



ADVISOR CONTEXT

Buying micro-caps ‘more of an art than a science’

DIANNE MALEY

Special to The Globe and Mail

Published Thursday, Oct. 01, 2015 5:00AM EDT

Last updated Wednesday, Sep. 30, 2015 5:04PM EDT

You’ve got some money in your jeans and you’re feeling lucky. You could head down to the casino. Or you could dip your toe into the vast pool of micro-cap stocks, where bargains abound thanks to the recent market selloff.

Risky, yes, but early-stage or micro-cap stocks can be a tantalizing play for nimble investors with nerves of steel and a long time horizon. Be careful, though: Identifying them can be tricky and playing them challenging, analysts say.

“From my experience, you can make a lot of money on them but you have to be very vigilant – and quick,” says Fabrice Taylor, a chartered financial analyst and publisher of The President’s Club investment newsletter. The newsletter has a joint distribution agreement with The Globe and Mail. Mr. Taylor specializes in promising early-stage companies, small-caps and turnaround situations of all sizes.

“You want something with blue sky behind it, a business that can grow, attract big investors and become more liquid [more easily traded],” Mr. Taylor says. He does not share the view held by some analysts that investors should avoid micro-caps because they are too risky. “Every company starts small.”

The market washout this past summer was terrible for the TSX Venture Exchange, where many small companies trade, but it produced some real bargains, he says. “There are some amazing opportunities.”

Harrison Keenan, an investment adviser at Dundee Goodman Private Wealth in Toronto, has been watching the sector for the past 15 years.

“I see ideas come across my desk every day – street research, promoters and industry insiders I deal with,” Mr. Keenan says. He looks for “something that works, that makes your life easier, that could catch on and potentially be something worthwhile,” he adds. “It’s more of an art than a science.”

The odds are not great for do-it-yourselfers. Of any 10 micro-cap stocks, one or two might do well, three or four will languish and the rest “will go bankrupt,” Mr. Keenan says. Diversifying is important.

The best way to buy a carefully chosen mix of micro-caps is through a pooled fund such as the Hillsdale Canadian Micro Cap Equity Fund, offered by portfolio manager Hillsdale Investment Management Inc. of Toronto. Hillsdale manages more than \$1-billion in assets for high-net-worth individuals and institutions. The fund is also available to investors with discretionary accounts managed by a portfolio manager or investment counsellor.

Since it was first offered as a standalone fund in December of 2013, the Hillsdale Canadian Micro Cap fund has handily beaten the benchmark S&P/TSX Small Cap Total Return Index, rising 3.1 per cent net of fees and expenses while the benchmark dropped 7.7 per cent. The fund was down 1.5 per cent at Aug. 31, while the benchmark was down 8 per cent. The current dividend yield is 3.1 per cent.

Chris Guthrie, Hillsdale Investment’s chief executive officer and portfolio manager of the Hillsdale Canadian Micro Cap Equity Fund, expects Canadian micro-caps to be one of the best performing asset classes over the next five years. Financial market jitters have made the stocks “desperately cheap” – more so than at the depths of the 2008-09 financial crisis, Mr. Guthrie says. The fund is trading at less than book value.

Mr. Guthrie uses a combination of fundamental and quantitative analysis to select the 40 or so stocks in the fund – mainly companies that export to the United States and so benefit from the lower Canadian dollar. Its top 10 holdings are Tree Island Steel Ltd., Klondex Mines Ltd., envelope-maker Supremex Inc., Hardwoods Distribution Inc., Acadian Timber Corp., tech firm Vecima Networks Inc., Ten Peaks Coffee Co. Inc., Claude Resources Inc., tour operator Transat AT Inc. and Noranda Income Fund.

While advisers may be tempted to wait for signs the market is recovering before buying, micro-cap stocks can snap back quickly, Mr. Guthrie says. “Buy before the last seller stops selling, not after.”

From Mr. Taylor, some words of caution: “Temper your enthusiasm.” Keep micro-caps to no more than 2 per cent of your portfolio, and never, never margin (borrow against) your blue-chip stocks to buy micro-caps. If you do and the stock market tumbles, there will be no buyers for the micro-caps, so you’ll have to sell your blue-chips to pay for them.

What to look for

Here are questions Fabrice Taylor of The President’s Club investment newsletter asks when analyzing an early-stage company:

What is the business proposing to do? “Does it make sense and is it simple to understand?” he asks. “If they’re developing something you don’t understand, just walk away.”

Who is on the management team? “Google their names, look at their bios and their track records to see if they have made people money,” Mr. Taylor says. “You want people with an entrepreneurial background.”

What is the company’s capital structure? Examine how many shares, warrants and stock options are outstanding, the analyst says. Find out what managers and other insiders paid for their shares. Call them up if necessary. “The closer you can buy it to their price, the better off you’re going to be.” If the company has 100 million shares outstanding (including options and warrants), it will be difficult for the stock to move higher, he says.

How committed is the CEO? If the person running the company has 10 other jobs, “forget it,” Mr. Taylor says. “Walk away. He will never make you money.” Look for an entrepreneur who gives his all to his company and is paid mainly in stock and stock options, he adds.

How is the company financed, and can it raise more money? The biggest risk facing most early-stage companies is running out of money, Mr. Taylor says. This can happen even to companies that are doing well. If their “burn rate” – what they spend – is \$100,000 a month and they have \$1-million in the bank, they’ll run out of money in 10 months unless they can raise more. “That’s difficult to do today,” he notes. Some early-stage firms are lucky enough to have the backing of a wealthy “angel” investor.

What is the company’s growth potential? Ideally, it will be vast – with few competitors. “I find manufacturing micro-caps rarely work out,” Mr. Taylor says, because the competition is too great. Technology, mining and oil and gas companies “tend to be better.”

Is the stock price attractive? Valuing a micro-cap company with no earnings can be difficult, the analyst says. Investors might consider a 5-cent stock cheap, but “it may still be overpriced.”