The Micro-Cap Bear Market of 2015

Chart Stack and Observations

Aberdeen Investment Management. LLC

A guide service for micro-cap technology investment.

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There has been a widespread drop in prices of micro-cap tech stocks similar to 2011, will the recovery mimic 2012?

The Russell Microcap Index Fund (IWC) fell 27% to a low in October 2011. It fell 22% to the recent low on Sept. 29. The drops exceeded the decline in the larger cap indexes in the same time frames.

2010 - 2011

2014 - 2015

The **IWC gained 20% in 4Q 2011** and **fully recovered by Mar. 13, 2012**, up 38% from the low.

What Lies Ahead?

Broad market bear markets are a function of recession. The probability of a recession using the NY Federal Reserve model is very low. It is at a level that preceded the two most recent recessions by over 3 years. The ability to foresee a recession is more complicated than a simple model. That said, a slow-down does not equal a recession. Recession prospects are debatable.

The current market drop has been driven by several “fear” factors”

- Panic Attacks – several news items surprised the markets this year including – large drops in crude oil prices, unsettling news on the Greece sovereign debt resolution and Euro implications, bear market in Chinese stocks as macro economic news from China came less than expected, etc. Micro-cap tech stocks are generally uncorrelated to these items.
- Slowing emerging market economies,
- Declining commodity prices
- Fear of Fed rate hike
- Rising US dollar
- Fear of another US budget battle and a show down over the US government debt limit.
- Political Presidential election season encouraging candidates to make inflammatory statements e.g. critical comments about drug prices leading to panic selling of pharmaceutical stocks.

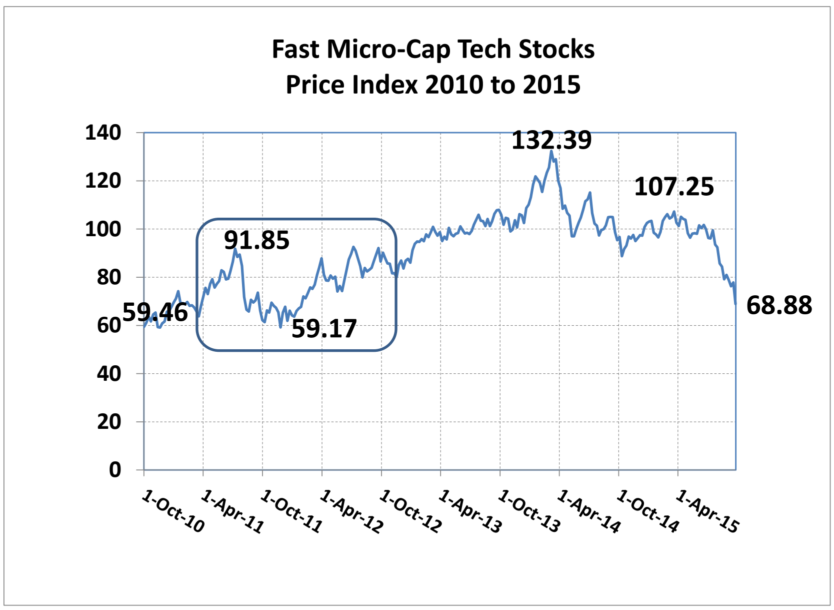
All of the above triggered increased stock price volatility and technical sell signals which triggered stop loss selling etc. etc. It also led to a reduction in Street estimates for 2015.

Data can now outweigh fear. We are now entering the 3rd quarter season. The bar has been set low. There are articles warning of a “grim” earnings season and “little improvement expected soon”. While that is certainly possible for global companies with commodity exposure, there may be strong performance by the companies whose sales and earnings are relatively untouched by the above stated factors – i.e. healthcare and small technology companies, our areas of focus. Note that corporate stock buybacks spiked in 2011 following the 3Q earnings season and may also this year.

The drop in micro-cap stocks has been virtually indiscriminant in 2015. A sample set of micro-cap tech stocks [*having a market value between $50mm and $500mm and having at least 20% compound growth in revenue – similar to AIM stocks*] reveals how widespread the drop has been this year. 84% of the sample companies saw their share price fall by an average of 29% in 3Q. 78% of the companies have seen share prices drop an average of ~38% YTD.

