

Bright opportunity illuminated by historic US drawdown By THB Asset Management

The magnitude of the fourth quarter pullback in the US stock market was rare, having occurred only five times in the past 25 years. Interestingly, only one of those periods coincided with an economic recession, and subsequent one-year returns were very strong for each of those periods.

Connecticut-based THB Asset Management (THB) suggests that investors should see through the noise of the current news cycle and focus on the sound fundamentals and low valuations in micro caps.

Opportunity

The historic drawdown in Q4 created a very attractive entry point for investment in US micro cap stocks. THB believes that a US recession is not imminent as employment trends are strong, underlying financial conditions are accommodative and absolute levels of interest rates remain low.

Even with the rebound in January, valuations remain near trough levels for micro cap companies which has historically created a very positive skew for forward returns. The corporations and the executives who run these companies are taking advantage of the depressed valuations through insider buying and corporate share repurchase programs.

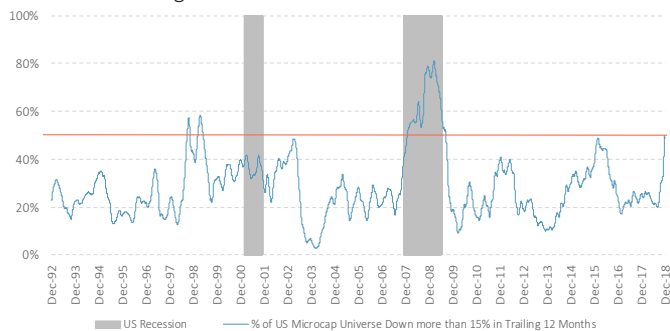
Forward returns following historic drawdown

The recent drawdown was indiscriminate and broad-based as most companies were sold off regardless of their outlook or fundamentals. Nearly 50% of all companies within the US 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 five times during the last 25 years (Figure 1) and have historically provided a great environment for active management. The subsequent returns following those periods were very strong (Figure 2).

The 4th quarter drawdown was likely caused by a confluence of events starting with the normalisation of above trend US GDP combined with economic weakness in China and Europe, strong USD and concerns about tariffs. The markets appeared to jump from moderating economic growth directly to fears of a recession.

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



Source: Compustat

Figure 2: Forward 1 Year Return*

	Micro Cap Universe	S&P 500
May 1999	32%	10%
May 2003	57%	23%
March 2009	67%	54%
March 2016	36%	25%

*Following periods when >50% of micro cap universe companies were down more than 15%

Source: Compustat, Wilshire, Russell

RESEARCH NOTE

Small business optimism remains high

Economic growth is still strong, business conditions remain accommodative and small business optimism remains near record highs (Figure 3).

Valuations are now very attractive

The current absolute and relative (to US large cap) valuations of micro cap companies are near extreme levels. Historically, levels such as these have created a very positive skew for forward returns. Conversely, the near record high valuation level of large cap equities has historically created a decidedly negative skew for forward returns (Figures 4, 5 and 6).

Figure 3: National Federation of Independent Business (NFIB) Small Business Optimism Index

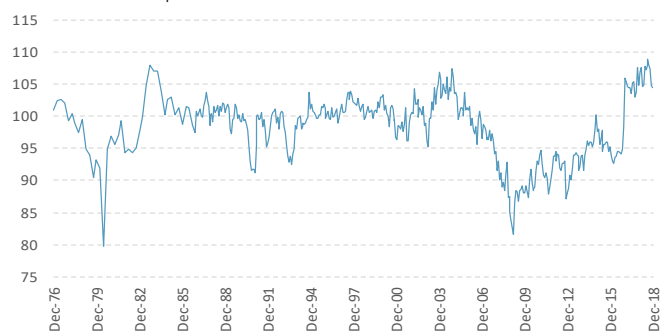
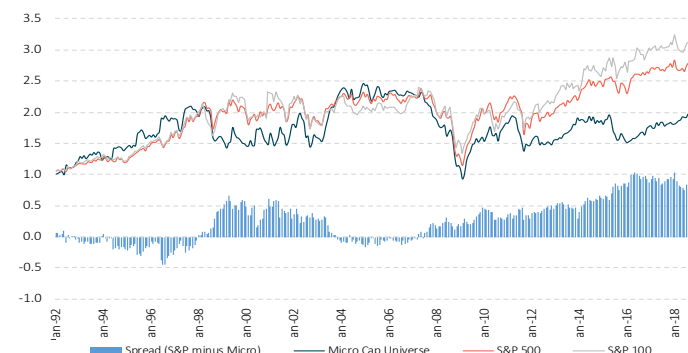
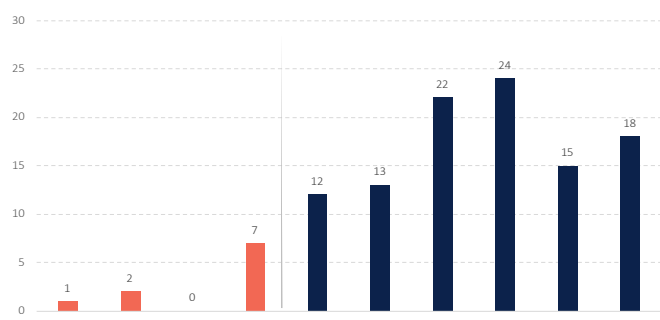


