

## ***Finding International Opportunities with a Microscope***

*by Jeffrey D. Braemer, CFA*

In many aspects of the world, what is bigger often gets more attention. That is also true for equities, where large capitalizations tend to be the proxies for the overall health and performance of markets. For example, U.S. investors gauge their market by the Dow Jones Industrial Average or the S&P 500, while investors in other markets may focus on the Nikkei 225, FTSE 100, or MSCI EAFE<sup>1</sup>. Groupings of large capitalization securities often are driven by a handful of the biggest, megacap names, which have become known by their acronyms, such as the FANGs, BATs, or GRANOLAS<sup>2</sup>. However, another market truism is that the overlooked often possess great value, if only because they have not been discovered by others. The case for looking further down the size spectrum to International Small Caps has been well explored (by many, including TimesSquare in 2012), though we believe that International Micro Caps deserve more attention than they have received from investors thus far.

### **A Vast and Underexplored Opportunity Set**

Investors in the equity markets stand at the edge of an ocean with more than 40,000 publicly traded securities. Over 30,000 of those have market capitalizations less than \$1 billion—a traditional demarcation line between micro and small caps. Only 11% of those micro caps are based in the U.S.<sup>3</sup>. Viewed another way, International Micro Caps collectively represent over 70% of the possibilities in the global investable equity universe. That also is evident when using proxies from MSCI to compare large/mid, small and micro capitalization stocks<sup>4</sup>:

**Table 1 – MSCI Index Comparisons (10/31/2020)**

	<b>MSCI World ex USA Index</b>	<b>MSCI World ex USA Small Cap Index</b>	<b>MSCI World ex USA Micro Cap Index</b>
<b>Number of Securities</b>	985	2,496	4,735
<b>Market Capitalizations (\$mn)</b>			
<b>Largest</b>	334,761	7,547	1,098
<b>Smallest</b>	948	34	1
<b>Average</b>	14,698	987	81
<b>Median</b>	7,129	638	53

*Source: MSCI Factsheets*

Several details are notable from Table 1. The number of securities within the micro capitalization index is far greater than the combined population of large, mid, and small capitalizations, which should provide a wider range of investment opportunities. There are also wide size ranges for each index so that micro capitalization overlaps with small capitalization and small capitalization encroaches on large/mid capitalizations.

<sup>1</sup> All of those represent a portion of the largest market capitalization stocks in their respective markets.

<sup>2</sup> Collective terms for 1) Facebook Inc., Apple Inc., Netflix Inc., and Google; 2) Baidu Inc., Alibaba Group and Tencent Holdings; and 3) GlaxoSmithKline Plc, Roche Holding, ASML Holding NV, Nestle SA, Novartis AG, Novo Nordisk A/S, L'Oréal SA, LVMH, AstraZeneca Plc, SAP SE, and Sanofi.

<sup>3</sup> Based on FactSet screening for public securities with market capitalizations of at least \$1 million.

<sup>4</sup> For this comparison, only MSCI indices were used to eliminate overlap and double counting. The World ex-USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the U.S., the World ex USA Small Cap Index captures small cap representation across 22 of 23 DM countries--excluding the U.S., and the World ex USA Micro Cap Index captures micro cap representation across 22 of 23 DM countries--excluding the U.S.

Regarding the underexplored nature of micro capitalizations, when examining asset data for investment strategies it becomes apparent that investors and asset managers barely have dipped their toes in these waters:

**Table 2 – Strategy Assets (9/30/2020)<sup>5</sup>**

	<b>Small Cap Strategies</b>	<b>Micro Cap Strategies</b>
<b>Assets (\$mn)</b>	\$1,453,194	\$23,437
<b>ex-U.S. (\$mn)</b>	\$320,370	\$3,377
<b>ex-U.S. (%)</b>	22%	14%

