

RESEARCH NOTE

AUGUST 2016

US MICRO CAPS:

BRIGHT OPPORTUNITY AMID OBSCURITY

Thomson Horstmann & Bryant, Inc. and Brookvine

Over the last year global investors have wrestled with mixed economic data points, volatile commodity pricing, slowing growth in China, terrorist violence, political unrest and US Federal Reserve rate policy. More recently the uncertain implications of “Brexit” on the UK, European and global economies have weighed on investor confidence and stifled optimism.

Through it all many investors have reduced their equity allocations and/or sought safety in US treasuries (with 10-year yields of 1.6% near all-time lows) and higher dividend yielding stocks (the S&P 500 Utilities Index is up 22.5% from 31 December 2015 through July 31). In addition, the Dow Jones Industrial Average and S&P 500 indices have climbed to all-time highs (as of July 31). Yet stocks at the lower end of the capitalisation spectrum have been relatively neglected.

Historically micro cap equities are the highest returning segment of the US market. If we have learned anything since THB began as a specialist firm in 1982, it is that the seeds of micro cap¹ opportunity are sown precisely during these times of risk aversion and safety seeking behaviour.

Currently the valuation gap between large cap and micro cap is the widest in 20 years. Further, micro cap absolute price-to-sales valuation levels are near long-term trough levels and similar to levels when THB launched the strategy in June 1998.

Broader investor optimism seems tepid. However we are confident that the positive US economic environment and valuation support provides a strong backdrop and compelling entry point for patient and longer-term focused micro cap investors. While history is not a predictor of future performance, the current sizeable valuation discount in an uncertain global environment provides parallels between the micro cap opportunity today and the micro opportunity in 1998 when the strategy was launched. Astute investors able to see through the noise and embrace the long-term micro cap opportunity at the time were rewarded.

SIMILARITIES WITH CONDITIONS IN THE LATE 90'S

It is noteworthy that a mix of political and economic factors weigh so heavily on investors today. THB's US Micro Cap strategy was launched in 1998 during a similarly tumultuous period as witnessed by some of the headlines below.

Major News Headlines (1998-1999)	Date
Europeans Accept a Single Currency Despite Late Snag	May 1998
India Sets 3 Nuclear Blasts, Defying a Worldwide Ban	May 1998
World Fury at Pakistan's Nuclear Tests	May 1998
Russian Economic Crisis: Mixed Views on the IMF Bailout Package	July 1998
Iraq Ends Cooperation with U.N.	August 1998
More than 20 Banks Sign Waiver on Default of Long Term Capital Management	September 1998
US Financial Companies Lose \$243B in Market Value	September 1998

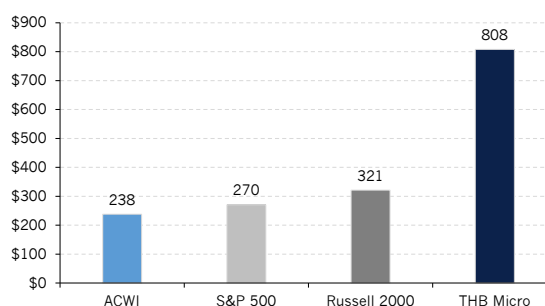
¹ The deciles used in this paper are defined by the Center for Research in Security Prices (CRSP) breakpoints for the US market. CRSP uses only the NYSE to calculate the breakpoints, then backfills the rest of the US market (NASDAQ) into those breakpoints. The number of names in each decile should be roughly equal until the 10th decile where there is a broadening of the number of names due to this NYSE calculation and then filling NASDAQ into those breaks, adding to the number of companies in the 10th decile. The breakpoints are calculated annually and used throughout the year, therefore the number of names in each decile will move around through the year as the market moves relative to the breaks. This methodology is used across the other markets to recreate a similar breakdown.

Major News Headlines (1998-1999) (continued)

	Date
Fed Chief Defends (Long Term Capital Management) Bailout	October 1998
Russian Central Bank Says Almost Half of All Banks Could Fail	November 1998
Clinton Impeached	December 1998
US Weighs Its Reaction To Massacre In Kosovo	January 1999
Indonesian Rupiah Weakens on Fears of Global Currency Crisis	January 1999
NATO Attack on Yugoslavia Begins	March 1999
Are we headed for a global Y2K crisis?	March 1999
The Military Coup in Pakistan: Implications for Nuclear Stability in South Asia	October 1999

In the face of this turmoil, a \$100M investment in the THB Micro Cap Composite at inception would have amassed to over \$800M (net of all fees and transaction costs) today, significantly outperforming the S&P 500, Russell 2000 and MSCI ACWI indices over that same time period.

