



Micro Cap Value: A Forward Looking Opportunity

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Long Term Believers

One of North Star Investment Management Corporation's core beliefs is that micro cap value stocks outperform the broad equity market indices over long periods of time. With a track record of outperformance relative to the S&P 500 and Russell 2000 that stretches back to 1997 in our flagship North Star Micro Cap Fund (NSMVX) and over 60 years of combined experience investing in the space, we also understand that the history of higher returns can come with periods of underperformance. For example, from 1998 to 2015 the Russell 2000 Value Index, a common proxy for small- and micro cap value stocks, underperformed the S&P 500 in 7 of 18 years yet outperformed the S&P 500 on an annualized total return basis.

	NSMVX	Russell 2000 Index	S&P 500 Index
Annualized Return [1998]	10.3%	6.8%	6.2%
Standard Deviation	16.4%	20.4%	15.5%
Up Years	15	11	14
Down Years	3	7	4
Biggest Down %	-40.3%	-33.8%	-37.0%
Biggest Up %	44.3%	47.3%	32.4%

2015 was a year of underperformance in the micro cap value space in general (the Russell 2000 Index was down -4.4% vs. up 1.4% for the S&P 500) and the North Star Micro Cap Value Fund in particular (down 14.4%). Accordingly, we sought to explain some of the reasons and to understand why there is such a wide divergence between the micro cap value space in general and our fund specifically, relative to the S&P 500.

2015: The Bigger the Better

The objective of the North Star Micro Cap Fund is to invest in securities with market capitalizations under \$500 million at the time of initial investment. As a result, the Fund's median market capitalization on December 31, 2015 was \$143 million, much smaller than the Russell 2000's median market capitalization of \$805 million. In order to make results more comparable between the Index and the Fund, we broke down the Russell 2000 into deciles sorted by market capitalizations.

The exhibit on the right shows the Russell 2000 at the beginning of the year sorted by market cap deciles as well as average 2015 returns by decile. Decile 1, which we feel is the most comparable part of the Russell 2000 to the North Star Micro Cap Fund, is comprised of the smallest ~200 companies in the Russell 2000 measured on 1/1/2015, had an average market capitalization of \$167 million and an average total return of -26.6% for 2015. Additionally, the three deciles with the smallest average market caps were the worst performers in 2015 (Deciles 1, 2 and 3).

Decile	Average Market Cap	Average Total Return
1	\$ 167.0	-26.6%
2	\$ 266.6	-9.6%
3	\$ 360.6	-10.5%
4	\$ 497.8	-3.9%
5	\$ 637.5	-2.7%
6	\$ 854.4	-6.1%
7	\$ 1,145.9	-3.6%
8	\$ 1,492.9	1.6%
9	\$ 2,021.5	-4.4%
10	\$ 3,248.5	-4.5%

We attribute these overall lackluster results in the micro cap space to a flight to liquidity (lower demand for the smallest publicly traded companies), as well as a rotation away from actively managed micro cap funds which have more flexibility to invest in sub \$500 million market capitalization investments to passively managed micro cap funds or ETFs whose average portfolio market capitalizations generally exceed the actively managed funds that they replaced.

Additionally, it is worthy to note that this trend extends into the larger echelons of the market. In the S&P 500 the largest 50 stocks at the beginning of 2015 were up 1.5% for the year while the smallest 50 stocks were down 11.9%.

Value: The More Expensive the Better

2015 underperformance also extended into the value space, regardless of size. In 2015 the Russell 2000 Growth Index was down 1.4% while the Russell 2000 Value Index was down 7.5%. The valuation spread between the Russell 2000 Growth Index and Russell 2000 Value Index is as high as it has been in 27 years with the only other period where it was greater being in 1999. Additionally, the S&P 500 Growth Index was up 5.5% while the S&P 500 Value Index was down 3.1%.

Historically, the opposite is the case, with value oriented equities outperforming growth oriented equities over longer periods of time. For example, a 31 year study conducted by Fidelity shows that the average return of growth oriented stocks from 1980-2010 was 10.4% while the average annualized return on value oriented stocks over the same time period was 13.1%.

