The Current Rationale for Micro Cap Securities in an Equity Portfolio

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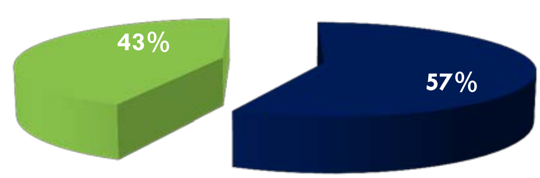
Micro Cap Stocks are largely absent in most asset allocation models. They are dismissed as being illiquid, under researched, small, domestic businesses which are likely to suffer in a rising interest rate environment. At North Star Investment Management we believe that these areas of concern offer investors an opportunity to achieve superior risk adjusted returns. We contend investors for which this type of investment is suitable should embrace these biases and allocate a reasonable percentage of their equity exposure to actively manage Micro Cap portfolios.

Opportunity Set

We define Micro Cap as a company with a market capitalization of under $500 million (although this definition varies between sources and over time). As of 05/12/14, there are currently approximately 1073 companies with market values of less than $500 million, which represents about 43% of all U.S. listed companies[1]

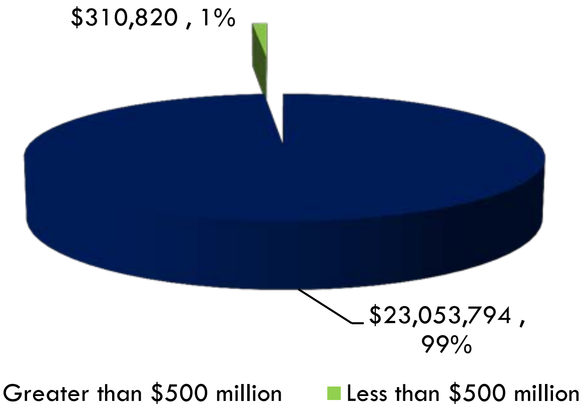
Share of Micro Cap Companies in U.S. Market



Yet because the value of each individual company is small, the total value of companies with market values of less than $500 million is approximately $310 billion, or <u>less than 2% of the total market capitalization of U.S. equity market</u>[2]:

[1] FINVIZ.com Screener - http://finviz.com/screener.ashx?v=111&o=marketcap
[2] FINVIZ.com Screener - http://finviz.com/screener.ashx?v=111&o=marketcap

Market Cap of Publicly Traded U.S. Companies



In fact, there are 5 companies that currently have market valuations that exceed the entire U.S. Micro Cap market 7 times[3].

Liquidity

Many investors eliminate the Micro Cap sector from their portfolios simply because the shares are illiquid; the stocks can be difficult to trade and for many institutions there is limited capacity for investment. Conversely recent research has demonstrated illiquid stocks can potentially provide superior returns.

"Of all the styles, liquidity has the most obvious connection to valuation. Investors want more liquidity and wish to avoid less liquidity. Less liquidity has a cost—namely, that stocks may take longer to trade and/or have higher transaction costs. In other words, all else being equal, investors will pay more for more liquid stocks and less for less liquid stocks. Fortunately, trading costs can be mitigated by those investors who have longer horizons and do less trading, which translates into higher returns for the less liquid stocks"[4]
Disclosure: Liquidity does not ensure profit or prevent losses and there is no guarantee that any investment strategy will achieve its objectives, generate profits or avoid losses.

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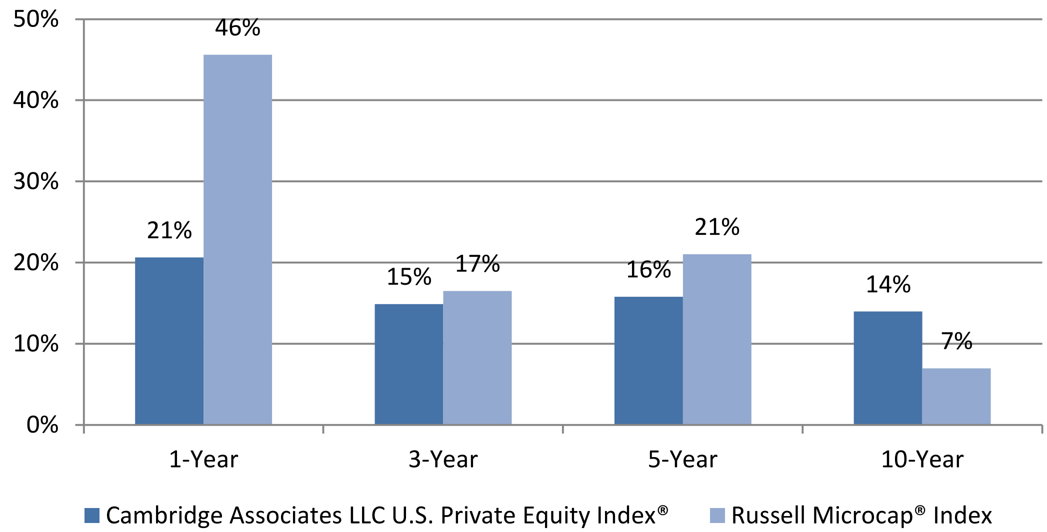
[3] As of 5/12/14 the U.S. companies with the hightest valuations were Apple, Exxon, Google, Microsoft, and Berkshire Hathaway. Their total combined market cap is $2.2T, while the combined market cap of companies with less than $500mm market cap is $310B.
[4] "Ibbotson, Chen, Kim, and Hu. "Liquidity as an Investment Style." Financial Analysts Journal 69: 30-44. CFAinstitute.org. Web. 1 May 2014.

