BLACKSUMMIT FINANCIAL GROUP, INC
A Registered Investment Advisor
132 Riverview Drive, Suite D Flowood, MS 39232
601.714.1034 Office 601.714.1038 Fax
www.blacksummitfg.com

REMEMBERING THE FUTURE

Vol. 2, Issue 9, March 2011

FINDING BIG VALUE IN SMALL PLACES: GLOBAL MICROCAP AND SMALL CAP PROSPECTS

John E. Charalambakis, Ph. D., Chief Economist

Introduction:

As we have stated before, the global economic landscape has been changing. The economic pie will be divided up with greater portions for the emerging world. These growing powers are leveraging the opportunities brought about by globalization's interconnectivity of capital, information, and markets. In correlation, political ties among the emerging powers and less-developed actors grant the former diplomatic leverage and capital, allowing their voice to dictate global affairs more so than in the past. We've gone through this rationale on multiple occasions through our newsletters and commentaries, and for this month we'd like to introduce you to an additional manner to take advantage of the prospects in the emerging world.

Decision Tree

Where is the money?
Emerging Markets
Where in Emerging Markets?
Rising Middle Class
How do we take advantage of that?
Global Microcap and Smallcap Assets

The rest of the newsletter for this month will expand upon the above decision tree and offer supporting evidence each step of the way.

Follow the Money

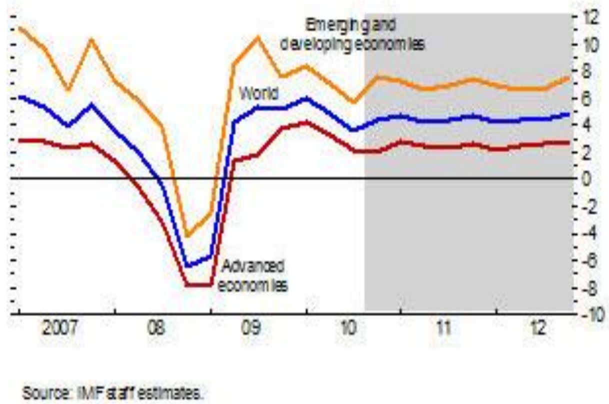
The ability to extract value out of existing – but sometimes dormant – resources defines capitalist capabilities. The premise, of course, is to target areas that are bound to rise in value in the future due to claims over expected streams of income to be generated via innovative methods in promising markets. At the scale of the world's economic direction, those areas of focus are the "emerging" and developing worlds.

Figure1: GDP Growth Rates Historical and Projected, IMF

GDP Growth	2004 - 2009	2009 - 2014 (Projected)
Emerging Markets	8.7%	12.6%
Developed Markets	3.5%	3.7%

Source: International Monetary Fund, World Economic Outlook Database, April 2010. Emerging and Developed markets as defined by the IMF.

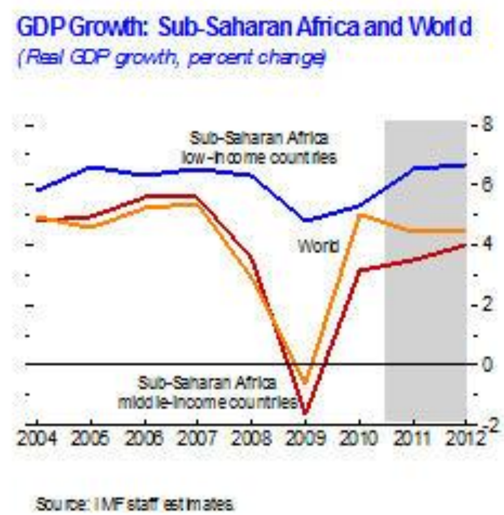
Figure 2: GDP Growth Rates Historical and Projected, IMF



Figures 1 and 2 above outline the phenomenon we are referring to. The realization that the engine of global economic growth will feel a greater impact from emerging economies has gained considerable traction from a wide spectrum of sources, including the IMF. The Fund's 2011 World Economic Outlook, released at the end of January, maintained these projections looking ahead. These forecasts also come in the midst of projected increases in energy and food costs. These inputs eat a much larger percentage of available resources in the emerging world compared to the developed. The fact that these growth projections are so robust despite such hurdles speaks to the enormous unrealized potential in these various markets. The scope of countries recovering strongly from the crisis is quite long and impressive: China, India, Brazil, Turkey, South Korea, Indonesia, Colombia, Argentina, Mexico, among others.

