WHITEPAPER

US Micro Cap: The Land that Time Forgot

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HighVista Systematic Strategies Team

HighVista Strategies LLC
200 Clarendon Street, 50th Floor
Boston, MA 02116
617.406.6500
highvistastrategies.com

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These days, market news cycles are dominated by acronyms like FANG, FANMAG and FATMAN and threads about the end of the American small business.

While technological advantage has given firms like Apple and Amazon market dominance not seen since the days of the Mellon's, Vanderbilt's and Rockefeller's, empirical evidence suggests that investor apathy to the smallest companies today may be a misstep. Indeed, history has shown time and again that from the seeds of investor neglect spring future opportunities. In what follows, we present the case that the often-ignored US micro cap ("micro cap") market is an unequivocally compelling opportunity in US equities today.

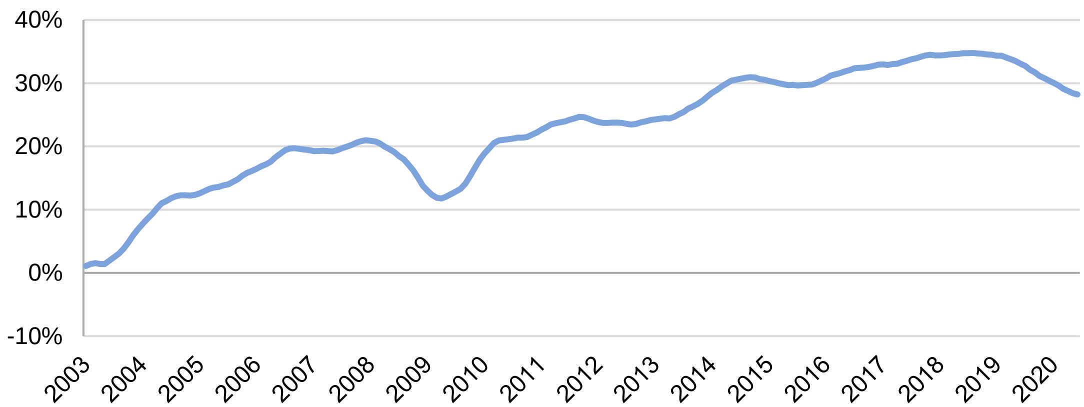
The central thesis of this paper is straightforward: on average, adding active US micro cap exposure to a US small cap ("small cap") portfolio has historically been a strongly positive decision[1], and conditions today indicate it is a particularly opportune time to enter the space. In addition to presenting evidence of this claim, we examine the reasons this has been true in the past and the current market conditions which make us believe that this trend will continue in the future.

There are many ways to gain active exposure to micro cap stocks, and examining these is beyond the scope of this paper. Instead, for simplicity, we utilize performance data from the eVestment database and take the median manager return within the universe as our unit of analysis. Similarly, while active micro cap is well positioned today relative to all US equities, we restrict our comparative analysis here to the Russell 2000 Index for a more apples-to-apples comparison.

Active Micro Cap Outperforms Passive and Active Small Cap

Adding active micro cap requires selling something else in the portfolio, and for many this means active Russell 2000 exposure. In recent years, some have abandoned active management in favor of cheaper passive exposure. We demonstrate that in both cases the decision to add active micro cap has been additive. **Figure 1** begins with a comparison to the passive Russell 2000 Index, where the median active micro cap manager has generated substantial outperformance.

Figure 1: Median Active Micro Cap Manager Outperformance Relative to the Russell 2000 Index[2]



