RESEARCH NOTE

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Small and micro cap stocks – a vast global universe where pricing inefficiencies driven by neglect and lack of research are greatest

THB Asset Management – Roadshow FAQ

During his trip to Australia and New Zealand in October, Christopher Cuesta, CEO and Portfolio Manager of THB Asset Management (THB), presented a timely case for investing down the market cap spectrum.

THB invests in the most inefficiently priced segments of global equity markets, focusing on companies in the lower tiers of the MSCI small cap universe and on investible micro cap companies. This paper outlines THB's response to key questions posed to Chris following recent discussions with investors about THB's strategies.

Differentiation

Q. How are THB's strategies differentiated from its peer group?

There is no denying the current neglect from investors and analysts in smaller cap stocks. While the vast majority of today's active and passive flows are directed to larger cap stocks, there are plentiful quality opportunities to be found in profitable small and micro cap companies around the world. THB's strategies are highly differentiated with respect to other global 'small cap' and 'micro cap' offers, for the following reasons:

- It focuses on smaller companies in the global small cap universe and on investible micro cap stocks
- Seeks outsized returns from market segments with greater scope for value-added active management
- Targets high quality, low risk businesses that can sustain a high return on operating capital
- Leverages THB's 37 years' experience investing with THB's successful US Micro Cap strategy now having a 20+ year track record and International (ex-USA) Opportunities strategy a 4+ year track record
- Diversifies across 100+ holdings in a segment where 'name' diversification is handsomely rewarded
- Focusses its top holdings in mature companies that dominate their market niches
- Has tightly integrated risk management and ESG disciplines

Stock selection preferences

Q. Summarise the characteristics of a typical THB 'business'.

THB typically pursues high quality, low risk businesses that can sustain a high return on operating capital, with the following criteria:

- Well entrenched competitive positions and a unique 'advantage' not fairly valued by the market
- Businesses which do not require significant (if any) leverage to generate returns
- High tangible asset ratios and low-cost structures versus peers
- A high degree of certainty of growth from reinvestment of their cash flows at high rates of return
- Businesses in industries with strong secular tail winds i.e. improving demand dynamics, structural industry change
- Entrepreneurial management teams and a (comparatively) high level of insider ownership
- A valuation that is considered by THB to be attractive
- ESG risks that are appropriately reflected in the price that THB was willing to pay
- A proven track record in public markets (THB does not invest in IPOs, for example)

Top holdings are typically in mature companies that dominate their market niches. These are businesses that are also more likely to be acquisition targets for private equity and larger listed companies. Moreover, THB's proprietary 'risk grading' process seeks to eliminate high risk companies from the universe[1].

Factors influencing an allocation to the strategy

Q. How do THB's investors typically incorporate global small/ micro caps into their portfolios?

Typically, in one of two ways, either as a complement to existing equity allocations, or as an alternative to private equity:

– Many clients use THB as a complement to existing equity allocations – either to diversify away from large cap exposures, as a replacement or complement to current small-cap allocations, or as an alpha generating addition in a core/ satellite model.

– PE managers often target similar smaller, niche companies. Like PE, THB favours companies with strong cashflow generation and stable business fundamentals. It also favours companies with aligned and entrepreneurial management teams. A considerable number of THB's investments are expected to be subject to PE-led takeover activity, and both strategies can provide direct and pure exposure to 'mega trends' (eg. e-commerce, green energy, health and activity, connectivity, cyber security and analytics). THB's strategy offers daily liquidity, lower fees and high levels of transparency.

Q. With micro cap valuations near historical trough levels and large cap valuations at historical highs, what might be the catalyst for a re-rating of the small and micro cap stocks THB favours?

There are two perspectives on this:

– Firstly, much has been written recently about the dispersion between value and growth, and between small and large. Over the last two years these valuation gaps have reached more extreme levels[2]. Investor behaviour shows some of the hallmarks of past late cycle excesses, too. Shiller's Cyclically Adjusted Price/Earnings (CAPE) ratio[3] for the S&P 500, for example, has risen to levels not seen since the tech bubble. However, it is almost impossible to identify a catalyst that will result in a turn of fortunes.

– Secondly, THB favours stocks that are inherently likely to re-rate. These are resilient businesses that are profitable and well capitalised. It pursues them at or near the inflection of underlying fundamentals (i.e. revenue/ EPS growth, ROIC, margin expansion). THB also favours stocks with positive buyback activity, insider purchases and near-term catalysts for change (i.e. new CEO, activist investment, structural industry change, etc). In so doing, THB seeks to identify them ahead of most other institutional, trade and private equity investors. As well, THB's experience has been that as *fundamentals* exhibit positive change these stocks typically garner greater recognition. This has been (historically) reflected in an uplift in trading volumes[4], research coverage, heightened takeover activity and changes in the register of shareholders with the addition of new and more sophisticated investors. Of the stocks that have made a positive contribution to THB's returns over their respective holding periods, a disproportionate share returned 20%+.

1. The risk grade is a quantitative score used to measure relative risk based on a company's specific country and /or region to allow for diversification in the portfolio and avoid low risk countries from dominating portfolio construction. The blended risk grade is calculated using a multi-year stock level standard deviation, historical sector adjustments and earnings volatility. The grades for the entire universe are grouped into quintiles and ranked by grade 1 through 5 (1 being the lowest risk and 5 being the riskiest).