Growth of US\$100M, Since Inception of THB Micro Cap Composite in 1998 thru 30 June 2016 (\$mil, net of fees)



Please see Appendix for disclosures and index descriptions

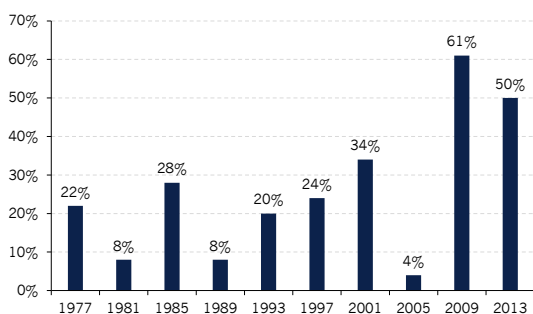
LESSONS FROM HISTORY

In the nearly 20 years THB has been running the US Micro cap strategy it has frequently observed that sentiment and outlook can change quickly and often. We can take examples of the concerns of today and review how similar factors impacted markets and our performance in the past. While the past is not a reliable indicator of the future, there are often patterns.

POLITICAL UNCERTAINTY IN THE US

US political tension over the upcoming presidential election is palpable. Every preceding election cycle has brought with it a certain level of uncertainty and fear-mongering from the opposing parties.

US Microcap Returns in Year Immediately Following US Presidential Election



Source: CRSP

Not surprisingly mudslinging on both sides of the aisle is painting draconian and worst case scenarios of an opposing party victory. However it would be difficult at best to assign any degree of probability to the impact a President Clinton or President Trump administration would have on US equities. Each presidential term is not created equally. Each encounters a myriad of geopolitical and economic challenges that impact markets.

Political affiliation aside, since 1976 the annual returns of US micro cap (as defined by the Center for Research in Security Prices) immediately

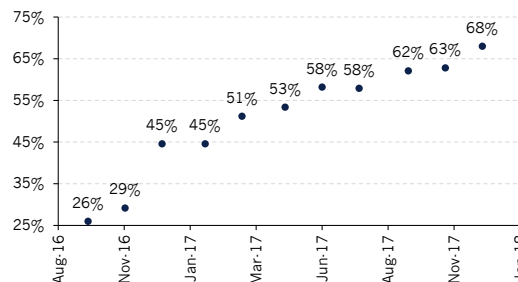
following a presidential election year have all been positive. Only once has it been below 5%. It certainly suggests the “fear” of elections is typically much worse than reality.

RATE HIKES BY THE FED

There is intense speculation about the timing and magnitude of Fed rate hikes and the impact this might have on markets. However the implied probability (calculated by Bloomberg using probabilities of various interest rate level outcomes implied by the futures, options and OIS markets) of a future rate increase one year from now remains below 60%. The broad market consensus is that any rate hikes will be measured.

If rates increase sooner than anticipated, it indicates a stronger than expected US economic recovery. In addition THB’s US micro cap portfolio company holdings are well-capitalised (approximately 60% of Russell Microcap Index companies have zero net debt). So a rate increase would likely have a limited impact on the free cash flow generating abilities and balance sheets of our portfolio companies.

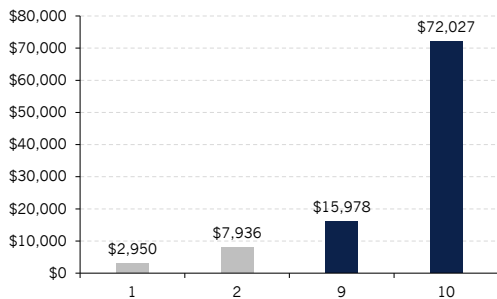
Implied Probabilities of Fed Rate Increase



Source: Bloomberg

MICRO CAPS HISTORICALLY HAVE OFFERED THE LARGEST RETURNS

\$1.0 Compounded from 1925-2015 (US Market Size Deciles)²

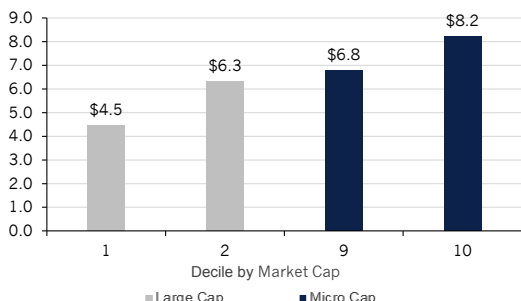


Cutting through the noise of current headlines, it is a fact that since 1925 micro caps, broadly defined as the 9th and 10th deciles (by market cap) of the US market, have offered investors the best returns relative to other market cap deciles.