	YTD Gain	YTD Loss	3Q15 Gain	3Q15 Loss
Count	17	64	13	69
Count % of Sample	21%	78%	16%	84%
Average	29.4%	-37.8%	9.8%	-29.0%
Max	123.6%	-3.3%	61.8%	-1.5%
Min	0.3%	-81.1%	0.5%	-82.6%
Median	18.5%	-36.2%	4.5%	-25.5%

Here is a chart of the price history of the sample set of micro-cap tech stocks since 2010. Note the similar decline in 2011 and the sharp recovery in 2012.

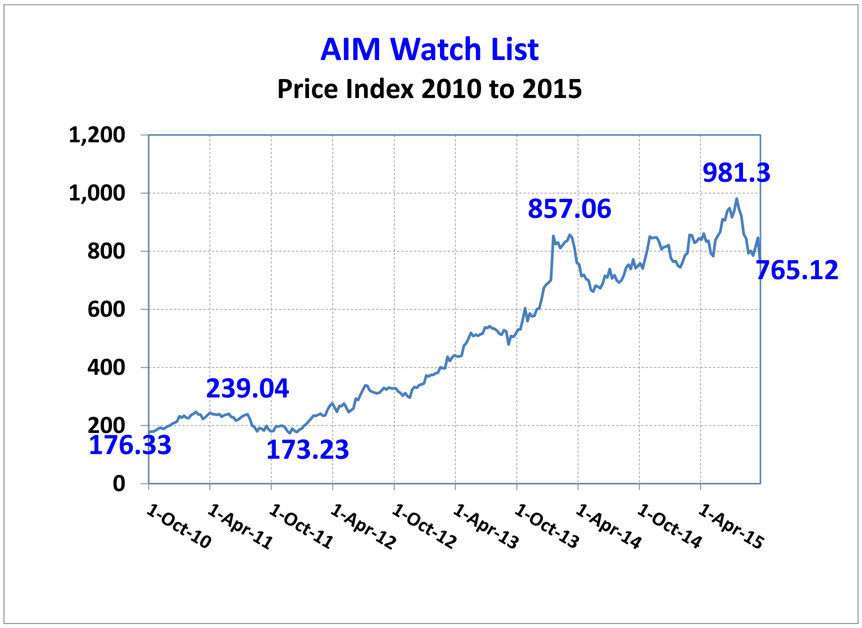


2011: Index fell 36% in 20 weeks from July 11 to Nov. 25
2012: Index gained 48% from the Nov. 2011 low to the end of 1Q2012
2012: Index recovered all of its decline by July 6 2012
2015: Index fell 36% in 27 weeks from March 20 to Sept 25.

Conclusion: The drop was not data driven but a function of overall "risk off" trading in the stock market. Smaller, less liquid microcap stocks were hit hardest . . . but they may recover the strongest if history is a guide.

What about Aberdeen positions?

A similar analysis of our "Watch List" consisting of 20 companies including our core positions and public venture investment companies follows below. They have outperformed the micro-cap index on the prior page. 75% of the Watch List companies had stock prices decline by an average of 24% off of their July highs to the Sept. low. 80% of the watch list companies have declined an average of 33% YTD. The entire Watch List is down 18% YTD.



2011: AIM Watch List fell 28% in 18 weeks from July 22 to Nov. 25

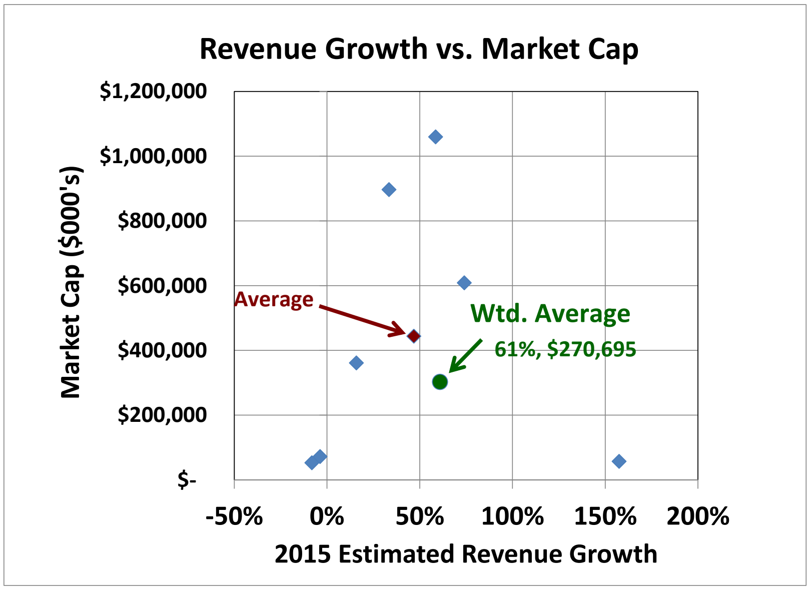
2012: AIM Watch List gained 60% from the Nov. 2011 low to the end of 1Q2012