Figure 4: Index (Large Cap, Micro Cap) Price/Sales



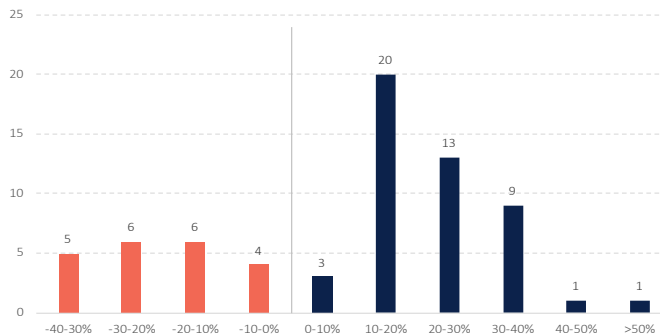
Source: Compustat

Figure 5: Micro Cap Universe Forward 12 Month Return Frequency (1998-2018) After Micro Cap Universe Price/Sales Falls Below 1.7x



Source: Compustat, Wilshire, Russell

Figure 6: S&P 500 Forward 12 Month Return Frequency (1998-2010) After S&P500 Price/Sales Falls Below 2.0x

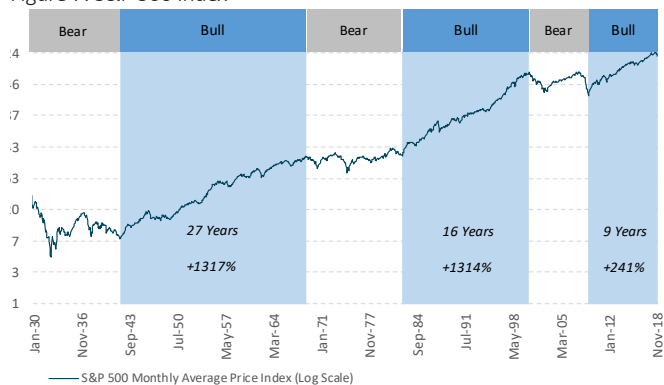


Source: Compustat, Wilshire, Russell

It is helpful to remember that market pullbacks and economic moderation can and do happen within the context of a longer-term secular bull market. Many pundits have debated the cyclical longevity of this bull market, but from a secular perspective it is young in years, the lowest in total return and near the bottom in cumulative economic output. The prior secular bull markets witnessed total returns of 1317% and 1314% with durations of 27 and 16 years, respectively, while this bull market is 9 years old and has only returned 241% (Figure 7).

Over one thousand micro cap executives from 484 companies made open market purchases totaling \$180M of their own company shares during the 4th quarter, while 88 companies announced new or enhanced corporate share repurchase programs totaling \$1.9B. Companies and their executives see great value in their own shares and are taking swift action to capitalise on the pullback.

Figure 7: S&P 500 Index



RESEARCH NOTE

Summary

Micro cap equities are a unique asset class which can offer returns and valuations that differ greatly from large capitalisation stocks. The large, diverse universe of companies with stock specific versus purely macro drivers is an ideal landscape for active managers. THB believes investors should take advantage of the recent drawdown and add to or initiate positions. Underlying economic conditions remain sound while valuations and market actions are reflective of a worst-case scenario. Conditions precisely like this have happened before and investors were well served by capitalising on them.

For more information about the THB US Micro Cap Fund please contact:

Brookvine Pty Limited

+612 9328 6445

clientservice@brookvine.com.au

Investment Strategy – THB US Micro Cap Fund

THB Asset Management (THB) is an employee-owned boutique investment management firm based in Connecticut specialising in smaller company strategies. THB's US micro cap strategy is based on the belief that there are inefficiencies in the micro cap segment of the market due to lack of analyst coverage, difficulty in identifying value and the impact that management skill has on the direction of smaller companies. THB utilises a disciplined, fundamental bottom-up approach that blends both qualitative and quantitative methods to construct a well-diversified portfolio of companies that possess attractive operating metrics, yet with comparable valuation to the Russell Microcap® Index.

This document has been prepared and issued by Thomson Horstmann & Bryant, Inc. (THB) and is intended for the general information of 'wholesale clients' (as defined in the Corporations Act 2001) only. THB is exempt from holding an Australian Financial Services Licence pursuant to ASIC Class Order 03/1100 'Relief for US SEC regulated financial service providers' in respect of the financial services it provides to Wholesale Clients, and is not licensed to provide financial services to retail clients, in Australia. THB is regulated by the Securities and Exchange Commission of the United States of America under US laws, which differ from Australian laws. Equity Trustees Limited (Equity Trustees) (ABN 46 004 031 298, AFSL 240975) is a subsidiary of EQT Holdings Limited (ABN 22607 797 615), a publicly listed company on the Australian Securities Exchange (ASX:EQT). Equity Trustees is the Responsible Entity of the THB US Micro Cap Fund (ARSN 600 158 450). This document is neither an offer to sell or a solicitation of any offer to acquire interests in any investment. The information contained in this document is of a general nature only. Accordingly, reliance should not be placed on this information as the basis for making an investment, financial or other decision. In preparing this document, THB has not taken into account the investment objectives, financial situation and needs of any particular person. Before making any investment decision, you should consider whether the investment is appropriate in light of those matters. Whilst every effort is taken to ensure the information in this document is accurate, THB provides no warranty as to the accuracy, reliability and completeness of the information in this document and you rely on this information at your own risk. To the extent permitted by law, THB disclaims all liability to any person relying on the information contained in this document in respect of any loss or damage (including consequential loss or damage) however caused, which may be suffered or arise directly or indirectly in respect of such information. Past performance is not a reliable indicator of future performance. The return of capital or any particular rate of return from the Fund is not guaranteed. You should obtain and consider the Fund's Product Disclosure Statement (PDS) before deciding whether to acquire, or continue to hold, an interest in the Fund. Applications can only be accepted on an application form attached to a current Product Disclosure Statement. Neither THB, Equity Trustees nor any of its related parties, their employees or directors, provide and warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it.