# Micro Is No Small Thing

Q&A ticker.com

*Started out of an "intellectual curiosity," the Satuit Micro Cap Fund never left Lipper's top-quintile in its three years of history. Robert Sullivan talks about the benefits in the trend of really small companies outperforming in the first year of a recovery phase.*

**Q:** *Some of your roots go back to Fidelity. You've come a long way since that time.*

**A:** Actually I started out in this business for some venture capital guys. I was doing some serious financial analysis – balance sheet, cash flow, income statement type stuff. My roots go back to real hard core fundamental number crunching. Then I went to Bridge. As a salesperson I walked into portfolio manager's offices and talked to them about the company's system and the type of equity data you could pull up. It was interesting. What I got was a nice exposure to all kinds of investment philosophies and investment styles, if you will. From there, going over to Fidelity Capital Markets as an institutional equity trader was a great experience to get to know how the execution process worked. When you're trying to buy and sell a million shares of a stock on the floor of the New York Stock Exchange, that's kind of an education in itself. Eventually, I moved from the equity desk to analyst and portfolio manager. Then I moved to Cadence Capital as analyst and portfolio manager. I guess my career from the investment side is rooted in real strict fundamental stock analysis and understanding of the types of styles and the execution process as well.

**Q:** *You probably had a choice to enter in any kind of market sector. Why did you choose micro-cap stocks?*

**A:** I began more out of intellectual curiosity. This was back in 1996 and 1997. There was a real clear divergence in the capitalization strata and the return characteristics of the capitalization. In other words, large cap was outperforming mid cap, which was really outperforming small cap, which was really outperforming micro cap. You could see it beginning in 1995 and 1996 when the large-cap market began to break out. There began some empirical dialog about how it was only the 20 highest market-cap stocks that were moving the market. When I saw data points like that, I just got curious as to what was really happening and why was it happening. I started doing homework on historical returns, valuation levels, price-to-book, and price-to-sales. What I concluded sometime in 1998 is that there's going to come a point in time where we go back to what's normal in the market place. What happened is that through 2000, the event basically continued. I decided that what I wanted to do was certainly come out and do my own fund. I wanted to use a GARP philosophy to do it, because I believe that you can combine both value and growth characteristics. I didn't want to do another small-cap fund because there are so many of them out there.

**Q:** *I personally couldn't argue with that observation about the plethora of small-cap fund products.*

**A:** Back in 1997, Morningstar actually had a micro-cap category. They subsequently merged it into the small-cap category in 1999. They only had 93 funds that were considered micro-cap funds. They probably looked at it and said that wasn't enough to give them reliable data.

### Satuit Capital Micro Cap

| Fund Facts | |
|---|---|
| Symbol | SATMX |
| Website | www.satuitcapital.com |
| Address | Satuit Capital Management<br>146 Front Street, Ste 204<br>Scituate, MA 02066 |
| Tel. No. | 800-567-4030 |
| Inception | 12/12/00 |

| Portfolio | |
|---|---|
| Total Net Assets * | $5.40 |
| Avg Mkt Cap ($ Weighted) * | --- |
| Average Price/Earnings Ratio | --- |
| Average Price/Book Ratio | --- |
| Turnover Ratio | 158% |

| Investment Information | |
|---|---|
| New Investment | Open |
| Min Initial Investment | $1,000 |
| Min Subsequent Investment | $250 |
| Min Initial IRA Investment | $1,000 |

| Risk (Against S&P 500 - 3 Years) | |
|---|---|
| Alpha | --- |
| Beta | --- |
| R-Squared | --- |

| Returns vs. Lipper Small-Cap Core Index | SATMX | Index |
|---|---|---|
| 1 Year (Cum.) | 5.72% | -2.37% |
| 3 Year (Ann.) | --- | 1.10% |
| 5 Year (Ann.) | --- | 2.98% |

