

International micro cap equities - valuations are attractive on a relative and absolute basis
 By THB Asset Management

The fourth quarter saw a rare pullback in the international (ex. USA) micro cap equities universe. 50% of the universe was down more than 15% in the trailing 12 months. The breadth of this drawdown (50%+) was rare, having occurred only three times in the past 20 years. Subsequent two-year returns were very strong in prior periods.

International micro cap valuations are extremely attractive, trading at 1.2x price to sales, a 40% discount to international large cap equities. Further, international micro cap has the lowest correlations in world equities markets, with intra-market pairwise correlations being 25% lower than emerging market small cap.

Concerns about the rate of global growth persist as a host of regions deal with softer data and contemplate stimulus responses, yet overall World Economic GDP estimates remain solid for 2019 and 2020.

Connecticut-based THB Asset Management (THB) suggests that moderating, but stable economic growth and attractive valuations are an ideal environment for active managers to harness the numerous stock specific opportunities in the universe.

Opportunity

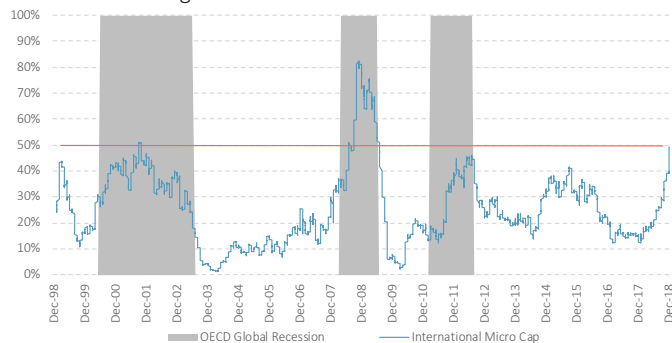
Notwithstanding January’s rebound, the historic pullback in Q4 has created a very attractive entry point for investment in international micro cap equities. The forward 2 year return opportunity remains compelling, valuations are attractive on a relative and absolute basis, and international micro caps offer the lowest intra-market pairwise correlations in world equity markets.

Forward returns following historic drawdown

The recent drawdown was indiscriminate and broad-based as most companies were sold off regardless of their outlook or fundamentals. Approximately 50% of all companies within the international micro cap universe were down more than 15% in the trailing 12 months following the 4th quarter pullback.

Broad pullbacks such as this have only occurred three times during the last 20 years (Figure 1) and have historically provided a great environment for active management. The returns following those periods have been very strong (Figure 2).

Figure 1: % Of International Micro Cap Universe Down More Than 15% in Trailing 12 Months



Source: Compustat

Figure 2: Forward 2 Year Annualised Return

	MSCI World ex USA Small Cap	MSCI ACWI
October 2001	19%	2%
December 2008	35%	22%

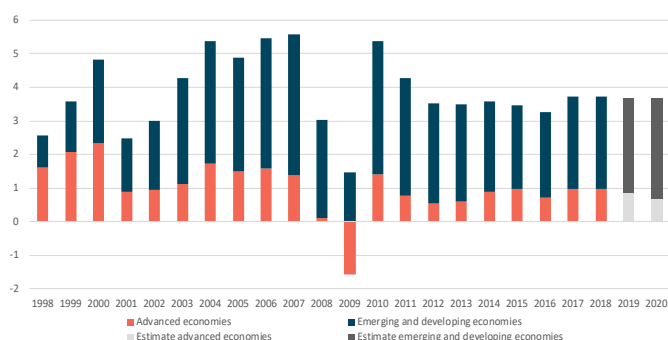
Source: MSCI

RESEARCH NOTE

World GDP expectations provide a positive backdrop for micro cap companies

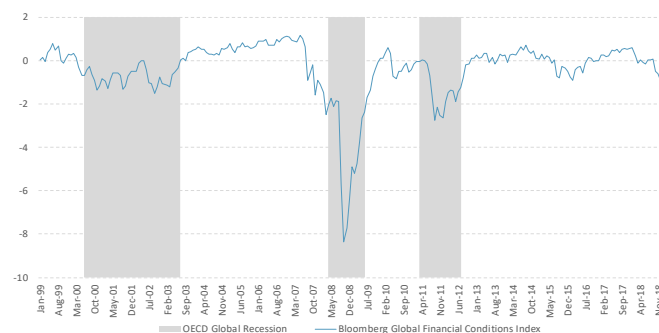
The 4th quarter drawdown was likely caused by a confluence of events weighing on investors' optimism and risk appetites. Emerging market weakness which began earlier in the year accelerated into the 4th quarter while tariffs, the strong USD and general concerns about overall world GDP growth added to investors' concerns. Moderated world GDP expectations of 3.6% and 3.6% for 2019 and 2020 are near the historical averages (Figure 3) and provide a positive backdrop for international micro cap companies. Additionally, stress within the global financial system, while slightly elevated (mostly due to Q4 2018 equity market volatility), remains within the historical range and above prior recessionary periods (Figure 4).

