Microcap investing

How microcap value stocks can be a smart investment **Interviewed by Sue Ostrowski**

Many investors avoid microcap stocks, thinking that companies in that category are too small or too risky.

However, the term "microcap" is misleading and stocks in that sector can provide a good return on investment, says Denis Amato, CFA, chief investment officer at Ancora Advisers LLC.

"There is a misperception of microcap stocks being this crazy, wild area, so a lot of people shy away because they think this is a terribly risky area," says Amato. "But by focusing on the value component, you will normally get good results over time, and if you put a microcap mutual fund in your portfolio, as opposed to buying individual companies, your risk is not as great as people's perception of the area."

Smart Business spoke with Amato about how to invest in microcap stocks.

Denis Amato, CFA
Chief investment officer
Ancora Advisors LLC

What are microcap stocks?

Microcap stocks are generally those with market capitalization of $500 million and below, generally corresponding to the smallest 20 percent of the stock universe.

Many times, when people think of microcaps, they think of a new IPO or a penny stock. But that is not always the case.

There are two categories of microcaps. First is growth oriented microcap stocks, which may only have a few million dollars in revenues but market caps in excess of several hundred million dollars. Not always a good combination from a risk perspective. The better area to focus on, in our opinion, is microcap value stocks. These are stocks that often have several hundred million or even $1 billion plus in revenue, but market caps of just a couple hundred million dollars. This represents much better risk-reward to us than a company with low sales and high market cap. The price could be down because of the sector the business is in; it could have stumbled in some way or it may have had an earnings problem and the stock has been driven down because of it. And sometimes it is just a matter of the market ignoring the stock or the industry, or that the company is being followed by so few analysts that the stock is inefficiently priced. So the opportunities are real.

In fact, studies have shown that over a 50-year period, returns for microcap value stocks have exceeded the microcap growth category by a factor of almost four to one. That is why it is better to focus on microcap value stocks.

For what kinds of investors can microcaps be a good investment?

Microcap stocks make sense for a lot of people, but because it is a more volatile area, it makes the most sense for investors willing to take some risk and who have a large enough portfolio to make this a component.

How can an investor get involved in microcaps?

You can invest in microcaps through individual ownership of stocks, but to do that, you have to have a pretty broad portfolio because you need diversification to lessen the single company risk factor. Because they are smaller, they are riskier, so you need to have more than a handful of companies so you do not get stuck with the one or two that run into trouble.

Microcap index funds and exchange traded funds are also options, but studies have shown that the lack of Wall Street research devoted to these companies, makes microcaps an area where an actively managed fund has a good chance of outperforming passively managed strategies over time.

What timeframe should investors in microcaps be looking at?

Two to four years is reasonable because it can take several quarters to turn a company around and change the fundamentals that might be hindering the stock. Even after a company changes its fundamentals, sometimes it takes longer for the market's perception of it to change. If you are going to get a really good return on a stock, it takes not only earnings going back up but also price earnings multiples to start reflecting that better result. The combination of those things generally takes two to four years.

What criteria should an investor look for in microcap stocks?

First, because microcap value stocks are where the better returns are, we always look for stocks that are undervalued in this sector. The financial condition of the company and its balance sheet also must meet strict criteria.

Finally, look for insider buying which is especially significant with small companies. With a large company, there may be 100 vice presidents, and five are buying and three are selling, so what does that really mean? With smaller cap companies, there are fewer insiders, and they tend to know what the real value of the company is. Management in small companies can be more aware of positive catalysts and this frequently gets reflected in insider buying.

A good microcap fund manager will take note of this and incorporate it into their decision-making process, especially with regard to the timing of the fund's purchases. It is easy to find microcap stocks, but finding those stocks that are a good value and have other characteristics that will enable them to provide a good return are best left to professional managers.

What percentage of a portfolio, in your opinion, should be invested in microcap value stocks?

Studies have shown that 5 to 10 percent of an equity portfolio can be put into this sector. These stocks have a diversifying effect relative to an all S&P 500 oriented portfolio so investors can actually increase their returns without significantly increasing risk. <<

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