The diffusion of global growth fuel to include the developing world is even reaching the margins of the world's landscape to include Sub-Saharan Africa. Uganda, Rwanda and numerous other countries are tackling AIDS, relaxing restrictions on entrepreneurship, ensuring property rights (more than in the past), managing civil conflicts, educating their people, and attracting investment.

Figure 3: Sub-Saharan African Growth, IMF



These various countries are finally catching up to the world of globalization, convergence, and interconnectivity. Capital, ideas, business models, networking, people, goods, and services are flowing across borders, through wires, and over walls. Not only are these countries connecting with the developed world, but connecting with each other, offering innovative solutions and thought processes towards moving up the development ladder. They are taking advantage of their previously unrealized economic, social, and political potential to become a factor and lever of influence in the global marketplace. They have learned how to build institutions in their own domestic context so as to stabilize markets and allow their people a chance at a better life. If they stay on their respective paths, adapting and grabbing hold to further modernization in various facets, the future impact on global economic growth will be staggering as Tables 1 and 2 demonstrate. (Our own reservation from the tables below is the possibility that these estimates may underestimate S. America's and Africa's prospects).

Table 1: Growth of Global Middle Class

Numbers (millions) and Share (percent) of the Global Middle Class

	2009		2020		2030	
North America	338	18%	333	10%	322	7%
Europe	664	36%	703	22%	680	14%
Central and South America	181	10%	251	8%	313	6%
Asia Pacific	525	28%	1740	54%	3228	66%
Sub-Saharan Africa	32	2%	57	2%	107	2%
Middle East and North Africa	105	6%	165	5%	234	5%
World	1845	100%	3249	100%	4884	100%

Table 2: Spending Growth of Global Middle Class

Spending by the Global Middle Class, 2009 to 2030 (millions of 2005 PPP dollars)

	2009		2020		2030	
North America	5602	26%	5863	17%	5837	10%
Europe	8138	38%	10301	29%	11337	20%
Central and South America	1534	7%	2315	7%	3117	6%
Asia Pacific	4952	23%	14798	42%	32596	59%
Sub-Saharan Africa	256	1%	448	1%	827	1%
Middle East and North Africa	796	4%	1321	4%	1966	4%
World	21278	100%	35045	100%	55680	100%

Source Table 1 & 2: OECD

Based on the above projections, we could say that with over 60% of global population outside of the developed world, the emergence of the developing world will provide a hunger and demand for a wider range of goods and services. With still so much room to grow, capital will continue to flow, investments will continue to be made, and the consumption power of the emerging middle class will grow to be much heftier than it is now (Figure 3).

Figure 4: Real Gross Fixed Investment and Real Private Consumption, IMF Estimates

Why Micro and Small Caps?

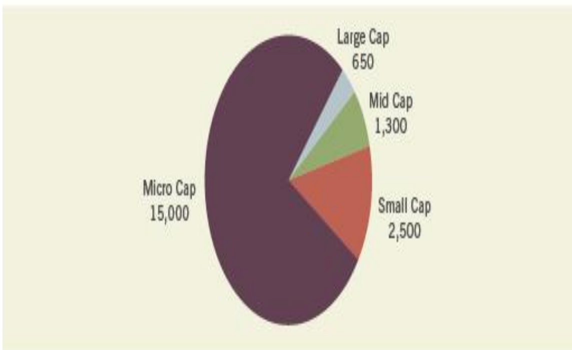
The most obvious and powerful reason for advocating positions in global microcap and smallcap assets is the direction we expect these funds to go. Global microcap assets are posting returns and behaving in a manner that reflects this greater economic narrative for very logical reasons. Emerging markets, as their label suggests, are not at the point of development or sophistication as their counterparts in the West. Most firms in countries such as Turkey or South Africa are more likely to be of the microcap and smallcap variety as opposed to being worth hundreds of billions of dollars. In fact, the majority of stocks internationally are of the microcap and smallcap variety, as the following figures demonstrate. They are bound to rise in value as the Turkeys, Brazils, and other emerging powers of the world realize more of their potential. Moreover, smallcap and microcap firms tend to outperform largecap companies in times of prosperity. They have higher margins for profits compared to the business models of larger companies, and usually their inelastic and fixed expenditures are lower. New industries and sectors are taking root, expanding their target markets, and innovative and unique products are created for their respective countries. Essentially, wealth is being horizontally and vertically created in this class of countries. As Figure 5 below demonstrates, market capitalization is growing at a much faster rate in these emerging countries compared to other parts of the world, including the United States. Companies in the BRIC group as well as other emerging market countries are posting stronger earnings growth and gradually finding a more liquid market for their securities.