2012: AIM Watch List recovered all of its decline by Mar. 16, 2012

2015: AIM Watch List fell 22% in 10 weeks from July 17 to Sept 25.

Aberdeen is in invested in better companies and has better performing prospects than we did in 2011. We anticipate the Aberdeen companies will have a strong recovery in coming months along with the rest of the micro-cap universe.

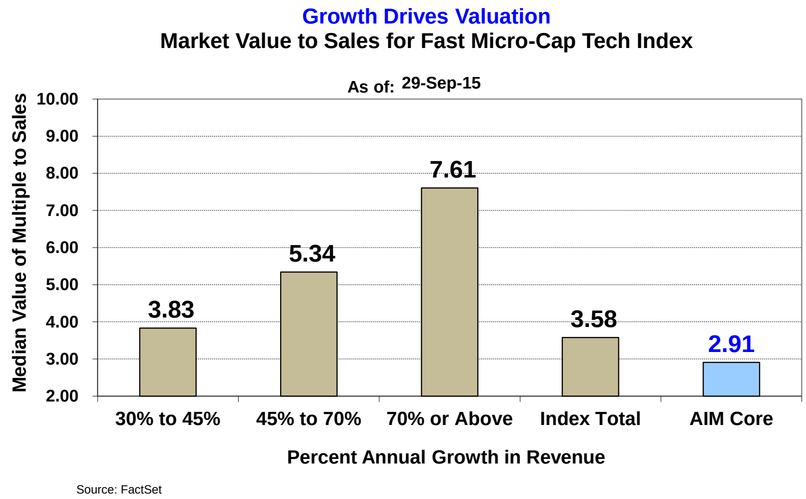
Micro-Caps are growth engines. The AIM core portfolio is estimated to grow revenue in 2015 by 61%. The S&P 500 composite revenue is expected to see a decline in revenue of 2.4% in 2015.



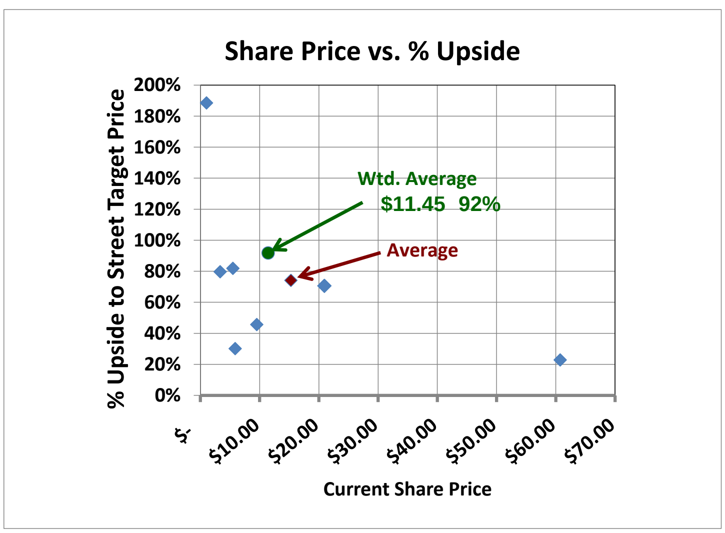
<u>AIM core portfolio:</u>

- Median sales growth = 25%,
- Wtd. Avg. sales growth = 61%,
- Median Mkt Values/Sales = 2.9X
- Wtd. Avg. Mkt Value/Sales = 2.6

The Aberdeen stocks are significantly undervalued compared to a screen of similar micro-cap tech stocks. The following chart shows the current market value to sales multiple for an index of micro-cap tech stocks similar to the AIM portfolio split into growth buckets. The AIM core portfolio has an average revenue growth rate of 41% (and a weighted average growth rate of 61%). This would put AIM in a "growth bucket" now garnering a valuation of 3.83X trailing LTM revenue even after the recent drop in stock prices.



