ACORN CAPITAL MARKET INSIGHTS

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ACORN CAPITAL
NEXT GENERATION INVESTING

THE OPPORTUNITY HIDING IN PLAIN SIGHT:

MICROCAP STOCKS IN THE RESOURCES & ENERGY SECTORS

Cyclicity is a well-known feature of the resources & energy sectors. While the main cycles are essentially driven by major shifts in supply and demand, in the last 2 years there has been a marked divergence in the behaviour between the solidly performing mid- and large-cap stocks and the largely underperforming microcaps stocks. This divergence, we believe, has created a pronounced mispricing in the microcap resources & energy sectors that is hiding in plain sight. We do not know when the current downswing in microcap stocks will end, but history shows that the recoveries can be quick and strong. Moreover, investors who recognise the opportunity and invest near the bottom can be generously rewarded.

MICROCAP INDEX

To track the performance of all companies outside the top 250 stocks on the ASX, Acorn Capital developed an in-house benchmark, called the Microcap Index. These stocks are divided into 11 different sectors so their relative performance can be measured over time. The quilt chart below shows the annual performance of the 11 sectors for the past 10 calendar years. Within the resource and energy sectors are the full suite of commodities covered by the Acorn Capital NextGen Resources Fund.

The last 2 years have been a challenging period for microcap stocks. In 2022, energy was the only sector with positive performance and that was up a meagre 3.9%. This was despite the Russian invasion of Ukraine in February 2022. And in 2023 only 4 of the 11 sectors produced positive returns. The poor performance of micro-cap stocks in 2023 is not unique to Australia, with U.S. small caps also near their lows, relative to large caps*.

MICROCAP RESOURCES SECTOR

A notable feature of the sectors comprising the Microcap Index is the highly cyclical performance of the resource sector (dark blue). Since 2013, the microcap resource sector has oscillated on roughly 2-year cycles from the bottom of the sectors comprising the Microcap Index, to the top. Furthermore, 2022 and 2023 were particularly tough years for the resources sector both in absolute terms and relative to other sectors: falling 18.4% and 16.4% in absolute terms for the respective years. This represents the largest 2-year fall over the past decade.

CALENDAR YEAR MICROCAP SECTOR RETURNS (%) – RANKED HIGHEST TO LOWEST

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
26.7 (return) AREITs (sector)	69 Staples	49.6 Indust – Capital	41.8 AREITs	7.7 Telco	51.5 IT	72.5 Resources	37.9 Resources	3.9 Energy	33.4 Indust -ex Capital
22.1 Staples	45.3 Telco	48.4 Resources	35.8 Resources	5.5 AREITs	39.8 Healthcare	45.2 IT	32.5 Energy	-3.9 Indust -ex Capital	16.1 IT
17.2 Telco	36.1 IT	20.8 Indust -ex Capital	33.5 Indust - Capital	-0.4 Staples	35.1 Discretionary	30.5 Discretionary	30.8 Indust - Capital	-11.6 Indust – Capital	15.6 Indust – Capital
16.3 Financials	21.2 Healthcare	20.7 Telco	30.1 Staples	-6.3 Indust -ex Capital	33.2 Financials	13.2 Healthcare	29.8 Indust -ex Capital	-13.1 AREITs	14.8 Discretionary
12.9 Discretionary	21.0 AREITs	19.2 AREITs	26.5 Financials	-7.4 Financials	26.5 Indust - Capital	10.2 Telco	28.1 Telco	-18.4 Resources	-0.4 Financials
2.6 IT	16.4 Discretionary	15.0 Energy	17.5 IT	-9.7 Energy	16.6 Staples	7.3 AREITs	26.3 Discretionary	-23 Staples	-1.7 Energy
-11.2 Healthcare	10.5 Financials	11.8 Healthcare	11.2 Indust -ex Capital	-12.8 Discretionary	16.4 Indust -ex Capital	5.3 Financials	25.3 AREITs	-26.1 IT	-1.9 Telco
-14.5 Indust -ex Capital	5.1 Indust -ex Capital	7.2 Financials	9.1 Telco	-14.2 Healthcare	16.0 Resources	4.1 Energy	15.5 Financials	-27.6 Financials	-2.1 AREITs
-25.6 Indust - Capital	-3.4 Resources	1.5 Discretionary	5.2 Discretionary	-15 Indust - Capital	14.1 AREITs	0.8 Indust - Capital	14.9 Healthcare	-29.3 Healthcare	-4.5 Healthcare
-28.4 Resources	-20.8 Indust - Capital	-9.1 Staples	4.6 Energy	-24.4 IT	-0.1 Telco	-3.5 Indust -ex Capital	-0.2 IT	-31.4 Discretionary	-6.3 Staples
-30.4 Energy	-29.7 Energy	-15.3 IT	0.7 Healthcare	-26.3 Resources	-4.1 Energy	-5.2 Staples	-2.0 Staples	-36.5 Telco	-16.4 Resources

