"The area which I am about to enter is one that excites a great deal of emotional feeling; nevertheless, it is worth examining"
-***Gordon Tullock***

Summary for 2019 Q3

After a robust first half of 2019, micro-cap stocks faded a bit during Q3 opening up a wide margin of underperformance relative to larger cap stocks. Historically these divergences have proved to be good windows for rebalancing between small and large-cap stocks, or positive entry points for micro-cap investors; more on this below.

For the year-to-date period ended September 30, 2019, the investment results for the Uniplan Micro-Cap portfolio are as follows:

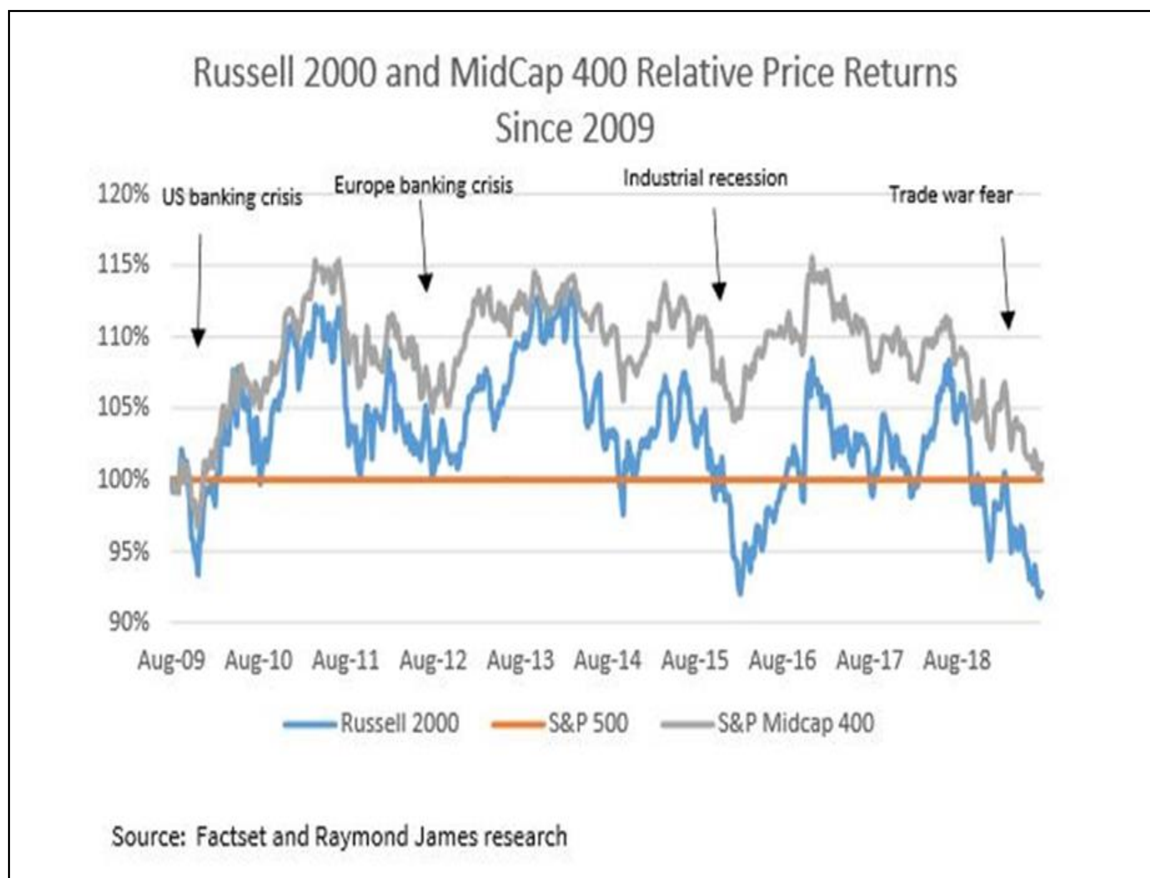
	QTD	YTD
Uniplan Micro Gross	-4.66%	22.92%
Uniplan Micro Net	-5.20%	20.95%
Russell Micro-Cap Index	-5.45%	7.92%

During Q3 and through early October, our micro-cap team participated in approximately 90 one-on-one or small group meetings with the management of micro-cap public companies across a diverse set of industries. The consistent feedback from management is that the small business operating environment remains strong and the capital markets in the form of both debt and equity remain open and available. Capital spending, as we have noted in earlier reports, which has been lackluster and below trend for several years, has posted modest gains. However, it remains low relative to past norms due to continued uncertainty about the outlook for the political, regulatory, and economic landscapes.

Divergence Creates Opportunity

There's a constant bombardment of financial news and data streaming from media outlets, which can oftentimes make connecting the dots about the bigger picture difficult. However, on rare occasions some interesting data points emerge which are worthy of attention. Often, they have an important historical context associated with them which makes them especially unique and eye-catching. Such is the case with

the recent divergence in performance and valuation between large-cap and small-cap stocks.