The same has been true over most long term sub-periods throughout this 90 year history. This includes the most recent 20 year period when an equal investment in the lowest 9th and 10th deciles generated 1.4x a similar investment in the 1st and 2nd deciles.

2. Wealth Index (1925 = \$1); Please remember that different types of investments involve varying degrees of risk, including the loss of money invested and that past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments of investment strategies recommended or proposed by THB will be profitable. Source: CRSP/Center for Research in Security Prices, The University of Chicago; Data through 12/31/15; CRSP Wealth Indices are displayed for illustrative purposes.*Hypothetical value of \$1 invested at year-end 1925. Assumes reinvestment of income and no transaction custody fees or taxes.

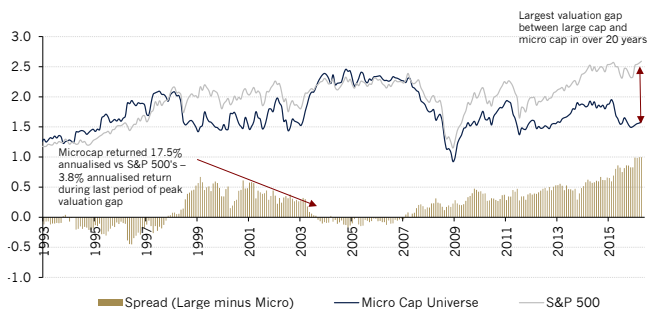
\$1.0 Compounded from 31 December 1995 to 31 December 2015 (US Market Size Deciles)²



THE VALUATION GAP BETWEEN MICRO AND LARGE CAP IS THE WIDEST IN OVER 20 YEARS

Notwithstanding the attractive return profile of micro caps in so called ‘normal’ market environments; at no other time in the past 20 years (since THB began managing the US micro cap strategy) has the price-to-sales valuation gap between micro cap and large cap been this large. The last time this spread came close to the current gap was during the tech bubble. Similar to today there was also a highly uncertain global environment (i.e. the headline summary from the late 1990s above). From the April 1999 peak in the valuation gap until the gap closed in October 2003, micro caps achieved a 17.5% total annualised return vs. -3.8% p.a. from large caps.

Index Price to Sales Ratio



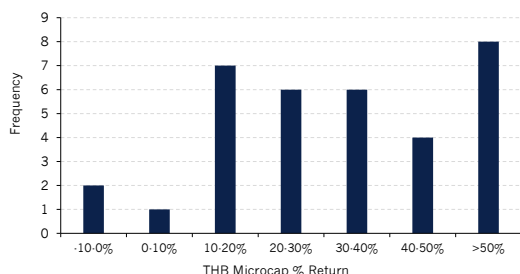
Source: Calculated based on data derived from Compustat; Index Price/Sales as of 30 June 2016³

CURRENT VALUATION AND 10 YEAR RETURN LEVELS HAVE BEEN INDICATORS FOR POSITIVE FUTURE PERFORMANCE

Independent of the relative valuation to large cap equities, historically we have observed that a price-to-sales ratio of the Russell Microcap Index below 1.5x has signaled a period of strong subsequent performance. In 32 out of 34 total observations of this key trigger point, the THB Micro Cap portfolio produced a positive performance over the subsequent 12 months at an average 35%. The chart below sets out the frequency distribution of returns over the succeeding 12 months from every point at which the 1.5x ratio was reached.

3. Index Price/Sales metric excludes Financials. The Microcap universe was derived utilizing those listed securities above a minimum market capitalization threshold up to and including the bottom 1000 companies in the Russell 2000 Index. The above Price/Sales ratio is calculated as a simple average of each data set.