Annual performance of Acorn Capital's Microcap Index that shows the strong cyclicity in Resources & Energy stocks for the last 10 years.
Source: Acorn Capital/SIRCA Microcap Index. Does not include Utilities or Materials ex-Resources as <2% of universe.

* Global small-cap stocks lure bargain hunters after sluggish 2023 | Reuters

INNOVATION EFFICIENCY GROWTH DIVERSITY

Sharply contrasting the performance of microcap resources in 2023, was the ASX200 Resources Index which was up 12.8%. This performance was largely driven by the major iron ore produces (FMG, Rio and BHP). There was also a contribution from gold miners (e.g. Evolution and Northern Star), and even Pilbara Minerals was up despite the big fall in lithium prices over the year. This strong performance of large produces has left many investors unaware of the sharp divergence in performance between the large cap resources and the underperforming microcaps.

MICROCAP ENERGY SECTOR

The microcap energy sector has followed a very different cycle to that of resources in the last 10 years. 2016 and 2021 were the only two years that the sector generated returns greater than 5%. While this lackluster performance has led many investors to ignore microcap energy stocks, it is important to understand the key factors that led to this sustained underperformance.

Uranium, oil, gas and coal are the four main commodities comprising the energy sector. Uranium experienced a prolonged bear market after the Fukushima nuclear accident in 2011, but since mid-2023, the spot price for uranium has risen strongly on a resurgence in demand. Oil, gas and coal demand has been more variable over the last decade, with several short-term spikes generated by major disruptions, such as extreme weather events and broader conflicts (e.g., Ukraine war). Importantly, the prolonged underperformance of the sector has resulted in a decade of underinvestment. As demand for oil, gas and coal continues to rebound, new supply will struggle to respond. The recent performance of microcap uranium stocks is, we believe, a window into the potential for oil, gas and coal stocks, when demand rises for those commodities.

THE OPPORTUNITY HIDING IN PLAIN SIGHT

The microcap resources and energy sectors are presenting investors with a rare opportunity that we believe is hiding in plain sight. For resources, the opportunity is being concealed by the recent strong performances of many mid- and large-cap producers. As a result, many generalist investors are unaware of the sharp divergence in returns between microcap and the larger stocks. The timing and trigger for a rebound in the micro end of the market is difficult to predict, but one possibility is a surge in mergers and acquisitions (M&A) activity. Foreseeably, either the cashed-up large caps will start cherry-picking the best undervalued microcaps, or the microcaps themselves start merging to produce a new tier of high-quality development companies. Alternatively, investors may start cycling down from overvalued large producers into undervalued explorers, developers, and smaller producers. Regardless of the trigger, we believe the best way to take advantage of this dislocation is to invest in the microcap stocks with the best exposure to quality assets.

For microcap energy stocks, 10 years of generally poor performance has led to the sector falling off the radar of many investors. The recent performance of the uranium sector provides a valuable insight into what could also happen in oil, gas and coal. After a decade of underinvestment in uranium, the spot price started to rise sharply in March 2023. Among the biggest beneficiaries of the price uplift were the developers and advanced explorers, such as Boss Energy, Paladin and Alligator Energy. For oil, gas and coal, a rebound in the demand could trigger a similar response for the respective microcap stocks. Similar to our comment on the resource sector, the microcap energy stocks to move first will be those with high-quality assets.

For Further Information

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