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This Micro-Cap Fund Generates Big Returns

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U.S. small-capitalization stocks are undervalued and underperforming vis-à-vis larger-cap stocks, which is why some investment strategists believe they're due to shine. Problem is, small-cap boosters who've spouted that line in recent years have been let down repeatedly as the sector on the whole has remained a laggard.

The Oberweis Micro-Cap Fund flies in the face of that storyline, however, as it has produced strong annualized returns during the past 15 years that have put it in the tops of its Morningstar category for that period. During that time, it has beat the S&P 500's average annual return during the five, 10 and 15-year time frames.

It helps to understand that micro caps are considered a subset of the small-cap universe, and sometimes the lines are blurred. As Oberweis portfolio manager Ken Farsalas explains, the borders setting small caps and micro caps have expanded through the years with the overall market.

He notes that when he started as an investment analyst for a small-cap portfolio manager in 1996, small caps were defined as companies with less than $1.25 billion while micro caps were sub-$300 million. But the size of companies in the small-cap category have increased over time so that last year the largest company in the Russell 2000 Index—the standard benchmark for many small-cap managers—had a market cap of $8 billion.

The Russell Microcap Growth Index, the benchmark for the Oberweis fund, has seen its companies swell in size as well, and as of last year the largest company in the index had a market cap of $1.8 billion. As a result, Farsalas says, anything under $1.8 billion is considered fair game for his fund's portfolio. (The index reconstitutes every June, so the fund's ceiling for the next 12 months will change.)

Regardless of size, Farsalas says, he builds his portfolio from the bottom up, stock by stock, without thinking about a benchmark beyond the ceiling on market-cap size. (Morningstar puts the Oberweis fund in its small-growth category.)

Surprise, Surprise

Farsalas became a portfolio manager on the fund in 2015, and he's now the lead manager. James Oberweis, president of Oberweis Asset Management in the Chicago suburb of Lisle, Ill., is listed as a co-portfolio manager. (He's also the firm's chief investment officer.)

The three analysts on the investment team screen every day for micro-cap companies that have reported significant positive earnings surprises.

"Our edge is at the company level, where we analyze what's driving better-than-expected results," Farsalas says. "We believe that investing in micro-cap companies that are growing earnings beyond expectations allows us to generate strong performance for our clients over the long term."

Part of that is finding companies whose businesses, the team believes, are fundamentally misunderstood, a discon-

Oberweis Micro-Cap Fund

TICKER	OMCIX
ASSETS	$509 million
PERFORMANCE	YTD **10.21%**; 1 yr. **10.64%**; 3 yr. **9.13%**; 5 yr. **18.39%**; 10 yr. **15.03%**; 15 yr. **16.62%**
TOP 5 HOLDINGS	ADMA Biologics Inc.; Camtek Ltd.; Ultra Clean Holdings Inc.; ACM Research Inc. Class A; Applied Optoelectronics Inc.
CONTACT INFO	800-245-7311 • oberweisfunds.com

TOP INDUSTRIES (As a % of portfolio)

Information Technology	**26.3%**
Industrials	**25.0%**
Healthcare	**21.0%**
Consumer Discretionary	**10.8%**
Financials	**6.1%**
Energy	**4.6%**
Cash	**2.8%**
Materials & Processing	**1.6%**
Consumer Staples	**0.8%**
Telecomm Services	**0.8%**

Performance as of 6/30/24. Assets, holdings and portfolio stats as of 3/31/24. Standard deviation (three-year period) versus the Morningstar U.S. Small Cap Broad Growth Extended Total Return Index. Sources: Oberweis Asset Management and Morningstar.

Manager: Ken Farsalas

Background: He joined Oberweis Asset Management in November 2004 and is director of U.S. Equities and portfolio manager for the firm's domestic strategies. He became the lead portfolio manager of both the Micro-Cap Growth and Small-Cap Opportunities strategies effective January 1, 2015. Previously, he was employed at Dearborn Partners LLC, where he was a managing director and the director of research. Before that, he worked as a small-cap research analyst and portfolio manager at Sterling Johnston Capital Management and began his career at SEI Capital Resources as an investment consultant.

Outside Interests: He enjoys cooking, especially Sunday dinner, where the meal is his responsibility. He also plays golf.

PORTFOLIO STATISTICS

Number Of Stocks	**83**
Average Mkt. Cap	**$1.35 billion**
P/E Ratio	**17.63x**
Std. Dev. Fund/Benchmark	**26.25/22.14**
Turnover Ratio	**58%**
Net Expense Ratio	**1.28%**

nect that might allow the stock to keep surprising on the upside. Sussing that out entails a 17-step fundamental research process that seeks to identify the reason for earnings surprises and a company's perceived durability.

The team forecasts what they think the company can earn over the next 12 to 24 months. "Looking out beyond two years for earnings in the micro-cap world is an exercise in futility," Farsalas says. "We want to understand what we think the business could earn, and we compare that with Wall Street consensus expectations. The delta between those two things is the earnings gap. All else being equal, the larger that earnings gap the more compelling that investment idea is."

PEAD Syndrome

Farsalas says the firm's investment philosophy is based on behavioral finance. "We try to exploit a specific phenomenon called 'post-earnings announcement drift,' or 'PEAD,'" he says. This relates to behavioral biases where investors tend to underreact to new information that shows up in an earnings report.

Why do they do that? "Because most investors tend to look at a company with preconceived notions about the fundamentals and earnings power of the business, and therefore what that business should be worth from a valuation standpoint."

As a result, he explains, many investors are slow to fully appreciate what the new positive information actually means for the company's earning power and what the stock ultimately should be worth.