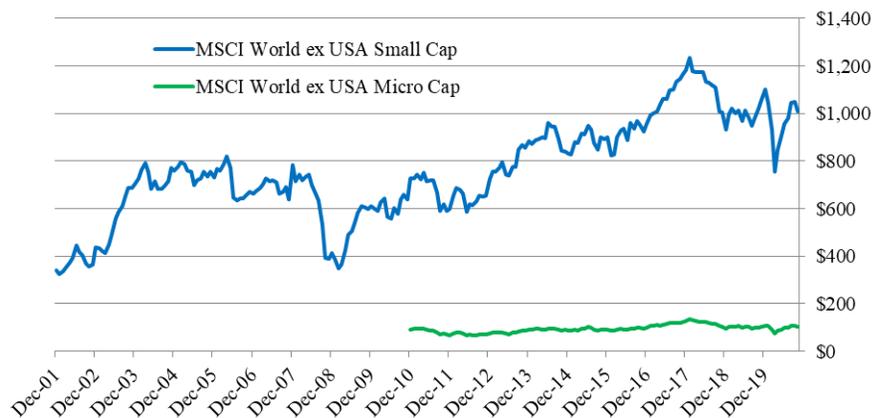
Source: eVestment

For additional context, various sources mark the aggregate level for the global asset management industry at \$80 trillion (e.g., BCG 2020 and eVestment 2020). Thus the \$3.4 billion of current strategies for international micro capitalization securities represent a rounding error of a rounding error in terms of the percentage of overall investment assets, or 0.004% to be more precise.

### Meaningful Differences between Micro Capitalizations and Small Capitalizations

Some investors may believe *a priori* micro capitalizations are so similar to small capitalizations, that a dedicated allocation is unnecessary. Such a view could be understandable, having earlier shown that there was some measure of size range overlap between the two indexes (Table 1). Delving deeper into that, when considering the median market capitalizations over time for the small and micro capitalization indexes, a measure of size drift appears for small capitalizations:

**Chart 1 – Median Market Capitalization (\$mn) over Time**



Source: FactSet

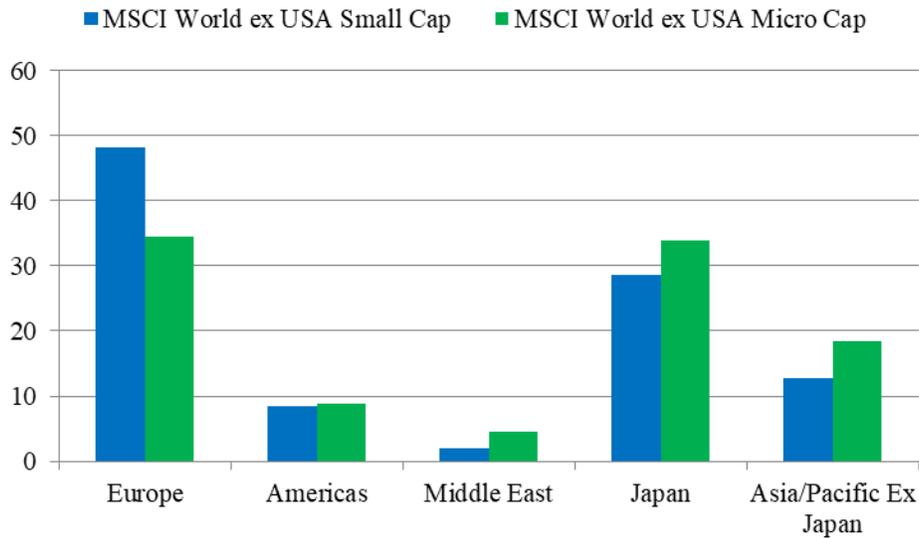
As seen in Chart 1, the typical international small capitalization security has grown in size over the years, though international micro capitalizations have been stable since the creation of that index<sup>6</sup>. That created an ever widening gulf between small and micro capitalizations, which should continue to distinguish the two.

