

EQUITY

In the Know: Finding Value Among US Microcap Stocks

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When many investors think of microcap stocks, they envision high growth stocks that are like rockets. They soar when times are good, and crash and burn when times are bad. We recently caught up with Oliver Wong, portfolio manager, Franklin MicroCap Value Fund. He explained his approach to finding higher-quality, smaller companies within the equity universe that have the potential to perform well in different market environments.

You are a portfolio manager of the Franklin MicroCap Value Fund. What's so interesting about microcap stocks?

We define microcap stocks as having market capitalizations below \$500 million. We believe this niche asset class deserves a role in many equity investors' portfolios for two main reasons.

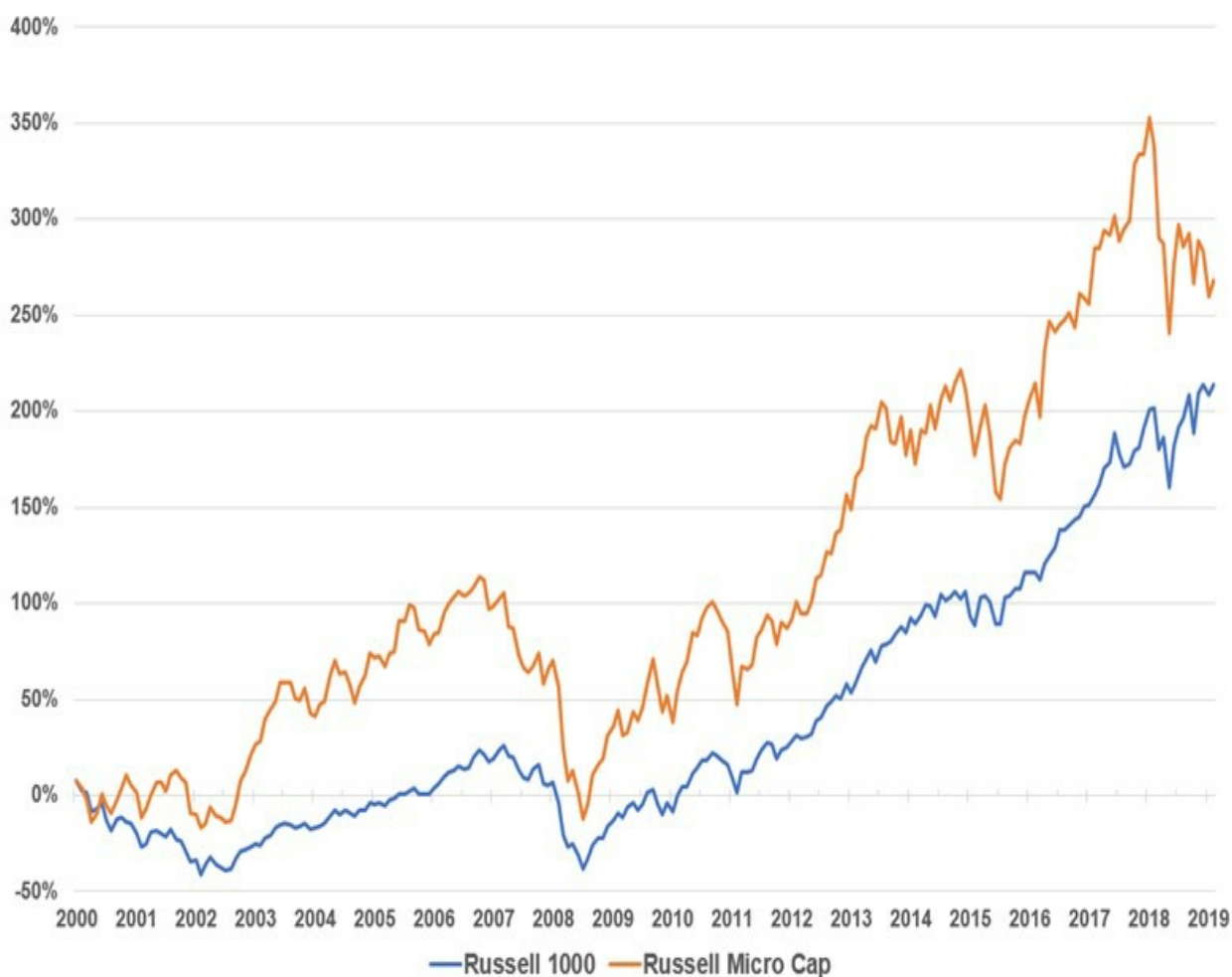
First, US microcap stocks, as measured by the Russell Microcap Index, have provided strong absolute returns since 2000, outperforming their large-cap peers in the Russell 1000 Index.¹

Microcaps Have Outperformed Large Caps Since 2000



Cumulative Return

August 1, 2000 to September 30, 2019



Source: Russell Indices. Calculation period: August 1, 2000 to September 30, 2019. Micro-cap stocks represented by the Russell Micro Cap Index. Large-cap stocks represented by the Russell 1000 Index. For illustrative purposes only and does not reflect the performance or portfolio composition of any Franklin Templeton fund. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance is not an indicator or guarantee of future performance.** Additional data provider information available at www.franklintempletondatasources.com.