Our portfolio would be valued 30%+ higher should we have a valuation aligned with our average growth rate. The following chart displays the average stock price of the core holdings in the portfolio relative to the percentage upside to the Street target prices.



The portfolio would be 93% higher if all the Street price targets were met. While it has not been our experience to see trending stock prices meet the Street targets, it has been our experience to see buy out prices approximate Street targets.

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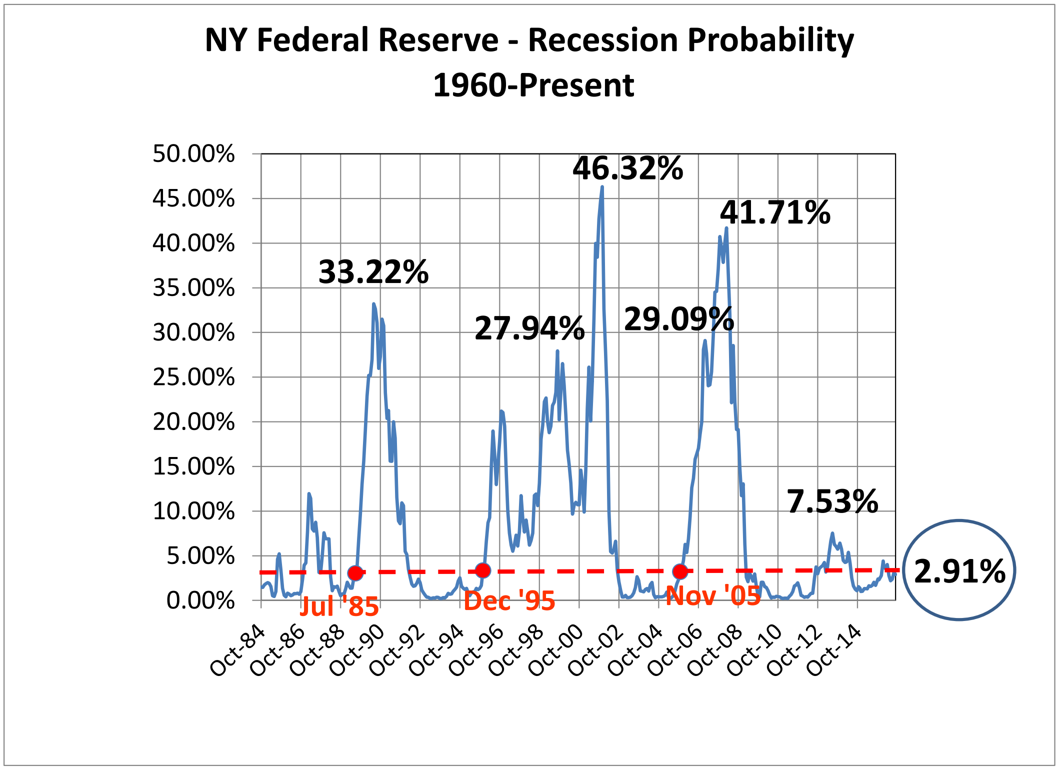
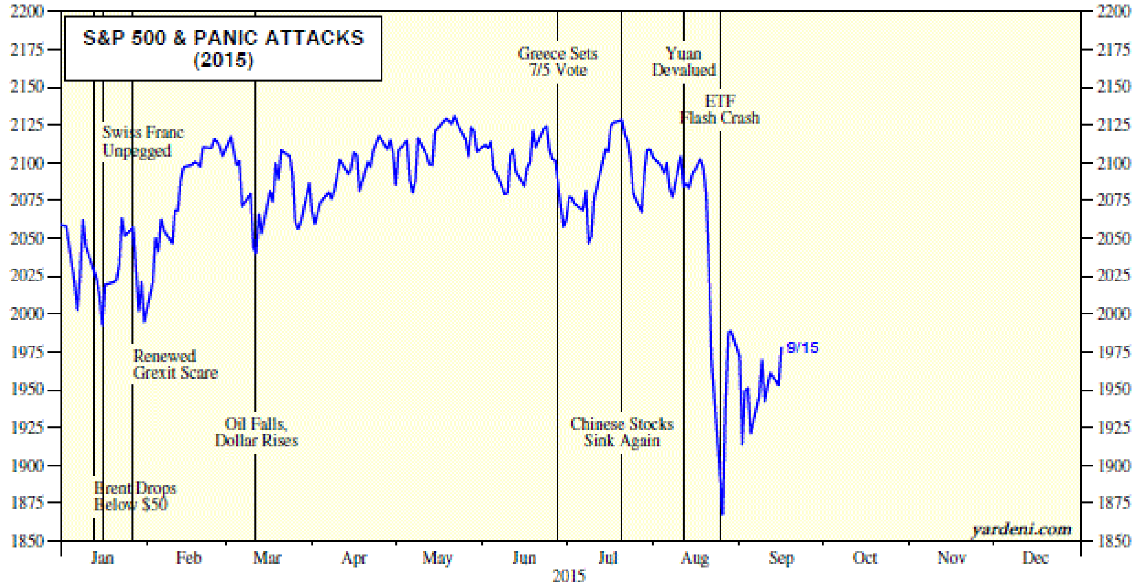
<u>Bottom Line</u>: There are legitimate prospects for a sharp recovery in share prices of high growth micro-cap stocks. Aberdeen welcomes qualified investors interested in focused high growth healthcare and technology companies.