Private Equity and Micro Cap Performance[5]



**Investors are not able to invest directly in the indices referenced in this illustration. The referenced indices are shown for general market comparisons and are not meant to represent the Portfolio. Past performance is no guarantee of future results.*

We construct our Micro Cap portfolios very similar to a private equity fund; taking large minority positions in companies with solid businesses and management teams that we like and trust at discount prices to our estimate of fair value. Yet our investors enjoy the additional benefits of daily pricing and liquidity and much lower fee structures.

Research

The Efficient Market Hypothesis asserts that one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made. The foundation of that theory is that sufficient research analysis is being performed on the available information in order to determine the security price. That premise is not valid in the Micro Cap sector since most companies are ignored by analyst and, therefore, most investors exclude these underfollowed securities from their selection process. This lack of research coverage, rather than being viewed as a negative, could be viewed as a potential opportunity to generate returns. It is highly likely that the price is wrong; the only question is whether it is too high or too low. The data may suggest that those prices are often too low. The "small firm effect" as first measured in 1978 by University of Chicago doctoral student Rolf Banz identified that common stocks of small firms have a statistically significant tendency to outperform the common stocks of large firms with the same level of risk[6]. Those returns become even more

[5] Russell Index Performance Calculator through 12/31/13: Russell.com/indexes/americas/tools-resources/index-performance-calculator.page
Cambridge Associates LLC U.S Private Equity Index® Selected Benchmark Statistics12/31/13: cambridgeassociates.com/our-insights/research/u-s-private-equity-2/
[6] Banz, Rolf W.. "The relationship between return and market value of common stocks." Journal of Financial Economics 9: 3-18. Web. 3 June 2014.

attractive with active portfolio management. If a tree falls in the forest, and an investor is the only one who hears it, that investor will have an information edge that may be valuable. This is an opportunity, as Micro Cap stocks are generally ignored by mutual funds and institutional investors. There are currently only 90 mutual funds and 4 ETFs that contain the words "Micro Cap" in their description.[7]

Limited Business Units

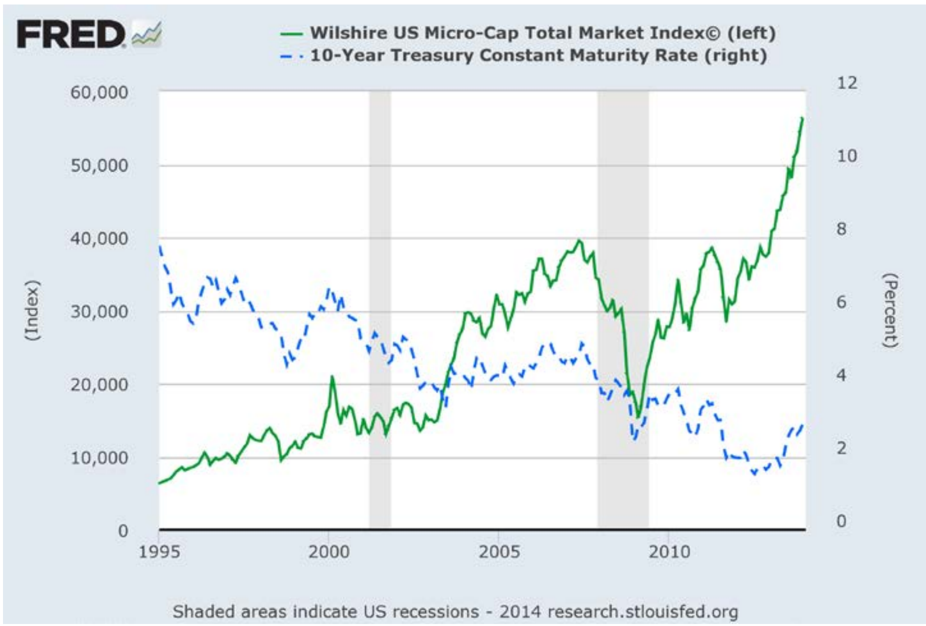
Most Micro Cap companies have simple businesses; they generally have a single business unit rather than multiple divisions. To many investors this lack of diversification is viewed as a negative. Quite to the contrary, we believe that it is preferable to create a portfolio of focused companies rather than invest in a company with multiple divisions. One of the drivers of micro cap performance has been the acquisition by these large companies to enhance the size of one of their subsidiaries. We have found that many micro cap companies have significant insider ownership and that management's interests are more aligned with public shareholders when it comes to a potential corporate transaction. Finally, a potential advantage with a simplified business structure is that financial statements become easier to read and more transparent.

