*An interview with Robert E. Kern, portfolio manager, Fremont U.S. Micro-Cap Fund*

# A Search for Growth and Innovation In the Micro-Cap Stock Market

*In this issue's Mutual Funds column starting on page 23, Al Fredman takes a look at funds that focus on micro-cap companies. These are firms that tend to be smaller in terms of market capitalization (share price times number of shares outstanding) than the firms held by "small-cap" mutual funds. It is also an area of the stock market that is very inefficient, where the stock selection skills of a portfolio manager can add (or subtract) real value.*

*There are very few funds that specialize in this area, and fewer still with a long-term track record. In addition, a number of funds have closed their doors to new money because of the difficulty of investing very large portfolios in micro-cap stocks. A sampling of micro-cap funds can be found on page 25.*

*One new fund that has gotten off to a good start is the Fremont U.S. Micro-Cap Fund. The fund was started in mid-1994, and in 1995 the fund returned 54.0% compared to 28.4% for the Russell 2000, a small-cap index, while in 1996 it returned 48.7% compared to 16.4% for the Russell 2000. During the first quarter, the fund has underperformed the index, with a loss of 9.6% compared to a drop of 5.1% for the Russell 2000. Currently, it has about $160 million in total assets.*

*In early June, portfolio manager Robert Kern discussed the management of the fund with Maria Crawford Scott.*

***What is the basic investment objective of the fund?***

The objective is capital appreciation and the focus is on the micro-cap universe, which we define to be the bottom 5% of the equity market based upon market capitalization, with a minimum market capitalization of $10 million. Currently, it encompasses companies between $10 million to $300 million in market capitalization, which is about two-thirds of all publicly traded companies, or about 4,400 companies—a huge universe of opportunity. Right now, we own about 60 stocks.

***What's the average market capitalization of the fund right now?***

The median market capitalization is about $135 million and the weighted average is about $170 million—by either measure quite a bit smaller than the traditional "small-stock" fund.

***How do you find the investment opportunities?***

A number of different ways. Some of it results from screening the various databases, and some from our own experience in micro-cap investing. We also find good research from analysts in some of the various brokerage firms, especially boutique and regional firms, that are focused in this area. The Red Chip Review, a publication based in Portland, Oregon, focuses a lot of their activity in the micro-cap area. And NatWest Securities has formed a micro-cap investment group.

We take a fundamental approach, so we visit with corporate managements, and one of the best sources for ideas is talking to the corporate managements about other companies in their areas, suppliers, customers, or even competitors.

***What is the main thing you look for?***

Growth. The bottom line is to find successful micro-cap companies that will grow and hopefully become successful small-cap companies, and in some cases mid-cap companies and maybe in one or two cases large-cap companies. So growth is the starting point in looking for opportunities. And we do that by focusing our efforts primarily on those sectors where the level of innovation in the economy is the highest, because it's really that innovation, new products, and new opportunities that give these small companies the chance to develop important positions in the smaller niche markets.

***What sectors are you primarily focusing on now?***

In terms of innovation, there are four sectors of focus: technology, healthcare, consumer goods and the whole area of services, both business and consumer. Now that doesn't mean there's no innovation occurring in other areas, such as energy or financial. But our primary efforts are where the greatest amount of innovation is occurring. And we are looking for companies that are innovative, not

*The Fremont U.S. Micro-Cap Fund is part of the Fremont family of funds, 50 Beale St., Suite 100, San Francisco, Calif. 94105; 800/548-4539.*

those that are driven by macroeconomic trends—for instance, we are not buying energy stocks because the price of gasoline or oil is going up, or financial stocks because of a development in interest rates trends. We're focused at the company level in terms of our research efforts, much more so than at the big-picture macroeconomic level.

***Do most of the companies in which you invest have enough of a financial record on which you can base your judgment?***

It varies, but I would say the vast majority of micro-cap companies in our portfolio are established and lend themselves to what I would describe as conventional financial analysis. But there's probably about 15% of the portfolio in development-stage companies, and the conventional analysis approaches would not be appropriate for them.

***What figures do you examine when analyzing the more established companies?***

It will vary based upon the type of company or the sector in which it participates. For example, technology and capital goods stocks are primarily product-oriented companies, so the items that are most important in terms of financial analysis would be the relationship of earnings growth relative to revenue growth. Another key variable is the gross profit margin, and clearly we would prefer to see relatively high gross profit margins because it tells you several things: One, if the company can price its products on a value-added basis as opposed to a cost-of-production or commodity basis; and two, how much money is going to be left over after the direct cost of production to grow the company in terms of funding research and development for new products, sales, and marketing. And then, of course, we look at the income relative to capital needs, and we invest primarily in companies that are able to finance at least a major portion of their growth from internal sources so they don't have to keep going back to the debt or equity or markets. We want to make sure that the business strategies of the company don't get constrained by an inability to finance those projects.

***Is price a consideration?***

We are valuation sensitive—we're not just buying things because the price is going up, the way a momentum investor would. But we are paying premiums relative to growth rates in many cases. We are more concerned with a fundamental analysis of the business and the sustainability of the growth over longer periods of time. So one approach we use in valuation is to ask the question: Would we buy the entire company at the market value of the equity?