Farsalas says he sees four instances where this phenomenon plays out. One involves a company's successful rollout of either a new product or the latest version of its most important product, which results in an earnings surprise.

The second pertains to the introduction of a new management team at a company, one that changes the strategic direction of the business, earning better performance and generating an earnings surprise.

The third instance is when a company gets a boost from some government action, such as a change in regulation, or an infusion of stimulus money for various economic projects that could benefit certain industries. "All of this money can have a positive and substantial impact on a micro-cap company where it doesn't take much to move the needle on the income statement," Farsalas says.

The fourth foreshadowing of a positive earnings drift involves a recent acquisition where investors fail to grasp its positive impact on the acquirer. "The bottom line is that when a company reports an earnings surprise, and that surprise is driven by a big fundamental change, the academic research suggests that investors tend to overlook the new information and don't appropriately understand what it means for the earnings power of the company," Farsalas says. "In our view, that leads to mispriced and undervalued securities."

Bus Stop

One of Farsalas's recent winners was Blue Bird Corp., which he added to the portfolio in the spring of 2023 after the maker of school buses reported a positive earnings surprise and his investment team discerned there was more upside in the tank.

He says there's a tailwind for school bus makers thanks to a multi-billion-dollar government funded program to transition away from diesel school buses to electric buses. "Blue Bird has about 30% market share," Farsalas says. "They're seeing a big uptick in their business related to these EV school buses, and that's supported by a large amount of money being pumped by the government into that marketplace."

In addition, he notes, Blue Bird stands to benefit from Environmental Protection Agency regulations aimed at toughening emissions requirements for school buses starting in 2027.

"That should create additional demand for school buses that run on propane, which is a much cleaner fuel," Farsalas says, adding that Blue Bird is a top player in that space.

He says his fund bought Blue Bird when its price was in the low twenties. Since then it has reported a string of earnings surprises and its stock traded north of $58 as of early June.

It's clear that Blue Bird's stock is no longer a secret. "When we're right, and we're not always right, what happens over time is that the earnings gap—the delta between our estimate and the Street's consensus estimate—should narrow," Farsalas says.

That usually coincides with the stock going up in price and with Wall Street analysts reviving their earnings expectations upwards. And as that earnings gap starts to narrow, the misunderstanding about the business starts to narrow and go away. "As that misunderstanding starts to whittle away, that's when we want to reduce the position size in the portfolio," he says.

Time To Rally?

In April, Morningstar noted in an article that small-cap stocks returned 48% while large-cap stocks returned 92% over the past five years (as of this year's first quarter). The article laid the blame for small caps' underperformance on persistently high interest rates, since small companies typically need to borrow money to fund their operations. The massive gains in mega-cap tech stocks have meanwhile diverted attention away from smaller-cap companies, Morningstar said.

Farsalas says that small caps are better bargains at their current prices than large caps to a degree not seen since the late 1990s. "When does the gun go off and things revert to the mean? It's hard to say, but historically when you have this type of differential between the two it does revert to the mean," he says. "If I were a betting man I'd bet very heavily that over the next 10 years small caps will outperform large caps. And micro caps as a subset should do particularly well compared to large caps."

He opines that micro caps are the more interesting part of the small-cap universe because they get less Wall Street research; what they do get can add value and generate alpha. He acknowledges that micro caps in general are riskier, but with risk comes reward when used properly. That means they are best used as part of a core/satellite approach within investment portfolios where the bulk of the equity sleeve is going to the larger-cap part of the market, something that's well covered and more efficient.

"If you have a passive core and want satellites around that where you can add alpha, micro cap [is] a great option in an active-satellite bucket," Farsalas offers.

He says an uptick in flows during the past two years have boosted his fund's asset base over $500 million. This suggests that some investors are warming to the notion of trying to find big things in small packages.

Average Annual Total Returns
as of 06/30/24

Oberweis Fund Name/Ticker/Share Class	*1 Year*	*5 Year*	*10 Year*	*Gross/Net Expense Ratio**
Micro-Cap Fund (OBMCX) -Investor Class	*10.40%*	*18.09%*	*14.75%*	*1.53%/1.53%*
Micro-Cap Fund (OMCIX) -Institutional Class	*10.64%*	*18.39%*	*15.03%*	*1.28%/1.28%*

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate, so that you may have gain or loss when shares are sold. Current performance may be higher or lower than quoted. Unusually high returns may not be sustainable. Visit us online at oberweisfunds.com for most recent month-end performance.

The Oberweis Funds invest in rapidly growing smaller and medium sized companies which may offer greater return potential. However, these investments often involve greater risks and volatility. Foreign investments involve greater risks than U.S investments, including political and economic risks and the risk of currency fluctuations. There is no guarantee that the funds can achieve their objectives.

Before investing, consider the fund's investment objectives, risks, charges, and expenses. To obtain a copy of the prospectus or summary prospectus containing this and other information please visit our website at oberweisfunds.com or call 800-323-6166. Read it carefully before investing.

**As of December 31, 2023. Oberweis Asset Management, Inc. (OAM), the Fund's investment advisor is contractually obligated through April 30, 2025 to reduce its management fees or reimburse OBMCX to the extent that total ordinary operating expenses, as defined, exceed in any one year the following amounts expressed as a percentage of the Fund's average daily net assets: 1.8% of the first $50 million; plus 1.6% of average daily net assets in excess of $50 million and for OMCIX 1.55% of the first $50 million; plus 1.35% of average daily net assets in excess of $50 million.*

Institutional Class shares OMCIX performance information was calculated using the historical performance of Investor Class shares for periods prior to 5/1/17. Investor Class share OBMCX inception date 1/1/96.

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