific risks (competition, customer concentration, end-market exposure, etc.)
- Common sense check – since many microcap companies are in earlier stages, it is important to evaluate the viability and sustainability of underlying companies/business models. In other words, does the company appear to have the ability and resources to become a bigger, better company over time?

To address these limitations in quantitative models, we believe the optimal process would also include some level of fundamental oversight. Given that this skill set is typically different than the skill set of purely quantitative managers, we would suggest a management approach that intelligently integrates quantitative modeling with fundamental inputs.

**Manager return profiles across different market cycles is important**

Just as investors are warming to the idea of microcap investing, asset managers are coming to the same conclusions. As a result, a number of microcap managers have launched strategies in the past few years. Given the high beta nature of the microcap universe, and the strong market returns since the Great Financial Crisis, strategy returns for many managers may not be representative of performance over full (or different) market cycles. We think investors are best suited if they can find managers with longer track records who have successfully managed through a variety of market environments, including downturns.

**Organizational commitment is particularly important in microcap**

One of the main drawbacks for managers offering microcap strategies is the limited capacity, and hence, the limited commercial opportunity. Given that many successful managers with long track records will be closed, investors may be forced to consider managers with limited AUM in the strategy. In that case, investors would be well suited to analyze the organization’s commitment to the strategy, and their willingness to keep the strategy open if assets take longer than anticipated to materialize.

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**Conclusion**

Microcap investing has historically seen less demand than small cap investing due to its lower capacity and lack of a natural style box. However, investors are warming to the benefits of microcap, in particular its higher return potential paired with multiple benefits in an asset allocation framework. We believe microcap has a compelling value proposition, and investors interested in the space would be well suited to consider key questions in picking a manager. In our view, quantitative approaches offer distinct advantages in the space, particularly when paired with fundamental review of names in the portfolio, and managers with organizational stability offer added comfort given the limited capacity of microcap. While microcap investing may require slightly more work in manager selection and in making the case to boards, we believe the investment payoff is well worth the effort.