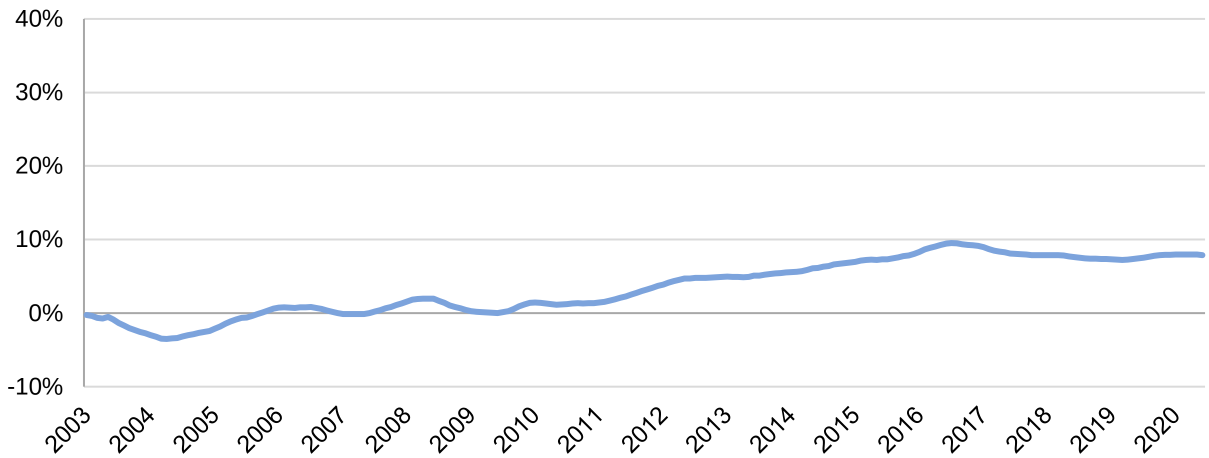
[1] Source: HighVista Internal Research. Past performance is not necessarily indicative of future results.

[2] Data source: eVestment Analytics. "Median active micro cap manager" data is sourced from the eVestment database and represents active and inactive products of managers utilizing an active portfolio management strategy within the US Micro Cap Core Equity universe (excluding a product benchmarked to the Russell 2000 Growth Index). Performance represents the trailing 12-month median manager return (gross) for the period from 1/1/2003 - 6/30/2020 vs the Russell 2000 Index.

While there have been periods of underperformance, they are overwhelmed by the much more frequent periods of outperformance. On average, over this period active micro cap has bested the Russell 2000 Index by 1.75% per year (arithmetic average return). An active micro cap strategy outperformed in 66% of all trailing 12-month periods and 84% of all trailing 3-year periods over the past 17 years. Given the many studies which have demonstrated on average no measurable benefit to active management in larger cap markets, the continued outperformance here is unusual.

This positive performance of active micro cap managers contrasts with the less stellar record of active management within the Russell 2000 universe. As **Figure 2** below illustrates, active managers focused on Russell 2000 stocks generated considerably less outperformance over this same period.

Figure 2 – Median Active Small Cap Manager Outperformance Relative to the Russell 2000 Index[3]



Figures 1 and **2** together appear conclusive: substituting active micro cap for passive exposure to small cap has been strongly additive, much more than utilizing active small cap managers, and thus replacing active small cap with active micro cap would have also been additive over this period.

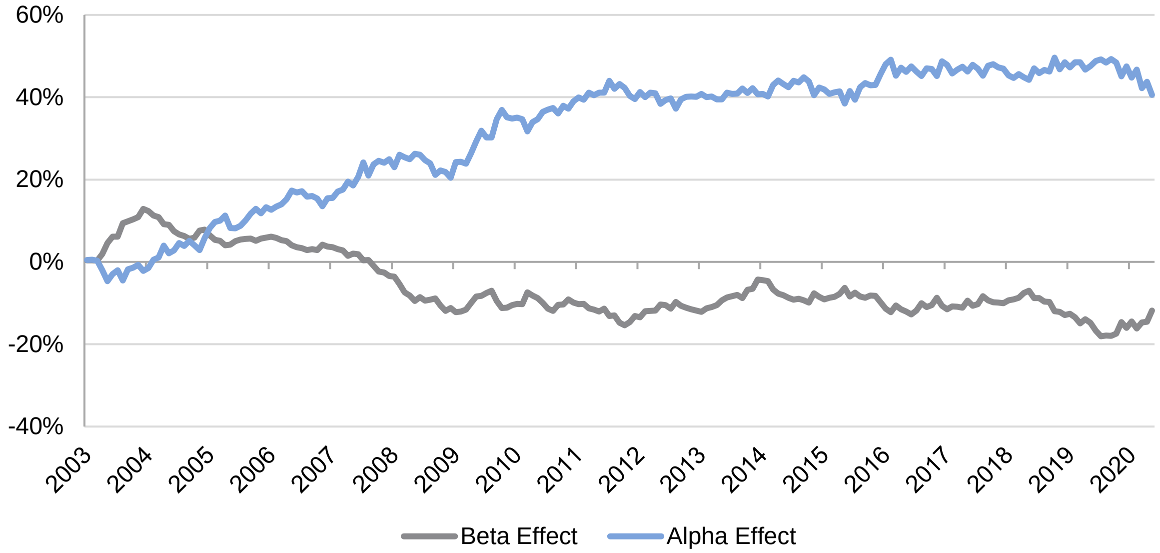
One obvious reason active micro cap may have been a better choice within a Russell 2000 portfolio is that micro cap stocks overall may have simply performed better than the larger stocks within the Russell 2000 universe. If this is true, then even a passive index allocation to micro cap would have been a good choice. This is a “beta” story.