Figure 5: GDP Growth and Market Cap Growth: 1999-2009, Wasatch Findings

Sources: International Monetary Fund (IMF); Standard & Poor's. As of December 31, 1999 and December 31, 2009. Population and GDP are from the World Economic Outlook Database, April 2010, published by the IMF. Market capitalizations are based on the individual country market capitalizations within the S&P/Citigroup Global BMI Index. BRIC stands for Brazil, Russia, India and China.

Figure 6: Breakdown of International Stocks by Capitalization, Factset

90% of International Stocks are Micro or Small Caps



Source: FactSet, as of 10/31/10.

An additional reason for including international microcap and smallcap funds in any portfolio is their diversification and hedging characteristics. This kind of diversification may turn out to be in a portfolio allocation as location is to real estate, the ultimate maxim. As we've seen and has been documented in a variety of news sources and publications, the globe outside of the developed West has recovered much better than the United States and Europe. In fact, investing in international funds such as these, like gold, would have substantially outperformed traditional American markets during the past, "Lost Decade." Their growth record prior to the Great Recession was more robust and their rebound much stronger, and their correlation to U.S. equities is low enough to advance such diversification (see figure 7 below).

Figure 7: Correlation with U.S. Stocks, Wasatch

Foreign Micro and Small Caps are Less Correlated with U.S. Stocks

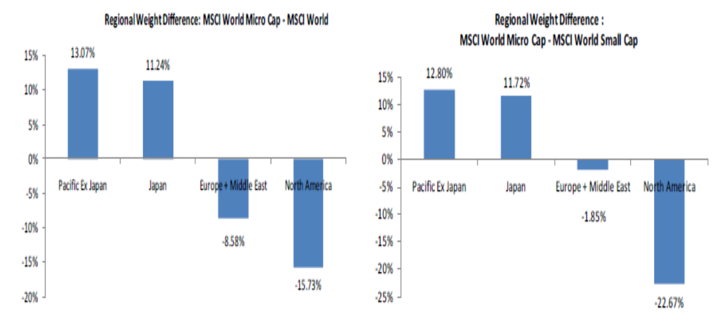
Correlation Table	U.S. Stocks
U.S. Stocks	1.00
Foreign Large Cap Stocks	0.66
Foreign Small Cap Stocks	0.59
Foreign Micro Cap Stocks	0.47

Sources: MSCI; Standard & Poor's. U.S. stocks are represented by the S&P 500, foreign large cap stocks by the MSCI EAFE Index, foreign small cap stocks by stocks within the S&P Global BMI with market capitalizations between $500 million and $2.5 billion, and micro cap stocks by the S&P/Citigroup Global BMI. Based on rolling 36-month returns from July 1989 through October 2010.

Figure 8: Micro Cap Funds Put More Focused Weight on Emerging Markets, MSCI

We are also of the opinion that as the above

Regional Weight Differences: MSCI World Micro Cap Index vs. MSCI World Index and MSCI World Small Cap Index

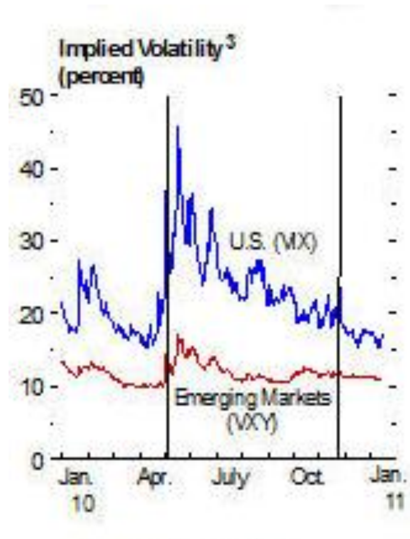


Based on Index data as of Dec 01, 2010.