Forward 12 Month Return Histogram of THB Microcap when P/S Ratio of Russell Microcap Index is less than 1.5x

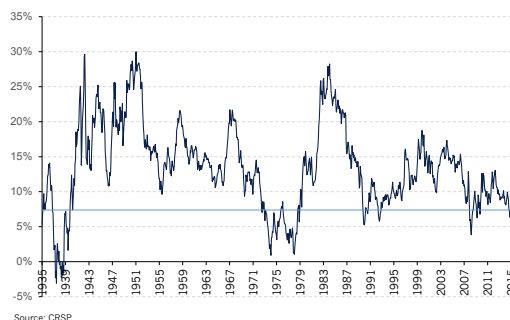


MICRO CAP ROLLING 10-YEAR RETURNS ARE BELOW HISTORICAL LEVELS

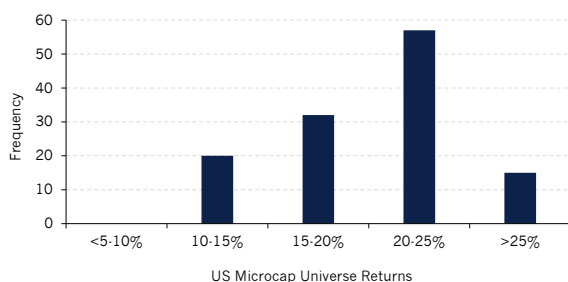
Micro cap returns have lagged the historical 10-year rolling average return levels since the Global Financial Crisis (GFC) of 2008. Since then investors seeking safety in a tepid global growth environment have contributed to the current valuation gap by focusing on large cap stocks.

Dating back to 1925, the forward 10-year annualised return of the micro cap universe has historically performed well when the trailing 10-year annualized return of the Russell Microcap Index has been below 7.5% (the current trailing 10-year annualised return of the Russell Microcap Index is 6.5 %).

US Micro Cap Rolling 10-Year Return History



Microcap annualised forward 10 year returns when trailing 10 year returns were lower than 7.5%



Source: CRSP

CURRENT OUTLOOK

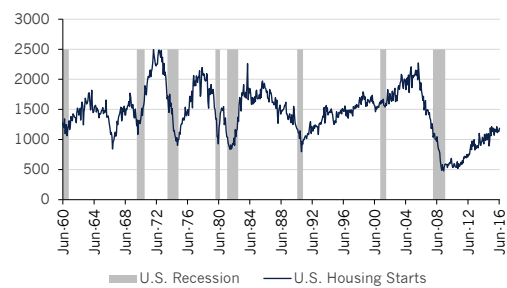
The US Economy is broadly positive with two key indicators suggesting it may be nearing an inflection point toward growth.

After an elongated business cycle that has confused both corporations and investors, we believe that the US Economy is finally nearing what is a “normal” economic recovery. Both total unemployment (as measured by U6 data) and new housing starts are approaching levels associated with a typical economic recovery. As the US economy continues to gain momentum, we believe the long awaited uptick in capital spending and increased merger activity will take place.

HOUSING STARTS AS A LEADING INDICATOR

The bottom of US recessions typically see 1 Million US housing starts annually. The GFC of 2008 has been an exception and 1 Million housings starts per annum was only reached post 2014. Residential investment and consumption spending on housing services is a meaningful contributor to the US economy. Historically the contribution to GDP has averaged 15 – 18%.

US New Privately Owned Housing Units Started

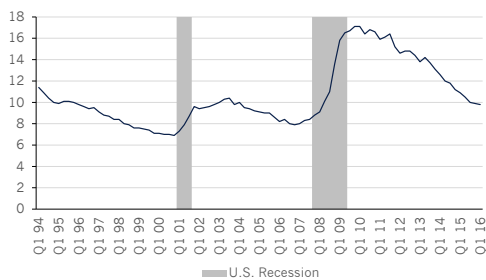


Source: Bloomberg

THE VIEW ON UNEMPLOYMENT

U.S. employment has steadily improved since the peak in December 2009. The U6 rate is the broadest measure of unemployment in the US. It includes people who have looked for work without success, are no longer seeking employment, as well as those who have settled on part-time jobs for economic reasons. The current level of U6 unemployment is only now falling below 10%, which is around the same level as when the 2001 recession peaked and a multi-year period of growth ensued.

US U6 Unemployment



Source: Bloomberg

The improving U.S. employment picture is having a positive impact on wages. Recent wage pressure should help support US consumer spending (approximately 70% of US GDP) and economic growth.