An alternative explanation might be that active management within micro cap was particularly effective. In this case, a passive micro cap portfolio would be a poor choice as it was active security selection within micro cap that created the outperformance. This is an “alpha” story.

To evaluate these two competing explanations we present a decomposition of the outperformance shown in **Figure 1** into two sources: the outperformance of a passive micro cap allocation versus the Russell 2000 benchmark (passive or beta contribution) and the outperformance of an active micro cap allocation relative to the passive micro cap benchmark (active or alpha contribution). The result is shown in **Figure 3** below.

[3] Data source: eVestment Analytics. "Median active small cap manager" data is sourced from the eVestment database and represents active and inactive products of managers utilizing an active portfolio management strategy within the US Small Cap Core Equity universe. Performance represents the trailing 12-month median manager return (gross) for the period from 1/1/2003 - 6/30/2020 vs the Russell 2000 Index.

Figure 3 – Contribution to Micro Cap Outperformance Relative to the Russell 2000 Index



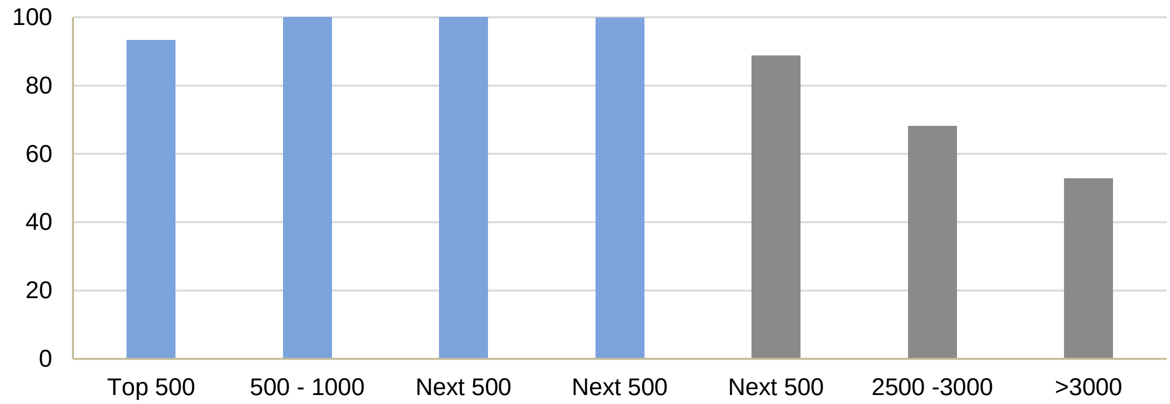
As the figure shows, active micro cap was an additive choice in a Russell 2000 portfolio because of the value created by active security selection, which more than overcame a headwind from the "beta" performance. Passive exposure to micro cap would have detracted from performance by roughly 10% over this period, but active managers were able to add more than 40% in cumulative outperformance to overcome this headwind by a substantial margin.

So, Why Doesn't Everyone Do It?

In some ways, it is remarkable to find strong outperformance by the median active manager in any space. Even if one does not believe the Efficient Markets Hypothesis holds for all securities, it is more surprising to see that it fails in large measure in a consistent way across multiple managers. So why does active management in this space seem like such an easy game? And shouldn't it get arbitraged away like everything else in finance?

