March 19, 2018 Pensions&Investments Pionline.com CRAIN

THE INTERNATIONAL NEWSPAPER OF MONEY MANAGEMENT

INVESTING

Microcaps becoming a popular source in hunt for alpha

By Christine Williamson

Institutional investors are developing a keen taste for microcap stocks such as Red Robin Gourmet Burgers Inc. and Tex-Mex specialist Chuy's Holdings Inc. as they seek higher-return pockets in global equity markets.

Managers said they've never been busier fielding inquiries from chief investment officers looking to active microcap equity as a reliable return source as they rebalance their exposure to large-capitalization stocks and as a proxy for private equity investments.

There isn't a standard market-capitalization size range for microcap equities, consultants said, but the upper limit can be as high as $1 billion. The average market capitalization is about $600 million.

Total assets invested in 76 active U.S. and non-U.S. microcap equity strategies increased 17.8% to $26.7 billion in the year ended Dec. 31 and were up 40% in the two-year period, data from eVestment LLC show. Growth in institutional investment in 67 active microcap equity offerings —18.6% — to $22.6 billion in the year ended Dec. 31 and was up 44.5% over two years.

A significant driver behind current institutional interest in the asset class is the alpha generation potential that comes from identifying and investing in some of the smallest companies in the public equity universe.

"There are tremendous inefficiencies in the microcap universe, which includes thousands of small companies about which there isn't a lot of information and which are poorly covered by sell-side research firms," said Aoifinn Devitt, chief investment officer of the $2.7 billion Chicago Policemen's Annuity and Benefit Fund.

"The smaller the company and the less well-covered it is, the higher the potential for alpha generation," Ms. Devitt said.

The Chicago uniformed officers' fund launched a search in January for one or more U.S. or global microcap equity managers to run $50 million in the fund's first dedicated investment to the asset class.

"Alpha generation by microcap stocks comes from the information differential that managers can exploit, especially given the lack of analyst coverage and low institutional ownership of these very small companies," said David A. Corris, managing director and head of disciplined equities at BMO Global Asset Management, Chicago.

"Over the long run, the size premium results in good long-term beta returns and alpha," he said.

Experienced a pickup

BMO Global Asset Management has experienced a pickup in the level of interest in its microcap equity strategy in the past year or so, Mr. Corris said.

In October, for example, the $2.4 billion Utah School & Institutional Trust Funds Office, Salt Lake City, invested $15 million in the $63 million BMO Disciplined Equity Micro-Cap strategy, which Mr. Corris co-manages with Thomas Lettenberger, director and portfolio manager.

BMO Global Asset Management managed a total of $260.7 billion worldwide as of Dec. 31.

Pensions & Investments' analysis of eVestment data showed the median annualized return of the universe of microcap equity managers outperformed the Russell Microcap index by 294 basis points for the 10 years ended Dec. 31.

EILEEN MOLONY

Aoifinn Devitt said inefficiencies in the microcap universe make it ripe for active investment.

The persistence of alpha generation is one of the reasons the $72 billion Massachusetts Pension Reserves Investment Management Board, Boston, announced a $700 million search for U.S. microcap equity managers in February.

The RFP has not been issued and fund officials declined to provide more details about the search.

However, in a statement, investment officers noted "PRIM staff believe that U.S. microcap equity is an inefficient asset class, thus allowing the potential for active management to generate consistent alpha."

Money managers and consultants said the PRIM search probably is the industry's largest search to date for microcap equity managers, highlighting one of the biggest impediments to investing in the asset class: capacity.

"What mitigates the appeal of microcap equity for big plans is capacity," said Travis T. Prentice, co-founder, CEO and CIO of EAM Investors LLC, Cardiff-by-the-Sea, Calif.

"There are constraints on how much you can invest in these small companies and there aren't a lot of microcap managers. Investors have to hire multiple managers to be able to make a sizable investment," he added.

EAM Investors managed a total of $2.2 billion, of which just more than $1 billion was in microcap equity strategies as of Dec. 31.

Executives at Acuitas Investments LLC, Seattle, a manager of managers in microcap equities, are cognizant of the capacity constraints and invest through early stage managers with low asset levels and concentrated portfolios.

"In reality, you can really only manage a couple of hundred million in microcap strategies," said Christopher D. Tessin, co-founder, managing partner and CIO.

Acuitas managed a total of $790 million as of March 13, of which $600 million was in microcap equity for institutional investors.

The $146 billion Teacher Retirement System of the State of Texas, Austin, for example, generally does not invest in microcap equity managers because "these strategies have very small capacity relative to the size of the TRS portfolio," said Dale West, senior managing director of the fund's external public markets group, in an email.

Some exposure

TRS does get some exposure to small-cap and microcap equities through its external U.S. and international active equity managers "when attractive," Mr. West said.

The high correlation between the returns of microcap equity stocks and private equity strategies has not gone unnoticed by asset owners.

The Chicago Policemen's Annuity and Benefit Fund along with other institutional investors is turning to active microcap equity as a proxy for private equity because "the asset class shares the desirable characteristics of private equity while avoiding illiquidity and transparency problems" with lower fees, said Ms. Devitt.

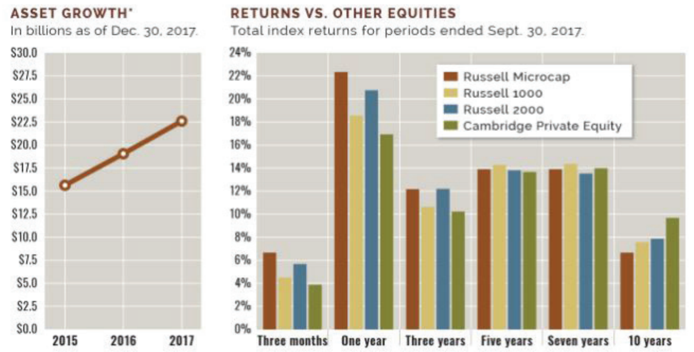
The fund sold its $80 million portfolio of private equity funds of funds at the end of 2017 and in seeking private equity substitutes, launched its search for microcap managers.

"The key is to remember that microcap stocks do not behave exactly like private equity in terms of the return stream," Ms. Devitt said.

She said the expected annual return from the microcap equity allocation is 7.5%, two percentage points over the fund's public equity return and close to the 8% annual return expected from private equity.

Other investors are adding microcap equity strategies in lieu of private equity because "private equity managers have too much money to invest and nowhere to put it," said Mark N. Stahl, senior vice president, co-head of global manager research group and manager of the microcap value multimanager solution for Callan LLC, San Francisco.

Microcaps on the rise



*Active microcap equity assets, U.S. and non-U.S. Source: eVestment LLC

Ironically, having "so much dry powder means that private equity managers are moving down the size spectrum and are looking for deals even in microcap companies. That's going to benefit microcap equity strategies and increase returns," he said.

EAM Investors' Mr. Prentice said the current of large biotechnology companies scooping up "smaller rivals rather than developing their own drugs" also will be accretive to alpha generation in microcap equity portfolios holding these stocks.

Contact Christine Williamson at Cwilliamson@pionline.com · @williamson_pi