US Wage % Growth



Source: Bloomberg

CORPORATE ACTIVITY AND FINANCIAL HEALTH

Well-run companies are returning excess cash flow to shareholders via a combination of share repurchases and dividends. We fully support these actions until our companies see the need to begin capital projects and/or seek to grow their businesses via mergers and acquisitions. Within the last 12 months, 75% of our portfolio companies have either repurchased shares or paid dividends totaling a combined \$1.3B. Share repurchases have totaled \$924M. They were entirely funded from excess cash flow unlike a host of large capitalization companies that are using debt to fund buybacks.

Recent activity has seen an uptick in acquisitions and capital projects. We believe that activity will gain momentum as the economy continues to improve.

CONCLUSION

History has shown that often the best times to invest can “feel” the worst. For example, Businessweek’s “Death of Equities” cover on August 13, 1979 predated the beginning of one the biggest stock bull markets in history. From the article:

“At least 7 million shareholders have defected from the stock market since 1970, leaving equities more than ever the province of giant institutional investors. And now the institutions have been given the go-ahead to shift more of their money from stocks—and bonds—into other investments. If the institutions, who control the bulk of the nation’s wealth, now withdraw billions from both the stock and bond markets, the implications for the U.S. economy could not be worse. Says Robert S. Salomon Jr., a general partner in Salomon Bros.: “We are running the risk of immobilizing a substantial portion of the world’s wealth in someone’s stamp collection.”

As a result, even institutions that have so far remained in the financial markets are pouring money into short term investments and such “alternate equity” investments as mortgage-backed paper, foreign securities, venture capital, leases, guaranteed insurance contracts, indexed bonds, stock options, and futures. At the same time, individuals who are not gobbling up hard assets are flocking into money market funds to nail down high rates, or into municipal bonds to escape heavy taxes on inflated incomes. Few corporations can find buyers for their stocks, forcing them to add debt to a point where balance sheets seem permanently out of whack. On Wall Street, the flight from stocks has forced firms to push alternative investments hard—thereby drawing still more money from the stock market.”

Had a thoughtful investor read the article, agreed with the well-constructed premise, and moved \$10,000 of their retirement money out of stocks and into gold, the gold portfolio would have compounded to \$34,601 thru June 30, 2016. Yet simply owning the micro cap universe would have grown that amount over 16x to \$572,000! A 10-year US bond portfolio would have done better than gold but still underperformed micro cap equities over that period. The portfolio value would have grown to \$169,314. The bond investment would have nearly caught the bottom of the bond market and participated in a 30 year bull market. With current yields, it is mathematically impossible to replicate those bond returns today.

Interestingly, while circumstances may have changed since that infamous article, the host of reasons fearful investors list to shun equities is familiar. But instead of taking advantage of high absolute rates of income, many global investors today are paying some governments (e.g. Germany, Switzerland, Denmark) to hold their money for them via negative rates.

RESEARCH NOTE

Although the ever constant flow of news can foster a myopic viewpoint, THB invest with a long time horizon. Regardless of the period, there always is a host of challenges (macro, industry-specific, and political) faced by public companies. However throughout history well-run, dynamic companies have continually adapted and prospered. In contrast static investments such as gold and bonds are timing specific and may not provide the desired results over a longer term horizon.

The elongated economic recovery, global political environment, non-traditional monetary policies, and lack of a cohesive fiscal response have left many investors searching for answers. Uncertainty is the breeding ground for fear and fearful investors tend to overestimate negative issues.

Only with hindsight is there ever a perfect time to invest. However a rational analysis of the facts and an examination of history suggests there is a confluence of factors today that we believe will, in time, prove to have marked an excellent entry point for US micro cap equities.