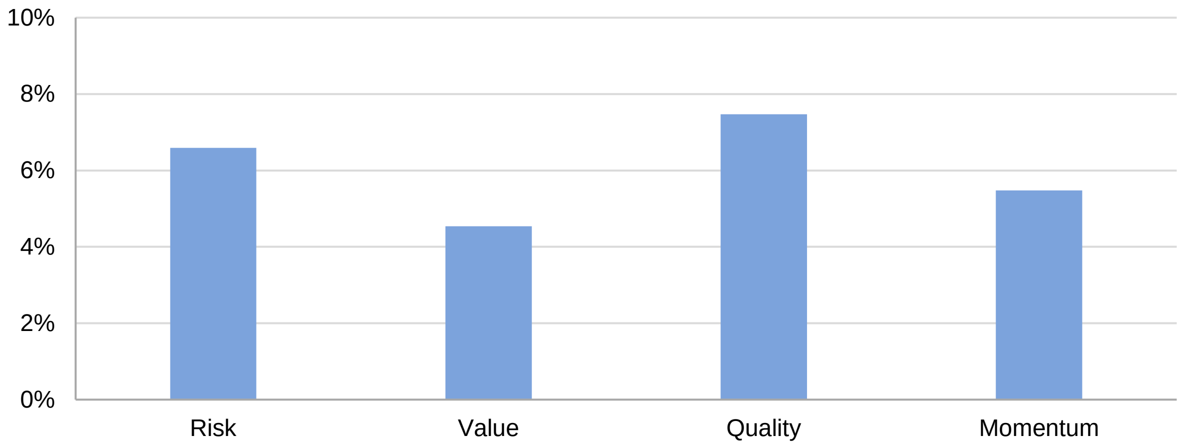
The answer is simple: micro cap is a space that remains somewhat forgotten by institutional investment managers, as illustrated by **Figure 4** below. The primary driver is the limited capacity it affords. Large asset managers cannot deploy enough capital to the space to make it a meaningful allocation worthy of the time required to understand it. High transaction costs and other idiosyncrasies raise the bar for entering the space—entering as a "tourist" might risk the brand of the larger, more profitable business in large cap markets. All of this leads to lower competition from more sophisticated institutional investors, which in turn leads to slower price reaction and greater inefficiencies for active managers to exploit. In many ways, the micro cap space looks like broader markets did 40 years ago, with retail and less sophisticated flows impacting security prices to a much greater extent than they do today.

Figure 4 – Institutional Ownership in the US Market[4]



The more limited institutional footprint in this market translates into strong performance for even well-known factors, including Value, Momentum, Quality and Risk. Whereas the death of several of these factors has been debated in larger stocks for several decades, **Figure 5** below illustrates that they are alive and well within the micro cap universe. This strong factor performance has provided a considerable tailwind to active micro cap investing especially among more systematic managers.

Figure 5 – Micro Cap Factor Returns Over the Last 10 Years[5]



The Case for Micro Cap Today

Given a time machine, there are many great investment decisions one could make! Of course, the more difficult question is whether a decision today is prospectively a good bet. In the case of active micro cap, we think there are many reasons to believe today is a uniquely attractive entry point: micro cap remains difficult to access for institutional investors, recent active underperformance has historically shown evidence of reversion, factor valuations are extremely attractive today, and the “beta” today is also relatively cheap. We explore each of these in greater depth below.

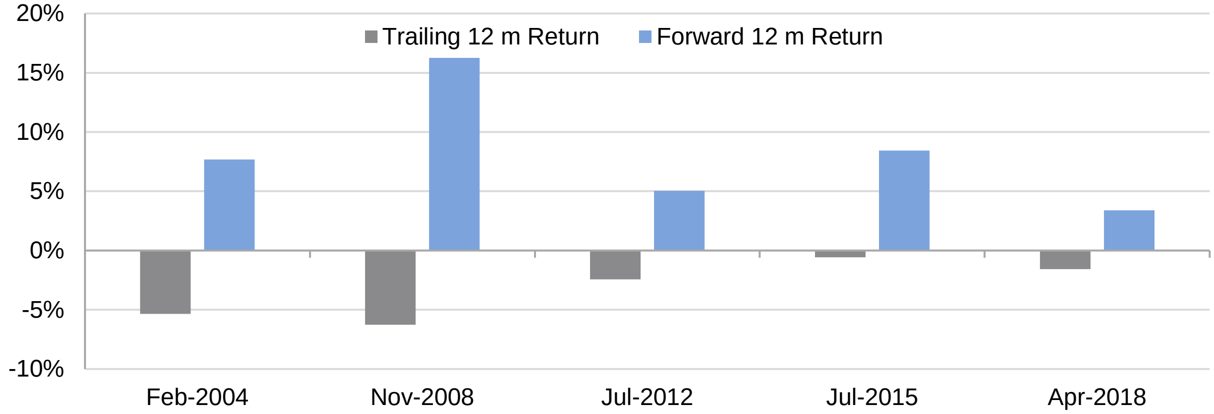
[4] Source: Bloomberg.