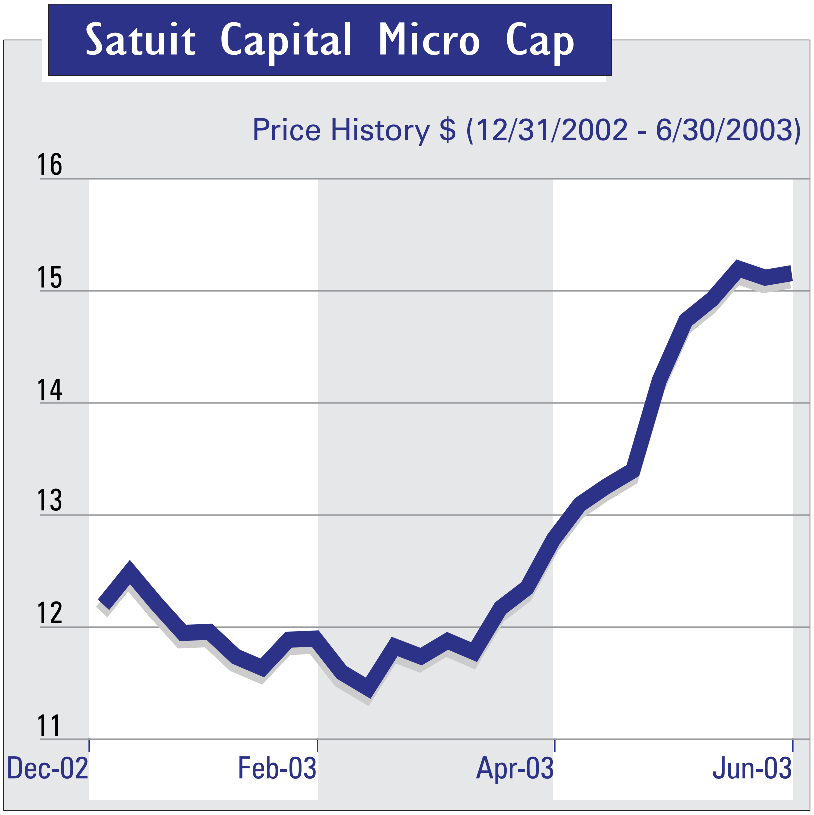
| Returns vs. S&P 500 | SATMX | Index |
|---|---|---|
| 1 Year (Cum.) | 5.72% | 0.25% |
| 3 Year (Ann.) | --- | -11.20% |
| 5 Year (Ann.) | --- | -1.61% |

| Fees and Expenses | |
|---|---|
| Max Sales Charge - Front | 5.75% |
| Max Sales Charge - Deferred | 0.00% |
| Max Redemption Fee | 0.00% |
| Total Expense Ratio | 2.80% |

| Portfolio Manager | |
|---|---|
| Robert Sullivan | 12/12/00 |

** millions* *Data through: 06/30/03*

*Source: Company Documents; Lipper*




**Q:** *There is a difference between small and micro cap in terms of capitalization. The number of companies is probably over 1,000 at any given time in the U.S.*

**A:** For the micro-cap universe, at one point at the market low, there were probably about 4,000. I thought that based on valuation criteria, eventually that market place comes back so why don't I put out a micro-cap fund? And, I'm defining micro cap as $500 million of market value or less.

**Q:** *Some interpretations of micro cap start at $100 million and lower.*

**A:** I think that's the old traditional definition which I don't have a problem with, but I think you kind of limit yourself. My sense is that when I look at those types of companies for our fund, it's a different kind of animal than a company that has $375 million in market cap. It can be the difference between a small-cap and a large-cap company.

**Q:** *During the bubble years, some small companies achieve equity capitalization of $30 billion on just $30 million of business.*

**A:** Sure, why not? As an editorial comment from the buy side in general, and maybe I was guilty of it, too, I think that we all, both institutional and retail investors really got away from the real fundamentals of a company. Your standard valuation matrixes were just thrown out the window. I think if there was anything I learned about the 1990s is, don't ever forget about fundamentals, because if you do, you're doomed.

**Q:** *Your top 25 holdings of the 85-stock portfolio came public into the marketplace well before the second half of 1999. What you like from micro-cap land tells me you like track records, which is something a fundamental investor would do.*

**A:** One of my favorite little companies is the Providence Worcester Railroad. It has been around as a public company since the 1800s in one shape or form. Getting back to the top 25, it's just part of what I do.

**Q:** *Since the micro-cap universe is very large now, how do you narrow down the search?*

**A:** Let's talk about philosophy. It's that growth at a reasonable price. For Satuit Micro Cap Fund, I try to find companies that have a reasonable multiple but have above average earnings per share growth rate. That's the GARP philosophy. That is what I call the first P, if you will. The second P is process. The first step that we do is we use Zack's database. We tell that database to first screen for companies of $500 million market cap or less. Then we ask it to take a look at things that I call valuation parameters: return on equity, return on invested capital, return on assets, price-to-book, and relative PE ratio. Then, on the growth side, let's take a look at: Does this company consistently beat consensus numbers? Are the numbers for this year and the next year going up? And, are those numbers positive? Let's pull out those companies. Then we rank all the factors and we come up with what we call the focus list. When you go through all that exercise of weeding out, what you come up with is a list of 300 to 500 companies that have better than average return parameters. They have that valuation anchor, if you will, while at the same time they are showing increasing earnings per share. I call that about 10% of the investment process. The other 90% is just me looking at this list and doing the homework on the names that look most attractive based on what I know about the industries and the companies.