A Look Back

Looking back over time reveals that this year was a bit of an anomaly given that historically the smallest deciles of the stock market outperform in the long run as well as in the short run. For example, analyzing data back to 1927 reveals that the smallest 10% of the market outperformed the other 90% for 40 of 89 years or 45% of the time. Furthermore, historical data tells us that there is a 41% chance, given that the smallest capitalization companies were the worst performing decile in 2015, that it will be the best performing decile in 2016.

Our experience in the North Star Micro Cap Fund confirms the historical performance noted above with the fund outperforming the Russell 2000 Index 67% of the fund's 18-year history and never having a two year stretch of underperformance.

Finally, we wrote a white paper titled [The Current Rationale for Micro Cap Securities in an Equity Portfolio](#) in May 2014 which can be found at www.nsinvestfunds.com. This paper seeks to explain some of the long term outperformance of micro cap stocks. The overriding reason is that micro cap stocks are often mispriced due to their lack of liquidity, research coverage, and intrigue.

Long Term Vision

Our core research process continues to revolve around finding high quality businesses with low net debt trading at discounts to intrinsic value with market capitalizations under \$500 million and holding those securities through market cycles (>3 years). Though the data clearly shows that the general market finds the intersection of micro cap stocks and value stocks unappealing at the moment, longer term we continue to be core believers in the space and refuse to let near term performance deter our commitment to a philosophy that has worked for decades.

	NSMVX	Russell 2000 Total Return
1998	-7.6%	-2.6%
1999	23.3%	21.3%
2000	18.0%	-3.0%
2001	20.2%	2.5%
2002	6.9%	-20.5%
2003	43.0%	47.3%
2004	22.1%	18.3%
2005	6.2%	4.6%
2006	22.3%	18.4%
2007	0.9%	-1.6%
2008	-40.3%	-33.8%
2009	44.3%	27.2%
2010	20.6%	26.9%
2011	6.8%	-4.2%
2012	12.9%	16.4%
2013	40.8%	38.8%
2014	9.9%	4.9%
2015	-14.4%	-4.4%

ANNUALIZED RETURNS OF FUND unaudited (net of fees) 12/31/15

	1-YR	5-YR	Inception
North Star Micro Cap Fund	-14.4%	9.4%	10.3%
Russell 2000 TR	-4.4%	9.2%	6.8%

**The Russell 2000 Index measures the performance of small-cap segment of the U.S. equity universe.*

Past performance is not indicative of future results. Current performance may be lower or higher than the performance data quoted above. For performance information current to the most recent month-end please call toll-free 855-580-0900. Performance shown before June 1, 2013 is for the Fund's predecessor limited partnership (Kuby Gottlieb Special Value Fund, LP). The prior performance is net of management fees and other expenses, but does not include the effect of the performance fee. The Fund has been managed in the same style and by the same portfolio managers since the predecessor limited partnership's inception on December 31, 1997. The Fund's investment goals, policies, guidelines and restrictions are, in all material respects, equivalent to the predecessor limited partnership's investment goals, policies, guidelines and restrictions. From its inception on December 31, 1997 through the date of this prospectus the predecessor limited partnership was not subject to certain investment restrictions of the 1940 Act of the Code, which if they had been applicable might have adversely affected its performance.

*The S&P 500® is widely regarded as the best single gauge of large cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

*The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe.

The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results.

Mutual Funds have investment risks including loss of principal. There is no guarantee the fund will meet its objective. The risk that the securities of small-cap and micro-cap companies may be more volatile and less liquid than the securities of companies with larger market capitalizations. These small-cap companies may not have the management experience, financial resources, product diversification and competitive strengths of large- or mid-cap companies, and, therefore, their securities tend to be more volatile than the securities of larger, more established companies.

Investors should carefully consider the investment objectives, risks, charges and expenses of the North Star Funds. No-Load Mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at www.nsinvestfunds.com or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINR/SIPC. North Star Investment Management Corporation is not affiliated with Northern Lights Distributors, LLC.

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