[5] Chart represents long/short factor return data from 09/01/2010-8/31/2020. All factor returns are calculated on a sector-neutral basis. Results indicate the Quartile 5 vs. Quartile 1 return spread.

Institutional investors continue to have weak incentives to enter the micro cap space, and this is arguably more true today than ever. As asset managers have consolidated and markets have created a "winner-take-all" connected global marketplace, larger firms are more focused on scale and asset growth than ever.

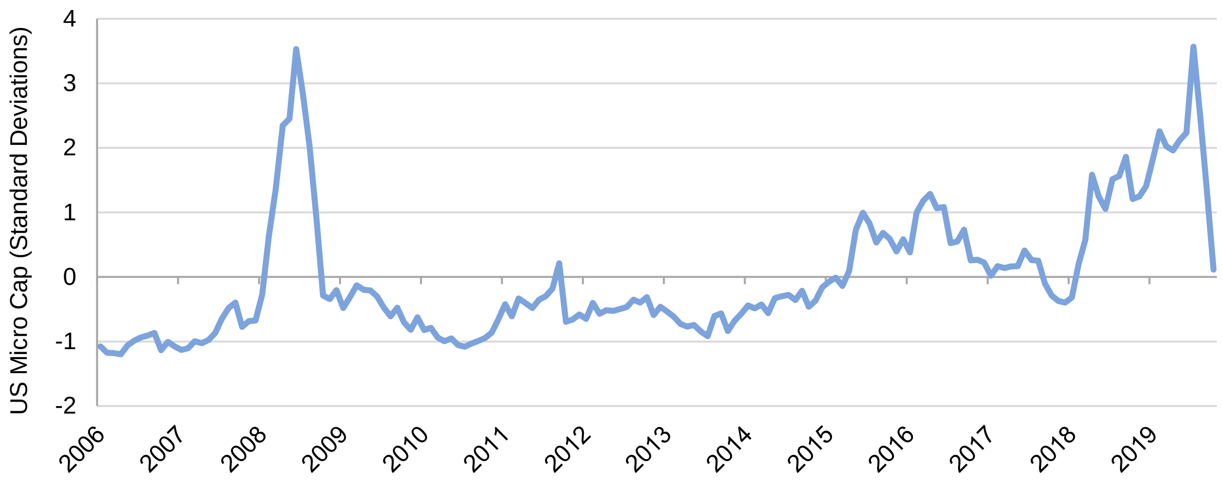
Meanwhile, active management in micro cap has underperformed leading up to and during the COVID crisis. Historically, buying the dip in active management returns has been beneficial as reversion in the time series has been strong. According to this metric, in the past decade, there has not been a better time to make this allocation. **Figure 6** below shows similar periods, illustrating the median manager returns following the drawdowns.

Figure 6 – Largest Periods of Underperformance Have Been Followed by Periods of Strength[6]



Further strengthening the argument that today is a compelling entry point is the current valuation of factors within micro cap. **Figure 7** highlights the historical valuation spread between High- and Low-Volatility stocks over the last 15 years—a lower value indicates Low-Vol stocks are more attractive. The argument could be made in recent years that Low-Vol had become expensive, but recent months have reversed this trend. Today, Low-Vol stocks look much more interesting.

Figure 7 – Valuation Spread of High Volatility vs. Low Volatility Stocks[7]

