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Market Update

January 8, 2009

Microcap Woes

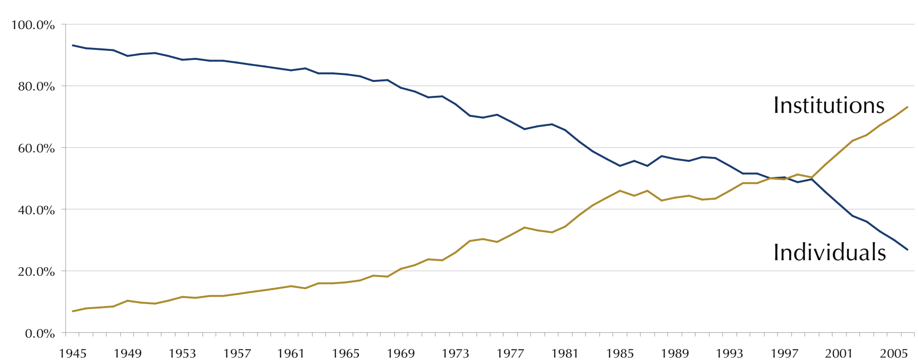
Since September 22, 2008, the day the market crisis began in earnest, through the end of the year, the Russell Microcap Index fell roughly 34% as compared to 28% for the S&P 500. The steeper decline in microcaps reflects four extraordinary forces:

1. The illiquidity of microcap stocks magnified the impact of the market sell-off
2. Hedge funds desperately and indiscriminately dumped micro cap holdings to meet redemptions
3. Traditional money managers focused on the value opportunities available in mid and large cap stocks where they perceived greater safety
4. Little-to-no new capital came into the microcap sector

An even bigger dilemma for microcap companies will be how to get out of this rut. When economic conditions and investor sentiment eventually improves, the stocks of small, mid and large cap firms should respond as in past cycles. However, microcap companies may find their shares in a prolonged state of undervaluation due to a long-term secular decline in the demand for microcaps shares.

Historically, individual investors have been great fans of microcap stocks. Today, however, institutional investors dominate public equity markets holding 75% of all U.S. stocks. Institutional investors have little regard for microcaps for two reasons; 1) investing even a small amount of money results in a high and imprudent percentage ownership of a microcap company, and 2) the cost of investment due diligence requires that each investment reach a critical mass that is larger than most microcap opportunities can bear. Further exacerbating the problem, Wall Street research analysts seeking to generate trading volume for their firms see little value in following microcaps because they know that institutional investors are not interested.

Ownership of U.S. Public Stocks



Hence, the microcap market lacks the efficiency required to produce trading values that represent, or even approximate, fair economic value. Fortunately, the merger and acquisition market for these companies is competitive. In the last ten years, every quarter has witnessed at least 20 acquisitions of public companies in the $25-500 million market cap range. Mid and large cap companies have a voracious appetite for niche businesses that can enhance their competitive position, accelerate their revenue growth, and augment their profitability. In exchange for these benefits, the shareholders of microcap firms are rewarded with handsome premiums to their shares' trading values.

Today, over two-thirds of U.S. public companies have less than $500 million in market capitalization, yet those 5,000 firms account for less than 2% of the market value of all U.S. public equities. Given the regulatory costs and management burdens of public ownership, it makes no sense for these companies to remain public. The good news for the best of these firms is that they are not likely to be around the next time a microcap swoon occurs.

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