Rising Interest Rates/Domestic Business

Once Micro Caps are considered as a potential component of a diversified equity portfolio, it is important to identify the periods where they may outperform or underperform the overall U.S. stock market. The generally held belief is that Micro Cap stocks will suffer as rates rise. Conversely, the data from the most recent recession from 2007-2009 shows the Wilshire US Micro-Cap Total Market Index© outperformed the S&P 500© during this period[8].

[7] Morningstar.com:
quote.morningstar.com/TickerLookupResult.html?ticker=micro%20cap&pageno=0&view=All&TLC=M#Result
ETF.com Finder: http://www.etf.com/etfanalytics/etf-finder
[8] FRED Economic Data: Wilshire US Micro-Cap Total Market Index© & S&P 500©

Additionally, performance of the Wilshire US Micro-Cap Total Market Index© and the 10-Year Treasury Constant Maturity Rate from 1995 to 2014 provides an illustration of Micro Caps independent performance from interest rates during multiple cycles[9].



Why Invest in Micro Caps?

Most investors ignore Micro Cap companies due to their lack of size, liquidity, research coverage or intrigue. As a result there is a robust opportunity set of publicly traded inefficiently priced businesses with motivated management teams and relatively easy to understand financial statements. Over time, we believe a diversified actively managed portfolio of these securities has the potential to provide superior long term risk adjusted returns.

[9] FRED Economic Data: Wilshire US Micro-Cap Total Market Index© & 10-Year Treasury Constant Maturity Rate

Indices Cited:

Cambridge Associates LLC U.S Private Equity Index®
The Index is an end-to-end calculation based on data compiled from 1,125 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2013. Pooled end-to-end return, net of fees, expenses, and carried interest.

Russell Microcap® Index
The Russell Microcap® Index measures the performance of the microcap segment of the U.S. equity market. Microcap stocks make up less than 3% of the U.S. equity market (by market cap) and consist of the smallest 1,000 securities in the small-cap Russell 2000® Index, plus the next 1,000 smallest eligible securities by market cap. The Russell Microcap Index is constructed to provide a comprehensive and unbiased barometer for the microcap segment trading on national exchanges. The Index is completely reconstituted annually to ensure new and growing equities are reflected and companies continue to reflect appropriate capitalization and value characteristics.

Wilshire US Micro-Cap Total Market Index©
This index is a subset of the Wilshire 5000. It represents a float adjusted, market capitalization-weighted portfolio of all stocks below the 2,500th rank by market capitalization in the Wilshire 5000 at March 31 and September 30 of each year.
Source: Wilshire Associates Incorporated

S&P 500©
The S&P 500 is regarded as a gauge of the large cap U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy, which are publicly held on either the NYSE or NASDAQ, and covers 75% of U.S. equities. Since this is a price index and not a total return index, the S&P 500 index here does not contain dividends.
Source: Standard and Poor's

10-Year Treasury Constant Maturity Rate
An adjustment for equivalent maturity, used by the Federal Reserve Board to compute an index based on the average yield of various Treasury securities maturing at different periods. Constant maturity yields on Treasuries are obtained by the U.S. Treasury on a daily basis through interpolation of the Treasury yield curve, which in turn is based on closing bid-yields of actively-traded Treasury securities. Constant maturity yields are used as a reference for pricing debt securities issued by entities such as corporations and institutions. (via Investopedia, definition: Constant Maturity)

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.

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