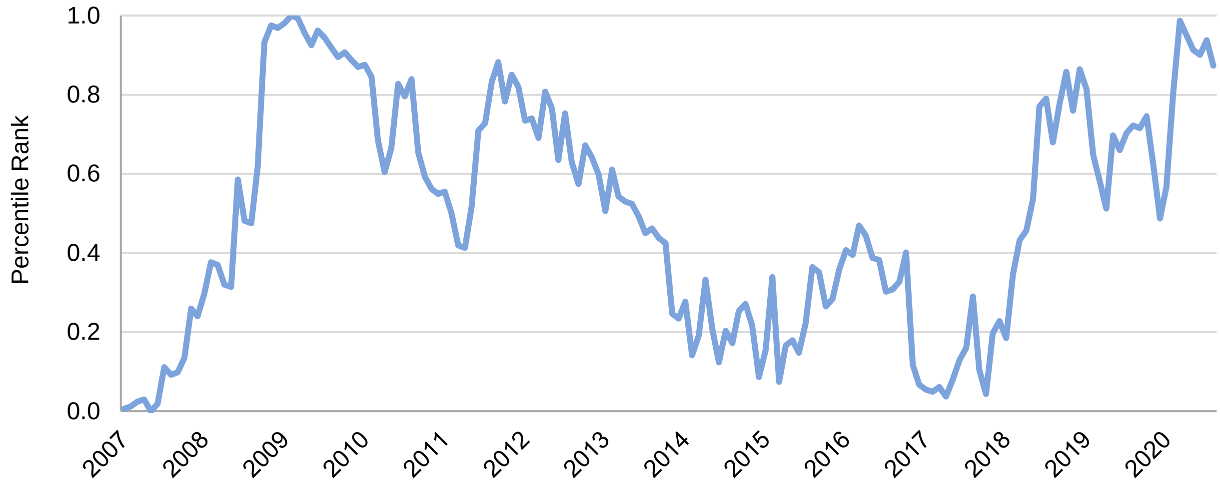


[6] Source: eVestment. Represents "median active micro cap manager" data defined in footnote number 2. Estimated data as of 06/30/2020. Past performance is not necessarily indicative of future results.

[7] Data is derived from HighVista analysis as of 08/31/2020.

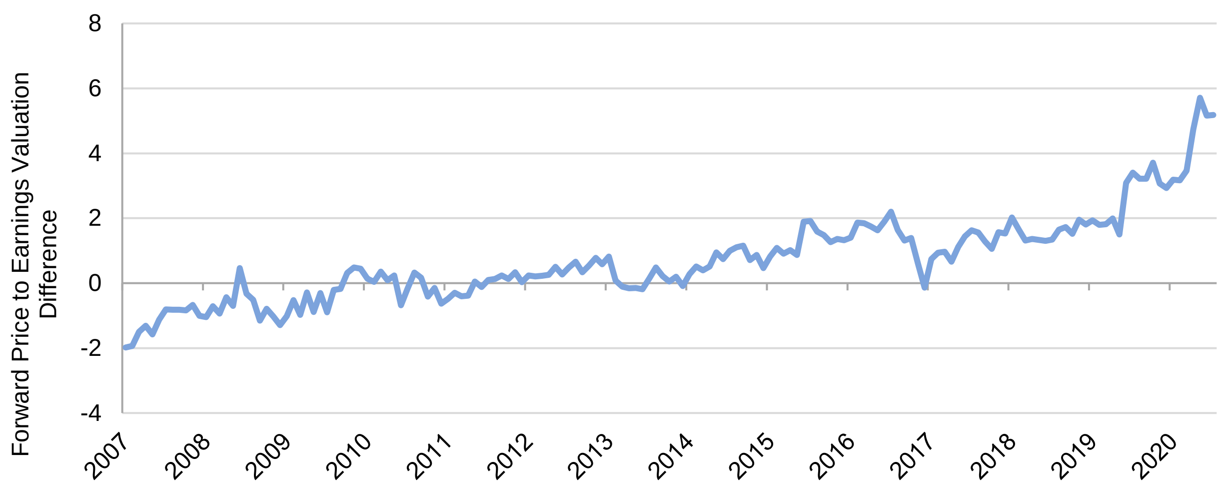
Figure 8 documents a similar statistic for the Value factor within micro cap. A higher value indicates a larger gap between "cheap" and "expensive" stocks in this space and historically has been a tailwind for investments in cheaper stocks. Today, it stands near an all-time high.

Figure 8 – Valuation Spread Ranked vs. History[8]



In addition to factors being attractively priced, the "beta" of micro cap is cheaper than any point we have ever observed relative to small cap stocks. **Figure 9** shows the time series—the greater the value, the cheaper micro cap stocks are relative to their larger counterparts. This statistic is also near an all-time high today.

