MICROCAPS: MAXIMIZING THE VALUE OF ACTIVE MANAGEMENT

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Ben James, CKA®, CIMA®
Mark Moss, BFA®

Microcaps: Maximizing the Value of Active Management

Factor investing is an investment discipline that involves focusing on specific drivers of returns. Factors can help improve portfolio outcomes, reduce volatility, and enhance diversification. Classic examples of Style Factors include Value, Momentum, Quality, Size, and Minimum Volatility.

While there is extensive research examining the efficacy of combining Value and Momentum (see citations), we found that the size of the stocks can have an impact on the potency of these factors.

While factors can be used across all market capitalizations, our research suggests that the inefficiencies in the Small cap and Micro cap space have historically provided the greatest opportunities to generate excess returns.

Value Factor

Value Investing is the process of identifying underpriced stocks based on their price compared to an accounting metric such as Earnings, Book Value, or Sales. For our study, we define *Value* as the stock's price to book ratio. Stocks with a price below book value are generally considered cheap. Stocks trading for many times book value are considered expensive.

Over time, investors who bought cheap stocks have been rewarded. In general, cheaper valuations resulted in greater returns (Figure 1). We found that as the size of a stock decreases, the impact of the Value Factor grows. For large and mega-cap stocks, investors are rewarded with a 1% value premium compared to similarly sized stocks, while micro and small-cap stocks offer value premiums of 6% and 3%, respectively (Figure 2).

"Over time, investors who bought cheap stocks have been rewarded."

Value Factor (cont.)

Figure 1: Annualized Returns by Market Cap and Value 1927-2023

	Most Expensive	Expensive	Moderate	Cheaper	Cheapest
Micro Cap	4%	9%	13%	16%	21%
Small Cap	7%	12%	13%	14%	15%
Mid Cap	8%	12%	13%	13%	14%
Large Cap	10%	11%	12%	13%	12%
Mega Cap	9%	10%	11%	10%	11%

Source: Fama & French Database, DJWM as of June 2023

Figure 2: Alpha Generated from Value Investing 1927-2023

	Most Expensive	Expensive	Moderate	Cheaper	Cheapest
Micro Cap	-11%	-6%	-2%	1%	6%
Small Cap	-5%	0%	1%	2%	3%
Mid Cap	-3%	1%	1%	2%	2%
Large Cap	-1%	0%	1%	2%	1%
Mega Cap	-1%	0%	1%	0%	1%

Source: Fama & French Database, DJWM as of June 2023

Momentum Factor

According to Sir Isaac Newton's 2nd Law of Motion, objects in motion tend to stay in motion. This is true both in the physical universe as well as the financial markets. As opposed to Value Investing which tends to pick stocks that are out of favor, Momentum Investing is typically defined as buying stocks that already are winners.

As with Value, we found that this strategy has been effective across all market caps but again becomes more pronounced as the size of the companies decrease (Figure 3). For mega-cap stocks, investors are rewarded with a 4% momentum premium, while micro-cap stocks offer a momentum premium of 7% (Figure 4).

Momentum Factor (cont.)

Figure 3: Annualized Returns by Market Cap and Momentum 1938-2023

	Lowest Momentum	Low Momentum	Moderate Momentum	Higher Momentum	Highest Momentum
Micro Cap	9%	15%	17%	20%	22%
Small Cap	5%	12%	14%	16%	19%
Mid Cap	5%	11%	13%	14%	18%
Large Cap	5%	10%	12%	14%	17%
Mega Cap	5%	10%	11%	12%	15%

Source: Fama & French Database, DJWM as of June 2023

Figure 4: Alpha Generated from Momentum Investing 1938-2023

	Lowest Momentum	Low Momentum	Moderate Momentum	Higher Momentum	Highest Momentum
Micro Cap	-6%	0%	2%	5%	7%
Small Cap	-8%	-1%	1%	3%	6%
Mid Cap	-7%	-1%	0%	1%	5%
Large Cap	-7%	-2%	0%	2%	5%
Mega Cap	-6%	-1%	0%	1%	4%

Source: Fama & French Database, DJWM as of June 2023

Conclusion

As the old joke goes, a hiker does not need to outrun a bear – he simply needs to outrun his competition. Investing, it turns out, is no different. And when you have less competition, it is easier to win.

Stocks such as the Magnificent 7 capture investor attention, but they have nearly 10x the analyst coverage compared to the average small-cap.

We believe market efficiency diminishes with the average market capitalization of a stock, leading to greater opportunity to generate excess returns in smaller stocks.

Citations

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Please contact your advisor for more information on the NewEdge Microcap Strategy.