figure 8 portrays, existing funds are discovering more value in microcap and small cap, that the mere demand factors advances their prospects. Again, this low level of correlation (like the growth being experienced in these areas) makes a lot of sense. Microcap and smallcap firms are smaller in nature. Their market share and customer base is more dedicated to their respective communities compared to large corporations whose primary customer base could be overseas. Developing markets and exposure to the West is an expensive and difficult endeavor, although it can be profitable given the wealth in places like the U.S. However, the fact of the matter remains that smallcap and microcap types of firms do not have the capital and resources to focus on such markets. Therefore they rely on the domestic market for profitability; microcap and smallcap firms are actually invested in the emerging market economy itself. This adds further credence to the recovery of smallcap and microcap firms; because of the fact they relied on developed markets less than larger firms, their customer base was not as severely impacted as say a Chinese multinational whose earnings haven't fully recovered due to deleveraging of the U.S. private sector. Since Europe's troubles are far from over (Greek bond yields are still over 11% at the moment, while Portuguese yields keep rising), international midcap and largecap firms are still at risk to face some hurdles in the future. After all, China's largest trading partner is the European Union economies. If European tremors start up again, it wouldn't be a surprise if such rumbling hit the U.S. given the ties between the two parties.

Moreover, the current tremors felt in the Arab world have already been impacting the markets via the oil venue. A word of caution might be necessary at this point: the emerging markets could also experience significant risks, if troubles continue. Exposure to international microcap and small cap stocks could limit volatility on account of the fact they lack as much exposure to these areas but also the fact that they've handled volatility during the last crisis. In addition to being diversified by country, microcap and small cap investments are diversified by sector as well, further spreading out risks.

Figure 9: Volatility: U.S. v. Emerging Markets, Chicago Board Options Exchange Market



As figures 8 and 9 above demonstrate, the volatility of micro and small cap in the emerging markets is lower and the fact that their returns are higher , as figure 10 shows, make them even more attractive.

Figure 10: Micro Caps Reduce Volatility and Increase Returns, Wasatch

Impact of Micro Cap Allocation

Stock / Bond Portfolio, 25 years ended 12/31/03

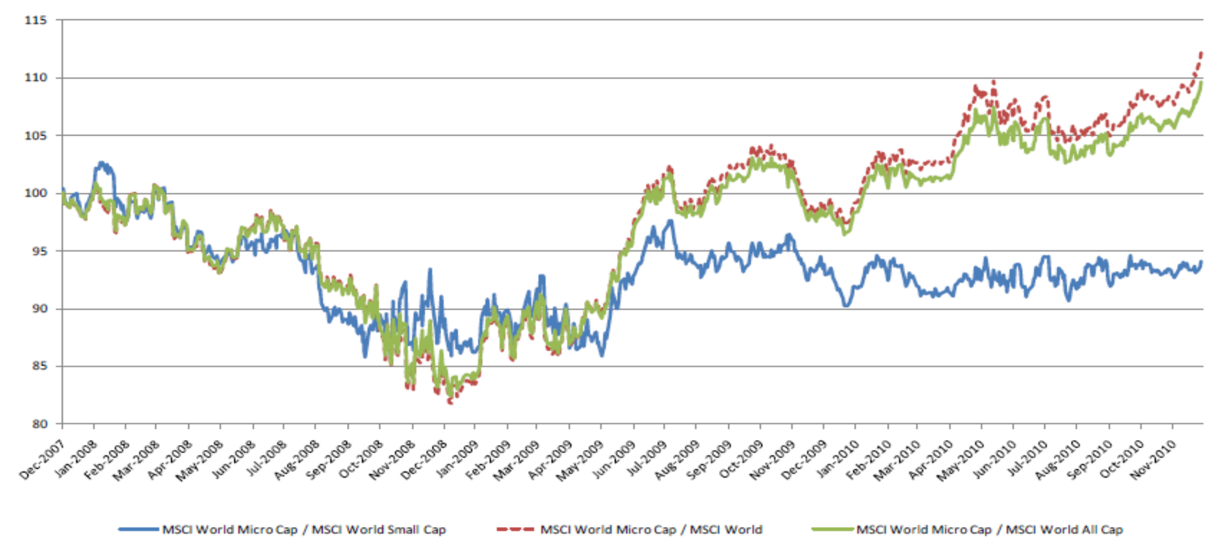
ALLOCATION				
Stocks	Bonds	Microcaps	Annual Return	Standard Deviation
60	40	0	7.7%	13.3%
55	40	5	8.2%	12.7%
50	40	10	8.7%	11.6%
45	40	15	9.2%	10.6%
40	40	20	9.6%	9.9%
35	40	25	10.2%	9.3%
30	40	30	10.6%	9.0%
25	40	35	10.9%	8.8%
20	40	40	11.1%	8.6%
15	40	45	11.2%	8.9%

Stocks: S&P 500, Bonds: Lehman Government Corporation; Microcaps: Wilshire Microcap
Source: Imperiale, Richard. The Micro Cap Investor. New Jersey: John Wiles & Sons, 2005. p. 49.