**Q:** *That is typical of the fundamental approach, doing the drudge work of peering over the historical results.*

**A:** At that point, it is just the fundamental work that everybody does. I have a spreadsheet that goes back four years of public information. I try to figure out where the company was in terms of revenue growth, margin expansion, balance sheet strength and cash flow. That's kind of the mantra. I'm trying to figure out what the drivers were and are, and the sustainability of those four pieces. To do that, you go back three or four years. You get some earnings estimates from some analysts if the company is followed. You talk to the analysts and try to figure out what their assumptions are. Then you circle back to the company and talk to the top management. What's nice about the small- and micro-cap world is that you can actually talk to some of the top management.

*Q: What tips the scale for you make a buy?*

**A:** At that point, if everything sort of fits and I can identify some of those things, and it looks like a pretty good fit, we'll put it into the Satuit Micro Cap Fund portfolio.

***Q:*** *Don't these small companies have very limited analyst coverage?*

**A:** In using that beginning data point, you're going to need at least one analyst's estimate. But, things fly across radar screens from some research that I do. We have a good dozen Wall Street sales people and analysts that follow me and know me directly. They might hear of a firm that is interesting to look at that nobody follows. There is a whole bunch of different distribution avenues that I can use to get into names that aren't really covered. But, I would say that there is at least one data point for most of the companies in the portfolio.

***Q:*** *Sometimes there is very little institutional participation in a company. My understanding is the big players drive the stock higher when enough participate. You would like to be early, of course.*

**A:** We don't really do that. If you look at the holdings in the Satuit Micro Cap Fund and look at our basis in the holdings, you could see for the most part that we are in early.

***Q:*** *Your performance shows you are participating with the peer group year-to-date.*

**A:** The Satuit Micro Cap Fund was publicly traded in 2000 and 2001. In 2000, it was either the number one or two small-cap blend fund until Morningstar changed it. In 2001, the fund was up 38% and that was the tenth best performing equity fund in the country.

***Q:*** *Nobody did well in the second half of 2002, no matter what they did. But that sentiment turned October 9th and hasn't gone to that extreme since then. Small companies' tendency to outperform in a recovery has proved historically correct so far.*

**A:** I did an analysis of economic cycles. We looked at past recessions and expansions. We looked at one year after a recession, two years and what we called the non-recessionary periods. What was fascinating to me, one year after the recession ends, the micro-cap universe, which is defined by CRSP, the Center for Research and Security Prices, was up more than 30%. Large cap is up 16%. Mid cap is up 21% and small caps are up 24%. It's the small and micro cap that certainly out perform one year after a recession. This is going back to February 1945. Two years after a recession, you see a little bit of a difference. Large and mid cap outperform small and micro cap. However, when I talk to advisers, I say, you know what? I don't really care about one and two years after a recession, because I'm not going to know when we're out of a recession until 18 or 21 months until after we're out of it.

***Q:*** *The economists like to set the official dates, but it is really only an arbitrary concept.*

**A:** In other words, by the time you know that is when the economists say we were in a recession and out of one. It's going to be 18 months after that fact. What I really care about is what happens during a non-recessionary cycle because I know that the economy has bottomed. I know that we're going to be expanding in 24 months, so where do I want to be now to capture what will happen in two or three years from now? That's my job as an investment advisor, not to figure out what the trading pattern is over the next 30 days. So, when I look at the non-recessionary periods what you come up with is: micro caps have an annualized return of 16%. Small caps are up about 14.5%. Mid cap and large cap is each up 12%. Inside a booklet I wrote is an analysis of the efficient frontier — if you believe in a diversified portfolio some of your allocation needs to be small and micro cap. When I talk to advisors about that, I challenge them. Bring me any equity portfolio you have, and I'll bet you if I add small and micro cap to it I can make a more efficient portfolio.

*"I think that we all, both institutional and retail investors really got away from the real fundamentals of a company.* ***Your standard valuation matrixes were just thrown out the window.*** *If there was anything I learned about the 1990s is,* ***don't ever forget about fundamentals, because if you do, you're doomed."***

**Robert Sullivan**

**Robert J. Sullivan, the portfolio manager of the Fund, has over 15 years of investment experience. He is responsible for implementing the day-to-day management of the Fund's investment operations. Mr. Sullivan holds a Bachelors of Science in economics from the University of Maryland and holds Series 7, 22, and 63 licenses from the National Association of Securities Dealers, Inc. He is also a member of the Boston Security Analysts Society, the Boston Securities Traders Association and the Association for Investment Management and Research.**

***Q:*** *You get more bang for your buck from these sectors when it turns back up from the low end of a cycle.*

**A:** Absolutely. We have data going back almost 60 years to suggest that in that non-recessionary cycle you'd still want to have an allocation there. We have data going back to 1929 in the efficient frontier that would suggest you still need to have that micro-cap allocation to have a more efficient portfolio — in other words, a portfolio that has less risk and more return.

***Q:*** *What is the efficient frontier?*

**A:** It's based on modern portfolio theory, MPT. The efficient frontier is the result of the study of modern portfolio theory. ▮

**Dave Jennings**