Second, microcap stocks tend to be an under-researched area, which increases the odds of discovering good companies at great prices. This is because larger-cap stocks dominate the overwhelming majority of US equity trading. As a result, the brokerage firms orient their research capabilities in that direction, leaving the microcap space largely unattended.

As active microcap managers, we scour this vast investment universe of under-researched stocks looking for good companies that have been ignored, overlooked or temporarily beaten up. We believe the fact that most institutional money managers aren't even looking in the microcap space allows us to find stocks that offer superior performance potential over the long term.

Microcaps seem to be a very niche part of the stock market, as you said. How did you get involved with microcaps?

I joined Franklin Templeton in 2012 as a research analyst covering small and microcap stocks globally. Personally, I find these small, oftentimes neglected public companies fascinating because the outcomes are so varied. One microcap stock could be a super high-growth company that's blazing new trails in its industry. Another could be a former large-cap stock headed toward extinction.

Given this wide divergence of fortunes, I believe that successful long-term investing in this space requires a focus on higher-quality companies and an adherence to value principles. This is the investment framework that I've always used and continue to apply today as a portfolio manager of the Franklin MicroCap Value fund.

What are some of the main characteristics you look for in these companies?

We assess value through multiple lenses, starting with low price-to-book (P/BV) ratio,² free cash flow generation and balance sheet strength.

Sometimes stocks look cheap by typical valuation measures because they operate in an industry that is currently out of favor, or they may be facing company-specific problems. Regardless of the situation, a large part of our job is to determine whether these issues are temporary and will eventually pass, or whether they will persist long term.

We typically avoid the latter. But if we think the problems are temporary or fixable, then we like to see a healthy balance sheet with little or no net debt, and positive free cash flow generation. We generally assume that it will take time (in some cases years) for things to get better. We want to see the company in good financial shape to weather the inevitable near-term challenges.

What advice would you give investors looking to invest in microcap value stocks now?

According to Bloomberg, there are nearly 10,000 common stocks traded in the United States, of which almost 6,000 have a market cap of \$500 million or less.³

Given the sheer breadth of the microcap universe, my advice would be to carefully consider active management for microcap investing. Yes, there are passive investment options, but they invest in many stocks that reported zero or negative cash flow from operations in their last fiscal year, or had net debt that exceeded their earnings before interest, tax, depreciation and amortization (EBITDA).⁴

Remember that companies on their way to bankruptcy are also part of the microcap universe!

We think microcap investors are better served focusing on the higher quality end of the spectrum, and that can only be adequately achieved through active management. In addition, active management can potentially lower volatility of returns, compared to a microcap index or exchange-traded fund.

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What Are the Risks?

Franklin MicroCap Value Fund

All investments involve risks, including possible loss of principal. The fund's ability to invest in smaller-company securities that may have limited liquidity involves additional risks, such as relatively small revenues, limited product lines and small market share. Historically, these stocks have exhibited greater price volatility than larger-company stocks, especially over the short term. In addition, the fund may invest up to 25% of its total assets in foreign securities, which involve special risks, including currency fluctuations and economic and political uncertainty. Value securities may not increase in price as anticipated or may decline further in value. These and other risks are detailed in the fund's prospectus. Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results.

These and other risks are described more fully in the fund's [prospectus](#).

1. Source: Russell Indices. The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the US equity market by market capitalization. The Russell Microcap Index is a capitalization-weighted index of almost 1,550 small cap and micro-cap stocks that captures the smallest 1,000 companies in the Russell 2000, plus 1,000 smaller U.S.-based listed stocks. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance. See www.frankintempletondatasources.com for additional data provider information.

2. The price-to-book ratio measures the price per share of a stock divided by its book value (i.e., net worth) per share.

3. Source: Bloomberg.

4. EBITDA is a measure of a company's overall financial performance and is used as an alternative to simple earnings or net income in some circumstances.