As the graph above showcases, the Russell 2000 has now experienced its third significant dip relative to the S&P 500 over the past 10 years. Recall that the Russell 2000 comprises the bottom two-thirds of Russell 3000 companies by market cap size, thus serving as a proxy for small-cap stocks. The Russell 3000 is comprised of roughly 98% of all investable stocks. The Russell 2000 also excludes stocks trading below $1/share, OTC traded stocks, and stocks with market caps under $30 m.

The divergence has become especially acute within the last several months, reaching an approximate 1200 bps difference in September as shown by the one-year chart below.

(Source: CNBC)

The reason for this notable divergence is primarily two-fold. First, the market generally perceives small caps to be more vulnerable to any type of global systemic risk, such as tariffs or low global interest rates. Additionally, the market may reason that because of their size, small caps may be less able to absorb new costs such as wage inflation, tariffs, or commodity prices. The market further perceives small caps to be more illiquid and debt-burdened than their large cap brethren. The exact magnitude of this perception effect on performance is obviously difficult to attribute accurately. It is a generally accepted axiom within the investment community that small-caps will under-perform if there is a lack of business confidence surrounding heightened global economic risk-the smallest and weakest will be most vulnerable.

But the second reason for the current stark divergence in performance involves the composition of the small-cap index itself, and this effect is much more quantifiable. The proverbial adage that “the devil is in the details” especially applies when inspecting the industry weights within the Russell 2000 index. The investing public generally views index and ETF investing as a highly cost-effective mechanism (low fees) for achieving a standard type of equity exposure. However, this so-called basket of stocks, 2,000 to be exact for the Russell 2000, is not as diverse or hedged to risk as one might think. It is not a perfectly divisible representation of risk due to the market-cap weighting of the index.

For instance, as of early September, the industry sector of Financials represented 27% of the Russell 2000's assets. Yet on a trailing twelve-month basis, this sector has been one of the worst performers. Conversely, the strongest performing sector, Information Technology, only represents 13% of assets. These two countervailing forces resulting from sector concentration have contributed materially to the relative underperformance of the Russell 2000 relative to larger stock benchmarks.

In a recent paper by the Jefferies quant team, the relative valuation gap between the Russell 2000 and the Russell 1000 (large-cap index), is the widest since June of 2003. This suggests that now may be an ideal buying opportunity for small caps. As the first graph depicted, small caps historically have tended to rally significantly from large divergent dips relative to large-caps as economic conditions improve and investor fears subside.

Given this context as background, we felt compelled to once again make the case for small-caps and micro-caps. Recall that micro and small-caps have tended to outperform larger-cap stocks due to the "size effect". We previously chronicled the litany of academic studies reaching this conclusion in a prior flash report listed below.
https://uniplanic.com/micro-cap-flash-2018-q4/

Despite the widely accepted conclusion of perhaps the most famous study, that by Fama and French in 1992, some critics remain dubious of the size-effect claiming that other factors, such as an oversized January effect and higher betas inherent in smaller equities may be the real driving factors for outperformance. They further argue that if there was a size-effect, it played itself out after publication of its existence and is therefore less relevant in today's world.

However, a fresh set of eyes has probed into this debate to more conclusively identify the real robust causal factors. This 2018 study, "Fact, Fiction, and the Size Effect", by the research team at AQR Capital Management, argues that controlling for "quality" in stocks resurrects the size effect. This study borrows from AQR's previous 2015 study, "Size Matters, If You Control Your Junk". The authors define quality as typical financial metrics such as high margins, high asset turnover, low financial leverage, amongst others. "Junk", as an example, would be very small companies with high leverage and very illiquid stock.

Again, the devil is the details. Most investors fail to comprehend the scope of an index fund. There can be quite a dispersion in quality among 2,000 stocks, yet the index owns a piece of every component, good or bad. The bad can include pre-revenue companies with excessive cash burn and share dilution risk, companies in intensely competitive industries, or companies with trailing technologies in secular decline. In fact, 25% of the Russell 2000 contains unprofitable companies.

This need to discern and filter details is where we believe the role of active management thrives and where we believe Uniplan and other active managers can add value, not only by filtering out the bad, but also by finding potential alpha-producing asymmetric information which is typically lost in the efficient market shadows of the more heavily trafficked large cap stocks.

Recall that we previously had made the argument that micro-caps were uniquely positioned to benefit from corporate tax reform while also being more immune to China and the tariff situation. See below.
https://uniplanic.com/microcap-2017-q4-flash-report/

Some critics have maintained that the insulation of small-caps to the trade war is overstated because of the intricacy of supply chain networks, concluding that small companies ultimately have some link to the larger, multinational companies doing business with China. While we concede that this may be true to some degree for the larger small-caps, we simply don't see any evidence of direct relationship exposure across our micro-cap portfolio. The Uniplan Micro-Cap portfolio has a wide breadth of companies participating in many discrete, US-based industries which do not sell materially into China or source from China. For example, cancer diagnostic testing, Caribbean water utility, US sourced pet food, etc.; these simply do not scream China exposure. And from a quality metric, recall that our portfolio has traditionally contained companies with below average debt levels.