Appendix:

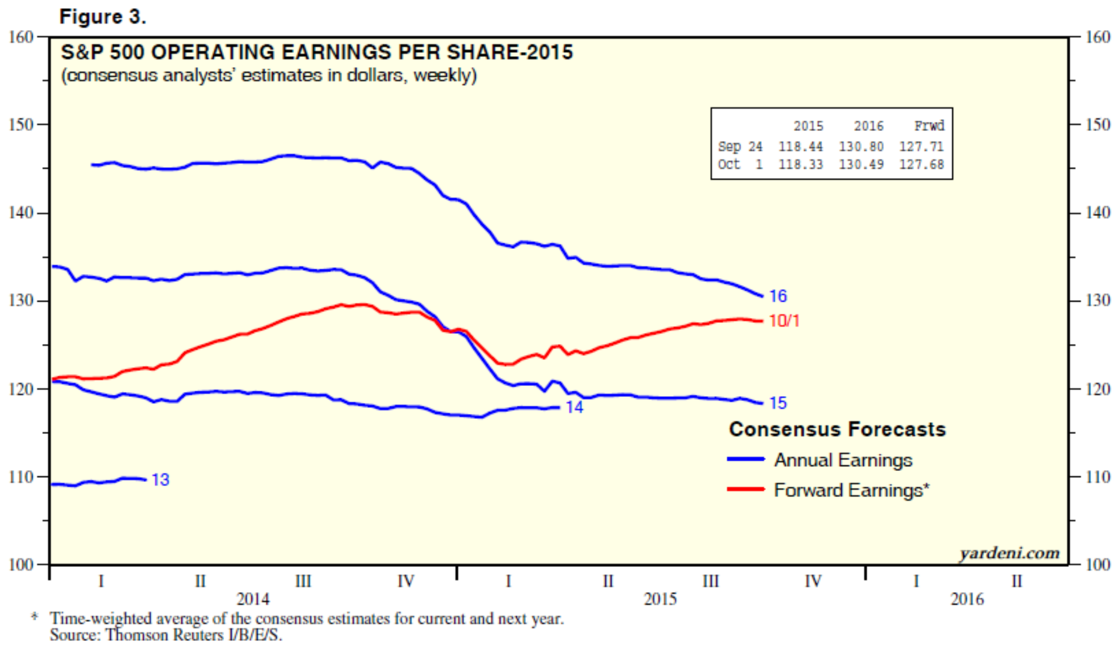


Note that the model has been a good predictor in the past albeit in very different interest rate regimes.



