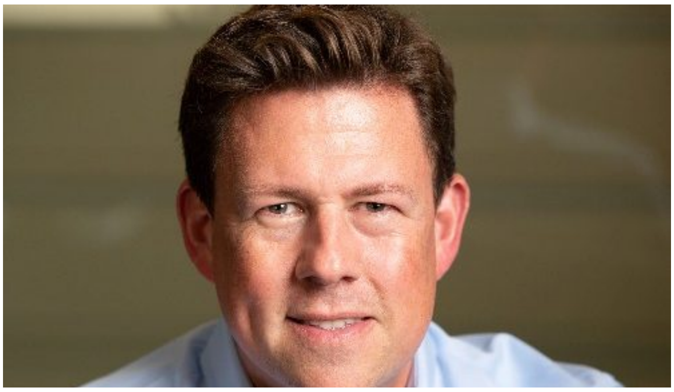

Chris Cuesta

The attraction of micro-caps in a yield-obsessed world

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Chris Cuesta, the chief executive and portfolio manager at US-based THB Asset Management, has been a frequent visitor to Australia for several years. It's been interesting to follow his story. International micro-caps are well worth studying, especially in the current investment climate.

With its Australian partner, Brookvine, THB held an investor breakfast in Sydney last week. While Cuesta's story was pretty-much the same as it was at the last breakfast, earlier this year, the investment world, with its higher risks and troubled bond market, has moved more into THB's favour. Here's the international and US micro-cap story.

Cuesta said in Sydney last week that most people accepted that active managers could add more value in the current climate than they might have in the past few years, when all markets had risen. Micro-cap strategies, he believes, could deliver between 13 and 17 per cent returns, both in US and international (world ex-US) strategies.

"We have a very long track record in the US," he said. "We have been doing this for 21 years, and we have outperformed the market in 85 per cent of all the down periods." There was an element of concentration in the US and other markets at the moment, with investors chasing returns from large-cap growth stocks. This had led to a neglect in the small and, especially, micro-cap sector.

"The last time this happened was in the tech bubble [around 2000]. We started this strategy in 1998. This feels a bit like then… Microsoft represented about 6 per cent of US GDP back then. It then collapsed and is now back to about the same percentage of GDP. Microsoft is a great company, but it all comes down to valuations. We think it has been pushed too far."

The differences between the micro-cap and other sectors in the US and international markets are stark. For instance, there are 3,000 companies in the micro-cap universe which have no debt, but there are only 100 companies in the global large-cap universe with no debt.

"Also, 53 per cent of micro-caps have no sell-side [broker research]coverage, versus 8 per cent of small caps. That's a great sign of inefficiency." When markets are concentrated for too long, they tended to collapse under their own weight. "Who will be the incremental buyer when everyone already owns the

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stock?" The top 100 in the S&P currently accounted for about 70 per cent that index's market value. "When it's going to end, I don't know. But when I'm talking to friends and family, I advise them to diversify now."

Steve Hall, the chief executive of Brookvine, said the premium differences between large caps and micro caps around the globe tended to be cyclical. "Style is like a bell curve and THB is a core manager – it doesn't buy into the extremes of style drift."

He said that THB also expected to see more M&A activity in the micro-cap sector in the current climate, helped by the tax-reform program of the current administration in the US. THB had participated in about 250 mergers or acquisitions in the past 21 years and about 30-35 per cent of those had been driven by private equity buyers. As is well documented, private equity managers are currently sitting on a record level of "dry powder" for acquisitions.

The other wind at the back of smaller companies, Cuesta said, was regulatory reform in the US. "What we are seeing are little or no recession fears in the US from the companies we speak with. People are going out there and looking to grow their businesses."

– G.B.