<sup>5</sup> Based on all equity managers in the eVestment database, using product data for assets under management, primary equity capitalization, and geographic region.

<sup>6</sup> The MSCI World ex USA Micro Cap Index was launched on Dec 01, 2010 while the MSCI World ex USA Small Cap Index was launched on Jan 01, 2001.

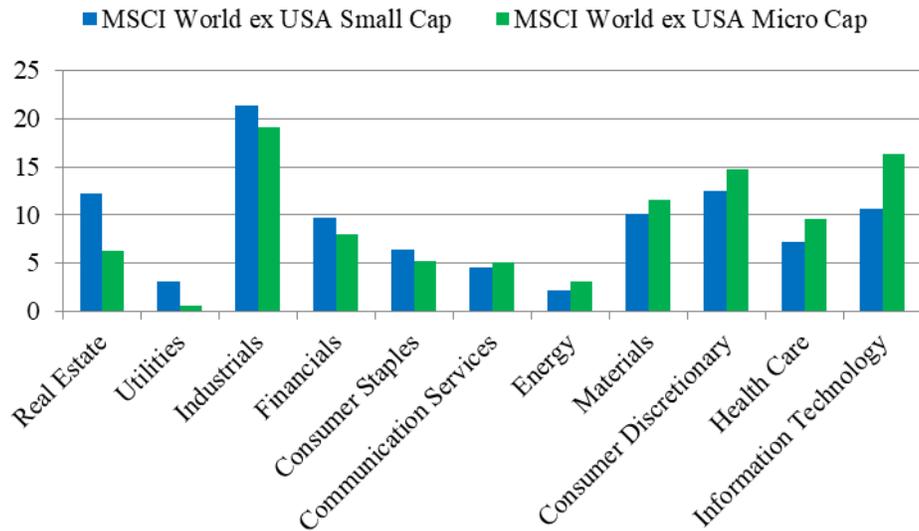
Another comparative dimension would be the respective weights across geographic regions or economic sectors:

**Chart 2 – Regional Exposures for Small Capitalizations vs. Micro Capitalizations (% on 10/31/20)**



Source: FactSet

**Chart 3 – GICS Exposures for Small Capitalizations vs. Micro Capitalizations (% on 10/31/20)**



Source: FactSet

Not only are there notable variations among the exposures to regions and sectors, but from TimesSquare’s perspective as a growth investor we appreciate that micro capitalizations have more emphasis on areas where we expect greater opportunities—Japan, the rest of Asia, Health Care, and Information Technology. We have also found that companies focused on their domestic markets are better equipped to adapt to local changes and are better positioned to benefit from development in their countries. This is another dimension where micro capitalizations appear more attractive than small capitalizations:

**Table 3 – Investment Considerations (10/31/2020)<sup>7</sup>**

	MSCI World ex USA Index	MSCI World ex USA Small Cap Index	MSCI World ex USA Micro Cap Index
<b>Domestic Sales as % of Total</b>	37%	61%	72%
<b><u>Ownership</u></b>			
<b>By Institutions (%)</b>	39%	41%	23%
<b>By Retail or others (%)</b>	43%	34%	38%
<b>By Insiders (%)</b>	17%	25%	37%

*Source: FactSet*

On the topic of the greater local focus among micro capitalizations, those securities also have a greater portion of their shares held by insider stakeholders. There are two implications from that 1) micro capitalizations have not been “discovered” by outsiders—especially institutional investors—to the same degree as small or large/mid capitalizations and 2) a high portion of insider ownership should closely align management interests with those of any outside investors.