Figure 3: World GDP (% Change On Year Earlier)



Source: World Bank

Figure 4: Bloomberg Global Financial Conditions Index



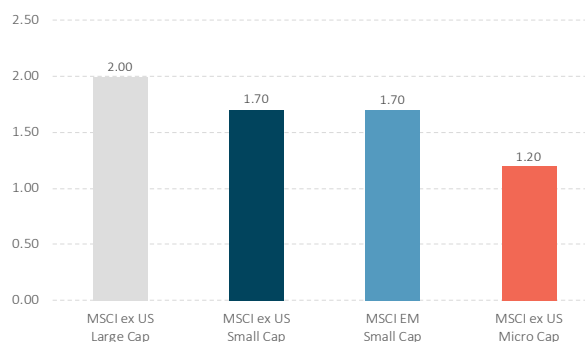
Source: Bloomberg

Valuations are very attractive

The current absolute and relative valuations of international micro cap companies are very attractive. International micro cap equities are trading at 1.2x price to sales and a 40% discount to large cap and 29% discount to emerging market small cap (Figure 5).

International micro cap equities offer investors some of the lowest valuations in world equity markets.

Figure 5: Price to Sales Ratio (31 Dec 2018)

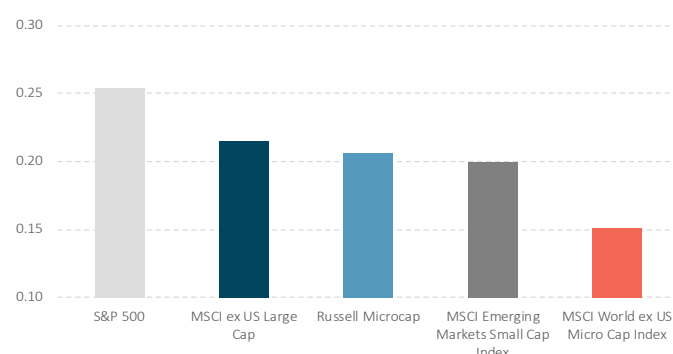


Source: Compustat, MSCI

Lowest rolling 3-year pairwise correlations

The international micro cap equity universe is large in size and diversity. The sizable number of companies in the 22 developed market universe with multiple industries and stock specific drivers leads to very low individual stock correlations. **International micro cap equities have the world's lowest intra-market pairwise correlations, 25% lower than emerging market small cap (Figure 6).**

Figure 6: Rolling 3-Year Pairwise Correlation



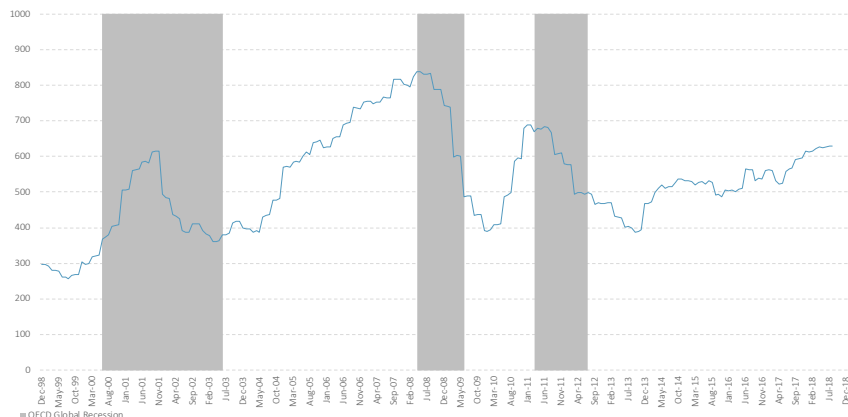
Source: Compustat, MSCI

RESEARCH NOTE

Revenue growth in international micro cap companies

Figure 7 highlights the number of international micro cap companies growing revenue by 30%+ each year. Even during recessionary periods, **there are large numbers of companies growing their revenue base more than expected relative to overall economic conditions.**

Figure 7: Number of Companies Increasing Revenue 30% in a Given Year



Source: Compustat

Summary

International micro cap equities offer investors exposure to a large universe of high quality, well capitalised and low correlated equities. The recent pullback in world equity markets and breadth of negative returns for international micro cap stocks has created an ideal entry point for investors as valuations are some of the lowest in world equity markets.

RESEARCH NOTE

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Investment Strategy – THB International Micro Cap Fund

THB Asset Management (THB) is an employee-owned boutique investment management firm based in Connecticut specialising in smaller company strategies. THB International Micro Cap is a long-only, quantitative strategy with a qualitative overlay. The strategy seeks to exploit inefficiencies amongst international micro cap companies. These are companies domiciled in developed markets outside the US but including Australia. THB uses a series of proprietary quantitative screening tools, developed over 10 years within their fundamental US Micro Cap strategy, to filter the international universe (which includes all common stock listed within these countries' primary exchanges) into an investable subset of securities. From this subset, THB creates a lower-risk and low turnover portfolio in the most inefficient and under-invested segment of the non-US equity market. The strategy is based on the same premise as the US strategy which holds that the most inefficient and under-researched segment of the market has significant opportunities to produce returns well in excess of market benchmarks and large-capitalisation stocks.

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