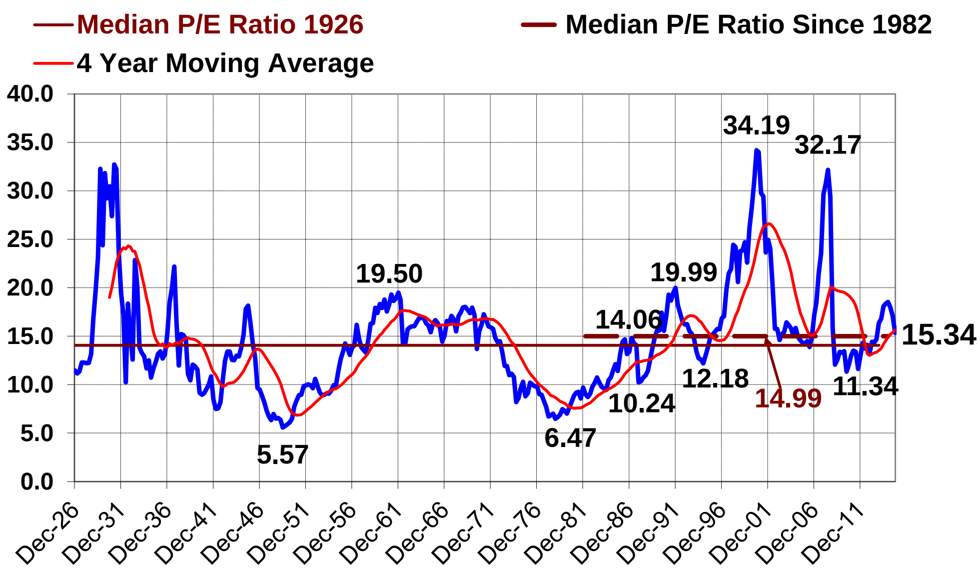
Source: Standard & Poor's Corporation.

S&P 500 Earnings Squiggles: 2015

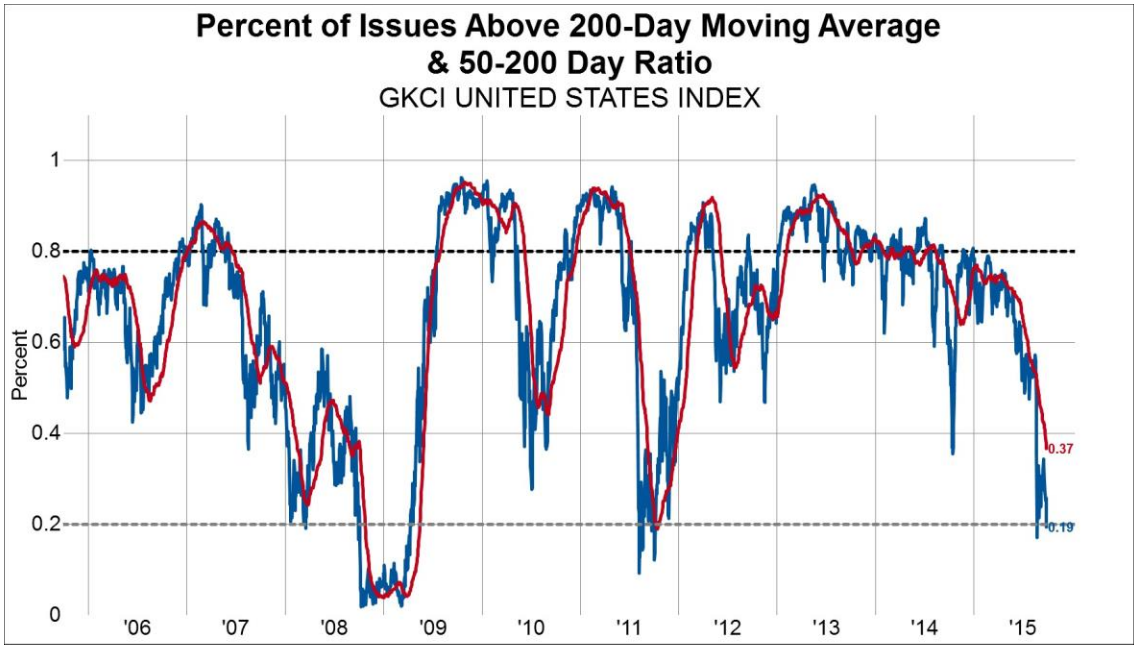


Note that the forward 12 month forecast is now trending up. This may signal that most of the bad news is well discounted.

FTM P/E Ratio S&P 500
1926 to Present



There is a large group of analysts who contend the market is expensive.



Stock prices have recovered in the past when they reached oversold conditions such as today. Note 2011 and 2008/2009.

Same comment as above.

Something to keep in mind is we are now entering the best time of the year for improving stock prices. November, December and January are the three strongest consecutive months of the year going all the way back to 1900.