### **The Need for an Active Approach**

Thus far the analyses and comparisons have illustrated aspects of standard benchmarks, but that does not mean to imply that a passive approach is advisable for micro capitalizations. In general, the micro capitalizations have received less attention from outsiders, which lead to relative advantages and disadvantages. For example, using a passive vehicle for the MSCI World ex USA Micro Cap Index effectively invests in a portfolio where two-thirds of the securities have limited to no external research coverage and a quarter of the securities lack positive earnings:

**Table 4 – Passive Characteristics (10/31/2020)<sup>8</sup>**

	MSCI World ex USA Index	MSCI World ex USA Small Cap Index	MSCI World ex USA Micro Cap Index
<b>Number of Securities</b>	983	2,409	3,502
<b><u>Analyst Coverage</u></b>			
<b>Average Number per Security</b>	13.4	5.0	1.3
<b>Percentage with 1 or 0</b>	1%	24%	67%
<b>Non-earning securities (%)</b>	5%	11%	26%

*Source: FactSet*

There are also liquidity issues to consider with micro capitalizations, especially when investing in the smallest names of the index with a passive strategy (recall from Table 1 that *half* the securities in the MSCI World ex USA Micro Cap Index have market capitalizations less than \$53 million). Because of lower trading volumes, some have noted that micro capitalizations resemble private equity in this regard, needing longer investment horizons though with relatively better liquidity and less risk (Acuitas 2017). At a minimum, investors should be cautious about strategy capacities with micro capitalizations.

These cautions apply to an autopilot approach to micro capitalizations that uses passive strategies, not a more nuanced investment method. Astute active investors could perform their own research and be less reliant on third-party research that is generally absent among micro capitalization securities. Those active investors also would evaluate a security’s profitability, potentially avoiding those that lack positive earnings.

<sup>7</sup> The ownership percentages may not total to 100% because of rounding.

<sup>8</sup> The numbers of securities differ from Table 1 data because of the different sources.

**Micro Capitalization Companies Are Not Necessarily Untested or Unknown**

Simply having a market capitalization less than \$1 billion does not mean that business is nascent. Many such companies have been operating just as long as their larger capitalization peers:

**Table 5 – Company Ages in Years (10/31/2020)**

	MSCI World ex USA Index	MSCI World ex USA Small Cap Index	MSCI World ex USA Micro Cap Index
<b>Median</b>	60	40	31
<b>Oldest</b>	262	242	239
<b>Newest</b>	1	<1	<1

*Source: FactSet (founding date)*

The micro capitalization Methuselah in Table 5 is Briscoe Group, a New Zealand retail firm that began as a British trading company in the 18<sup>th</sup> century and has been operating its namesake Briscoes Homeware stores across its home market for over 150 years<sup>9</sup>. A public company since 2001, thus also well-established in the equity markets, its \$600 million market capitalization places it solidly in the micro category.

Another example of a micro capitalization security, though likely recognizable to motorcycle enthusiasts worldwide, is the Japanese company Shoei Co. Formed in 1959 with an IPO in 2004 and current \$800 million market capitalization, Shoei sells premium helmets globally (80% of revenues are from outside Japan) and is the market leader for that segment:



*Source: Company Reports*

There are many other examples of companies with security market capitalizations less than \$1 billion, which may have long operating histories, dominate their competitors globally, or be household names locally. It then becomes the diligent investor’s task to sort through and evaluate the potential of each.

**Conclusion**

Investment opportunities abound among International Micro Caps, though the individual choice of securities requires a precision approach. From the earlier statistics (Tables 1 & 2), International Micro Caps represent over 70% of the investable universe though currently are 0.004% of investment strategy assets. As a group, those micro capitalization securities differ meaningfully from small capitalizations, so merely having an International Small Cap allocation would not capture the same potential. However, simply buying an index fund would include in many unappealing securities. This market segment calls for precision research with an active investment approach. Or to paraphrase and recast Willie Sutton<sup>10</sup> as a modern day investment sage, one should actively invest in International Micro Caps “because that’s where the opportunity is.”

<sup>9</sup> From company reports and <https://www.briscoegroup.co.nz/about-us/history/>

<sup>10</sup> For more information, see <https://www.fbi.gov/history/famous-cases/willie-sutton>

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