2. Whilst acknowledging that, over much of the past decade, many dominant and at all times expensive-looking large cap stocks delivered on the lofty promises implied by their (then) valuations.

3. The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

4. For example, THB bought ASX-listed stock Appen Ltd (APX) in 2016 when it had USD386K daily volume and sold in 2019 when it had USD13M daily volume. Eckert & Ziegler (Germany; EUZ:GR) was purchased on daily volume of USD220K in 2017 and currently (October 2019) has daily volume of USD3.9M. Digital Arts Inc (Japan; 2326:Tokyo) was purchased on daily volume of USD464K in 2015 and currently (October 2019) has daily volume of USD8.8M.

Portfolio construction

Q. Why does THB hold over 100+ stocks in its strategies?

While THB gives a higher allocation to its 'best ideas', these funds hold 100+ stocks. Why so many stocks?

1. The universe is exponentially greater, and rich with high-quality ideas. Of the ~11,800 companies in the MSCI world universe, just 1,600 are mid and large cap companies. The balance of over 10,000 companies are small and micro caps. Thousands of these companies have low valuations and yet are profitable with attractive metrics including low debt, high ROIC, strong margins and attractive growth profiles.
2. Smaller companies are typically mono line, with a niche focus and domestic orientation. While large companies typically have at least 3 or more operating divisions, a diverse product line and a global customer base, small companies' single line of business and niche focus often carries substantially more business and operational risk. This risk is best managed with name diversification. As a rough rule of thumb, a portfolio of around 30-35 large cap stocks equates to roughly 100 micro cap stocks.
3. The low pair wise correlation of stocks within the micro cap indices provides diversification benefits. With even lower correlation than EM small caps, micro cap stocks are a strong diversifier. Adding more names to the portfolio improves the diversification benefits – a technology stock in Japan has little correlation to a healthcare stock in Ireland.
4. Liquidity is improved. For an actively managed strategy, liquidity is significantly improved by the higher number of names to deliver an institutional calibre portfolio.

Q. What is the estimated allocation for the highest rated 20 stocks in THB's strategies?

The estimated allocation of the top 20 stocks is typically 20-30% in each strategy.

Organisation of the investment function

Q. How is the senior team organised?

The PM's are Christopher Cuesta, Manish Maheshwari and Keith Dickinson. The PM's function collectively as the Investment Committee (IC) for each strategy, reviewing any names bought or sold, with Christopher Cuesta having final authority on all decisions. Meetings of the IC are held a minimum of once per week and may meet more frequently to discuss changes. The PM and analyst team combines individual members focused on fundamental research and quantitative disciplines.

A monthly meeting attended by the entire research team including the IC is held to review performance, attribution, risk, turnover, etc. These meetings include all research personnel and are used to specifically target portfolio construction and any names that may be lagging. Original research packages are brought to the meeting to discuss any change of thesis or company specific events which warrant further attention. The PMs will solicit comments from other senior members of the investment team on any holdings that require additional attention. This meeting is also used to make sure the other goals such as market capitalisation diversity are being met. Note in particular:

- Christopher Cuesta oversees and manages risk for the portfolio and ensures that all aspects of the portfolio meet stated guidelines. Duties include measuring portfolio risk versus the benchmark, ensuring philosophical alignment of portfolio holdings and disseminating such information on a weekly basis to the research team. If changes need to be made, Chris will work with the team to develop a plan of action. Weekly reports are distributed to the team which highlights THB's Risk 4/5 graded stocks (Grade 4/5 being the highest risk grades) and what THB's weightings are in these risk baskets versus the benchmark.

- Manish Maheshwari manages the quantitative functions of the process and ensures philosophical alignment of the holdings. Duties include data production of proprietary risk tools and accounting verification.
- Keith Dickinson liaises with the analyst team to manage the fundamental/ qualitative aspects of the process.
- Victoria Konstantinova (Senior Research Analyst) manages the analyst team and ESG review/ processes. The analyst team will review/ produce data such as geographic revenue exposure, pending corporate actions, ESG factors, THB quality assessment and legal / regulatory items.

Capacity and liquidity

Q. What is your aggregate capacity across strategies?

Estimated future capacity is estimated to be USD1.5–2B. Capacity should expand over time as these markets mature.

Q. How do you manage liquidity (and ensure there is no mismatch between underlying holdings and fund investments, given the funds offer daily liquidity)?

THB will not typically hold stocks that are below reasonable market capitalisation or liquidity thresholds, and cannot be held at necessary levels to make a meaningful contribution to fund returns. Portfolio guidelines include, for example, minimum liquidity of individual stocks, maximum portfolio holdings of individual shares and maximum holding of outstanding shares.

ESG and ESG reporting

Q. What is THB's stance in respect of ESG issues and factors? Will it report back on these matters?

THB is a signatory of the UNPRI and the Montréal Carbon Pledge. THB also integrates ESG factors into its US and international investment processes and no investment is permitted in entities involved in the primary manufacture and/ or production of:

- Tobacco products
- Cluster munitions
- Thermal coal and fossil fuels

THB also measures, monitors and discloses the carbon footprint of its investment portfolios and reports on the portfolio's characteristics relevant to ESG on a quarterly basis.

For more information about THB and its strategies please contact:

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