Figure 9 – Micro Cap Trading Historically Cheap vs. Russell 2000[9]



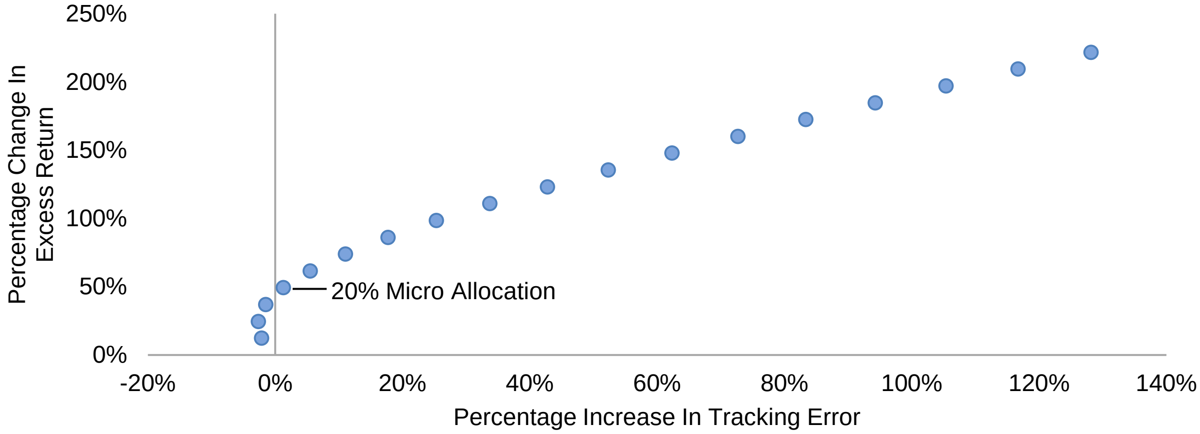
Active micro cap investing going forward may benefit from the space being as "cheap" as ever, including several factors being relatively cheap, and recent underperformance indicates a high chance of reversion in active manager outperformance. Taken together, we believe today affords a unique opportunity in this space.

[8] Data is derived from HighVista analysis as of 08/31/2020.
[9] US small cap vs. US micro cap (ex health care). Source: HighVista analysis. Estimated data as of 7/31/2020. Past performance is not necessarily indicative of future results.

Role in a Small Cap Portfolio

One practical question is: how does micro cap impact a portfolio's tracking error? This is a fair concern—just because something is attractive doesn't mean it will fit into a small cap portfolio. Fortunately, micro cap is related enough to fit well within an allocation without substantially increasing tracking error, and at modest size, may even reduce it because of the positive diversification effect. We illustrate the impact on tracking error within a portfolio benchmarked to the Russell 2000 at different levels of allocation to active micro cap in **Figure 10** below.

Figure 10 – Risk Return Frontier for Micro Cap in Small Cap Portfolios at 5% Increments[10]



In **Figure 10**, the x-axis shows the percentage increase in tracking error at different levels of active micro cap allocation. For very small allocations the diversification benefit outweighs the impact of owning things outside the benchmark, and tracking error actually decreases. We've labeled the point showing a 20% allocation, which is roughly where tracking error begins to increase relative to no allocation. That is, a portfolio with 20% allocated to micro cap managers and 80% to small cap managers would have had roughly the same tracking error to the Russell 2000 as a portfolio that was 100% invested in small cap managers. The y-axis illustrates that the portfolio with a 20% allocation to micro cap would have had 1.5x the excess return of the 100% small cap portfolio. Intuitively, the risk impact at that level is offset by the benefit of diversification, while the return impact is not. Note that these are historical results, and while not necessarily representative of the future tracking error impact, we have argued in this piece that the return impact prospectively may be greater than in the past—leading to an even more pronounced positive effect than is captured in the figure.

Conclusion

This paper has validated how adding active micro cap exposure has historically been beneficial within a Russell 2000 portfolio and that current conditions indicate it is likely to be markedly additive going forward. The security selection landscape is better than it has been in some time and the valuation difference between small and micro cap securities appears to provide a margin of safety in allocating to the micro cap benchmark. Additionally, an allocation to micro cap can potentially be done without substantially increasing tracking error while still improving portfolio performance. For these reasons, we strongly believe that micro cap is one of the best opportunities in today's market environment.

[10] Data source: eVestment Analytics. Represents "median active micro cap manager" and "median active small cap manager" data defined in footnotes 2 and 3 respectively. Estimated data as of 06/30/2020. Past performance is not necessarily indicative of future results.

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