Conclusion

We believe an ideal environment for small-cap/micro-cap investing may be presenting itself. This begins with the extreme divergence in both valuation and performance between small-cap and large-cap stocks which we highlighted in the beginning of this paper. More importantly, this dip in small-cap valuation and performance has demonstrated an empirical propensity to rebound quite substantially from negative macro events, whether actual or perceived.

Additionally, as the data and research affirm, small and micro-caps tend to outperform large-caps over time due to the "size effect", which has now been corroborated with new academic research pointing to the need to control for "junk". Controlling for junk is the essence of active management and we believe active management still plays a legitimate role in achieving outperformance in small and micro-cap investing. Finally, we caution that investors should be aware of the "devil is in the details" when selecting a small-cap index fund. The index fund composition is not uniform across industry sectors or company quality and hence has its own unique risks.

While micro-cap stocks do tend to have greater volatility and higher trading costs (wider bid-ask spreads), they offer long-term investors an opportunity to capitalize on market inefficiencies in which large professional investors cannot participate. In addition, these stocks offer diversification benefits when added to a portfolio of larger-company stocks, since the two groups tend to not move in perfect unison as we have recently seen. For these reasons we believe micro-cap stocks have a useful and meaningful place in the portfolios of individual investors.

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The Uniplan Micro-Cap Portfolio is a low-turnover high-conviction micro-cap strategy designed to offer investors a quality alternative to private equity having a similar unlevered return while providing daily liquidity. The Uniplan core investment thesis is focused on companies trading at a low multiple of cash flow or EBITDA, those with little or no debt and meaningful insider holdings. We search for smart money activity which we define as insider buying which is found in 13G/13D filings. A cash dividend and an identifiable macro or company-specific catalyst are preferred.

Important Information: 1. Uniplan Investment Counsel is a boutique investment firm, with roots dating back to 1984, that manages a variety of portfolios primarily for US clients. Uniplan maintains a complete list and description of composites that is available upon request. 2. The composite was created August 1, 1999. Performance is calculated in US dollars utilizing a time-weighted total rate of return. Total return for the composite is represented by the asset-weighted returns of the portfolios within the composite. Trade-date valuation is used. 3. Performance is net of all transaction costs and net performance is net of transaction costs and (maximum allowable total) investment management fee, but before any custodial fees (that may be incurred separately by the client). 4. The benchmark for the composite is the Wilshire US Micro-Cap Index that represents a float-adjusted, market capitalization-weighted portfolio of all stocks below the 2,500th rank by market capitalization in the Wilshire 5000 at March 31 and December 31 of each year. The index is used to measure small stocks and is adjusted to reflect the reinvestment of dividends, when applicable. 5. The Russell Micro Index may be used as an alternative benchmark. The Russell Microcap Index is an unmanaged total return index of the smallest 1,000 securities in the small cap Russell 2000 Index and the next smallest 1,000 companies based on a ranking of U.S. equities by market capitalization. 6. It is not possible to invest directly in an index. The index figures do not reflect any deduction for fees, expenses or taxes. 7. The dispersion of annual returns is measured by the standard deviation of asset-weighted portfolio returns represented within the composite for the full year. The standard deviation of the annual returns for the period August 1, 1999 to September 30, 2019 is 18.07% for the composite and 24.65% for the Wilshire Micro-Cap Index. 8. The composite does not have a minimum size criterion for composite membership. All fee-paying discretionary accounts with similar investment

objectives are included. Leverage is not used in this composite as a means to generate higher returns. There may be non-fee paying portfolios in the composite. Individual account holdings may vary depending on numerous factors including the size of an account, cash flows, and account restrictions. 9. There have been no changes in the personnel responsible for the management of this composite. 10. The composite contains both traditional and wrap fee portfolios. Uniplan has a flexible and negotiable fee schedule reflecting the differences in size, composition and servicing needs of clients' accounts. A complete description of investment advisory fees is contained in Uniplan's Form ADV and is available upon request. 11. Uniplan Investment Counsel does not claim GIPS Compliance. Individual account performance may vary from the results shown because of differences in inception date, restrictions and other factors. 12. Investors should understand that micro-cap stocks are subject to a higher degree of risk than other equity investments due to the small size of the companies and the limited trading volume inherent in micro-cap stocks. 13. This information is not an offer to buy or sell a security nor does it constitute investment advice or an offer to provide investment advisory or other services. All information is subject to correction or change. **Past performance is no guarantee of future results. Investment involves a risk of loss.**

All investments carry a certain degree of risk, including possible loss of principal. REITs are subject to illiquidity, credit and interest rate risks, as well as risks associated with small and mid-cap investments. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style. Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other style investing during given periods.

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