***At what level would you say that a company is too expensive?***

There isn't any universal yardstick, you have to look at it based upon the current valuation relative to the growth prospects and relative to the confidence that that growth will continue for a prolonged period of time. Over shorter time frames, though, you've got to be very sensitive and earnings are very key—we look at the expectations of other analysts and we want to find a company that we would expect to at least meet and hopefully exceed those expectations, because if expectations are too high and disappointments occur, the result is a severe decline in a very short time frame.

***How do you analyze less-established companies?***

One of the most important points is the partnership arrangement: Who are they partnered with in terms of development of their products and the markets they hope to serve? If you see very high quality larger companies doing partnering arrangements, or larger companies taking an ownership position in smaller companies, you know that the larger company has done its homework in terms of the smaller company's technology or capability, and it can help the smaller company develop its own opportunities.

The other aspect is, to the extent that it is marketing a product or service: Is there a fundamental demand for that in the marketplace? This is particularly important if the company is attempting to go at it alone.

***What is the average length of time that you would hold on to a stock?***

Our fund has been growing rapidly and the current portfolio turnover ratio reflects that growth rather than our holding strategy. Longer term, I would guess our portfolio turnover ratio would be in the range of 80% to 90%. The turnover would come from several things. When companies grow outside of our market-cap range we will sell and reinvest the proceeds back into the micro-cap universe; usually that decision depends upon our fundamental confidence in the company and valuation levels. And then of course there are companies that are disappointments. The other aspect is what I would describe as a dynamic approach to portfolio management, and by that I mean we have portfolio weightings that generally vary between 1% and 4%, but we adjust those weightings based on our level of fundamental confidence. For instance, we can increase weightings where we think things are going to be better than expected in the short run; or if we are somewhat concerned, we'll reduce the weighting.

***How large would a company need to become to be out of your range?***

Of course, our range for initial investment is $300 million or under. It's hard to specify a limitation—there's certainly no requirement to sell at any particular point, and we've had investments in the past that have grown to almost $1 billion in market capitalization before

we recycled the money back into the micro-cap universe. You want to try and stay with your winners, but usually there comes a point where it reaches your valuation objectives or growth objectives, and then you sell.

***What about disappointments?***

We're fairly conservative in terms of our approach, and I think our success has been due in large part to minimizing the investment mistakes. But I haven't found a way to eliminate investment mistakes—one example is GeoWorks. We had an investment in this company for a short period thinking that its operating system for smart phones would have a big market potential. But it appears to be in a work-out phase, and the valuations have dropped due to investor disappointment based on the fact that the fundamentals haven't developed as quickly as most people, including ourselves, anticipated.

***How would you change the portfolio during difficult market environments? Do you try to time the market?***

We have been through some difficult times despite our short time frame and the fact that the overall performance has been outstandingly good—some of last year in particular, and then, of course, earlier this year. Basically, we tighten the portfolio in terms of criteria, consolidating into our highest-confidence investments. And to some extent, we may raise tactical cash reserves. But our goal is to be fully invested—we don't try to time the market.

***In 1995 and 1996, you had very high returns. What accounted for the bulk of those returns?***

There was no single reason in each instance, although we did have some stocks that did extremely well, such as Delta and Pine Land Company, which is the company that reached almost a $1 billion in terms of market capitalization from roughly about $200 million. Delta and Pine is a service company; it's the largest cotton seed company in the world. The reason for the interest and excitement is that Monsanto developed a genetically engineered cotton seed that is insect-resistant, but they didn't have the distribution, so they did a joint venture with Delta and Pine to achieve worldwide distribution. This is an example, too, where partnering made a difference.

***Did you buy the company knowing about the Monsanto partnership?***

I bought it knowing that they were potentially going to work together, but there had not been EPA approval of the cotton seed at that point. This was early 1995, and the approval didn't occur until the fall of '95, and it was really between the fall of '95 and the spring of '96 that the stock did so well, but it started moving up in anticipation. It's a company that we had known for some time before we made the investment. Sometimes it takes longer to get approvals and things like that from the government, but in this case, our timing was pretty good.

***How do you manage the trading activity?***

Experienced trading capability is critical, and we have our own experienced traders. It's important in keeping transaction costs down because many of the micro-cap stocks don't trade all that heavily, and there aren't that many market makers. In many cases, you have to be very careful in terms of how to approach the market and what brokers to work with.

***Is the micro-cap sector a distinct asset class, or is it part of the "small-cap" market?***

I think the micro-cap market is distinct. The primary reason is the much greater inefficiency that's occurring in micro caps because of the lack of coverage by research analysts and the interest on the part of investors, especially institutional investors. Whereas, quite frankly, in small caps today, there are a lot of small-cap funds, there is a lot of research coverage, and small-cap conferences often attract 2,000 to 3,000 investors. So I think that it definitely is a separate asset class.

The real opportunity in micro caps is the stock selection opportunity. The media always talk about the relative performance of the asset classes—how small caps are doing versus large caps, and of course, small caps until at least May had been lagging, and micro caps have been somewhat in the same boat. But the opportunity is not so much in performance of the class as a whole, but in the stock selection. People ask us how our performance can be so good when micro caps and small caps really haven't been doing that well, and I say: "Stock selection, stock selection, stock selection." Based on the definitions we use for company size, there are 4,400 companies in the micro-cap universe, 1,600 in the small-cap universe, 450 mid caps, and 200 large caps. We define large caps as representing 60% of all firms based on market capitalization, so only 200 companies account for 60% of the total value. If I'm going to select stocks, I'd much rather do it from a universe of 4,400 stocks than I would from 200 that are widely followed, covered, and held by investors all over the world.