What speaks volumes more than anything else regarding small-cap and microcap investments has been their performance over the last few years. The following graph sums up our points nicely. For one, emerging markets have recovered better than other parts of the globe in the aftermath of the Great Recession. Second, microcap and small-cap firms are the hidden gems in these areas. Finally, as the figure below shows, we may be witnessing a divergence between developed and emerging markets that could serve as an integral part of a portfolio.

Figure 11: MSCI Undervalued

Relative Performance of MSCI World Micro Cap vs. MSCI World Small Cap, MSCI World and MSCI World All Cap Indices



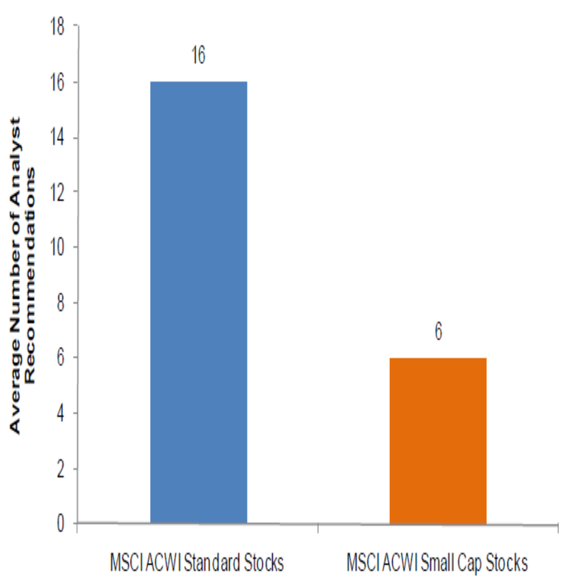
Based on historical MSCI World All Cap Index data from December 3, 2007 – November 30, 2010.

So if investing in international small-cap and micro-cap funds is such a golden opportunity why haven't we been hearing more about it?

It's a fair question, but not one that can't be answered without rationale.

First, just like their name identifies them, smallcap and microcap assets are smaller. Understanding their operations and their prospects requires lots of intimate and often times hands on knowledge with regards to the various firms involved. For an analyst sitting at a computer screen on Wall St., obtaining information of that sort can be hard to come by and when you're managing millions of dollars for high-end clients, your time is valuable. Plus, there are so many of them out in the marketplace (as Figure 6 illustrated earlier) they are hard to keep track of. To an analyst at a big time firm, "there are bigger fish in the sea." Thus, most Wall St. firms prefer to analyze assets whose information is more readily available or at least less confusing to peruse through. It becomes a matter of prioritization, and figure 12 portrays that fact.

Figure 12: Average Analyst Coverage



Source: I/B/E/S and MSCI

Second, like any other asset class, there is risk involved. Again due to their small nature and structure, smallcap and microcap companies don't have the cash on hand like larger firms due. Morgan Stanley Capital International (MSCI) refers to this as a liquidity premium and it is simply part of the nature of this asset type. Tying in with the lack of coverage smallcap and microcap assets get, MSCI also refers to a "Neglected Firm" effect, implying that the existent uncertainty is also a factor with regards to risk. Investing in these types of assets usually means trusting other managers' instincts, knowledge, and judgment, which is a tall order for Wall St.

Conclusion

By now our narrative toward portfolio allocation should be pretty clear in one regard: we're quite optimistic on the prospects for the emerging world, as part of the new – under construction – Silk Road. They've absorbed one major shock already with 2008 now behind us and yet continue to grow in a healthy manner. Getting invested into emerging markets isn't some short term trick, but rather a sound, prudent decision that may yield strong results over the long term. There will be bumps along the way, sure, but the fundamentals are just too robust to ignore. They are growing in the right manner: building social safety nets, creating an industrial base, educating their people for a service career, and innovating goods that will be compatible with future technological advance, such as alternative energy. This foundation will be something these emerging powers can rely upon if and when obstacles jump in front of their growth trajectory.

Until then, foreign economies and their maturing middle classes will continue to embed themselves in the global economy as a dynamic force and their imprint will most probably be felt in the micro and small firms that are burgeoning around the globe.

Ode to portfolios that integrate micro-cap and small-cap companies.