APPENDIX

Time	Composite Assets		Annual Performance Results			Benchmark		3 Yr. Standard Deviation	
	Firm AUM (MM)	USD (MM)	# of Accts	Gross	Net	Russell Microcap	Dispersion	Composite	Benchmark
2015	942	659	8	-8.52%	-9.63%	-5.15%	0.50%	14.28%	14.82%
2014	1531	873	15	-5.63%	-6.81%	3.64%	0.44%	14.41%	14.31%
2013	1820	958	11	55.70%	53.85%	45.64%	0.44%	18.70%	17.09%
2012	1297	393	11	24.14%	22.60%	19.75%	0.46%	21.83%	21.20%
2011	1444	311	9	-6.85%	-8.06%	-9.27%	0.61%	27.12%	26.10%
2010	2222	81	Five or fewer	32.36%	30.43%	28.89%	N/A	31.73%	29.02%
2009	1814	291	Five or fewer	43.81%	42.05%	27.48%	N/A	29.00%	27.48%
2008	1286	209	Five or fewer	-45.31%	-46.03%	-39.78%	N/A		
2007	2514	403	Five or fewer	6.83%	5.51%	-8.00%	N/A		
2006	2552	389	Five or fewer	16.56%	15.13%	18.34%	N/A		
2005	2164	274	Five or fewer	5.88%	4.57%	4.56%	N/A		
2004	2314	210	Five or fewer	21.14%	19.66%	18.32%	N/A		
2003	2211	168	Five or fewer	66.86%	64.87%	47.25%	N/A		
2002	1777	85	Five or fewer	0.17%	-1.08%	-20.48%	N/A		
2001	2431	38	Five or fewer	25.42%	23.89%	2.49%	N/A		
2000	2505	26	Five or fewer	15.48%	14.06%	-3.03%	N/A		
1999	2655	16	Five or fewer	43.18%	41.45%	21.27%	N/A		
1998	2355	11	Five or fewer				N/A		

N.A. – Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year

1. The THB Micro Cap Composite contains fully discretionary micro cap equity accounts and for comparison purposes is measured against the Russell Micro Cap Index. Prior to January 1, 2007 the composite is compared to the Russell 2000 Index. The index was changed to be more representative of the composite strategy. The minimum account size for this composite is \$1 million. The objective of the micro cap strategy is to capture multi-investment themes across five broad sectors in a risk-averse portfolio. The strategy implements a disciplined long-term approach with an average portfolio turnover of 70-80%. The focus of the strategy is on smaller-micro capitalization companies in the US market that are under-researched and over-looked.

Thomson Horstmann & Bryant, Inc. is an independent registered investment advisor. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Returns are presented gross of management fees and include the reinvestment of all income. All fees are negotiable. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule for the composite is 1.25% on assets under management and all fees are negotiable.

The Micro Cap Composite was created June 30, 2002. Thomson Horstmann & Bryant, Inc. claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Thomson Horstmann & Bryant, Inc. has been independently verified for the periods January 1, 1992 through December 31, 2015. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed

RESEARCH NOTE

to calculate and present performance in compliance with the GIPS standards. In addition, a performance examination was conducted on the Micro Cap Composite for the period June 1, 1998 through December 31, 2015. The verification and performance examination reports are available upon request.

2. Portfolio holdings and allocations are subject to change and should not be considered as investment recommendations to trade individual securities. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified were or will be profitable. There is no assurance that any securities discussed herein will remain in the portfolio at the time you receive this report, or that securities sold have not been repurchased. There can be no assurance that investment objectives will be achieved.

3. The index comparisons herein are provided for informational purposes only and should not be used as the basis for making an investment decision. There are significant differences between client accounts and the indices referenced including, but not limited to, risk profile, liquidity, volatility and asset composition.

The Russell Microcap Index measures the performance of the microcap segment of the U.S. equity market. It makes up less than 3% of the U.S. equity market. It includes 1000 of the smallest securities in the small-cap Russell 2000® Index based on a combination of their market cap and current index membership and it includes the next 1,000 securities.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. MXWD includes both emerging and developed world markets. For developed markets only, please see MXWO.

Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The index was developed with a base level of 10 for the 1941-43 base period.

4. Alexander J. Thomson, Richard A. Horstmann, and William W. Bryant, Jr. founded the firm in 1982. Equally owned by the three founding principals, THB agreed to transfer their ownership through a sale of the firm to United Asset Management ("UAM") on June 9, 1997. From June 1997 until October 2000, the firm was a wholly owned subsidiary of UAM, a publicly traded U.S. company listed on the New York Stock Exchange. UAM was subsequently purchased by Old Mutual, a London based insurance company. Old Mutual is also publicly traded on the London Stock Exchange and is a company in the FTSE 100 stock index. On August 27, 2010 the key investment professionals acquired the firm from Old Mutual to become 100% employee owned.

5. Past performance is not necessarily indicative of future performance, future returns are not guaranteed.

6. The firm maintains compliant presentations and a complete list of composite descriptions which are both available upon request. Please contact Steve Lee at (203) 992-4326 or slee@thbinc.com.

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