

Sector on the Run!

As fundamental bottom-up stock pickers, we believe that investing in good companies, trading at low prices and that are often overlooked will add value for our clients. Sometimes, unintended consequences arise from being agnostic in terms of sector weightings relative to an identified benchmark. At times these consequences work in our favor and other times they can cause frustration. In this particular instance, we describe an excellent example of how index construction methodologies and pricing trends can create short-term benchmark-relative performance issues.

Pacific Ridge Capital Partner's Micro Cap Value strategy does not invest in biotech or pharmaceutical stocks because they generally lack strong cash flows, experience inconsistent profitability, and are not value stocks in our opinion. However, these stocks are included in the Russell Microcap® Value Index (our benchmark) and have had a noticeable impact on short-term results.

To understand the recent issue with biotech and pharmaceutical stocks, we need to think back to June 2017 when the Russell Microcap Value Index was last reconstituted. The number of companies in these industries rose from 98 to 133 in the Index, thereby increasing its exposure from 4.1% to 6.8% in a single quarter. So why did this happen?

The short answer is that Russell reconstitution methodologies focus on a stock's price-to-book ratio as a primary determinant for whether it belongs in a value index. In the simplest sense, we saw a good number of biotech and pharmaceutical stocks either drop in price, increase their book values, or both prior to the 2017 reconstitution. We can support this view given that median price-to-book values for biotech and pharmaceutical stocks dropped from 2.9 in March 2017 to 2.6 in June 2017 when reconstitution occurred.

As a result, our strategy had a roughly 7% underweight to the benchmark exposure in biotechs and pharmaceuticals. At first glance, one might not think such a small relative exposure difference could cause much of an issue, but this has not been the case. In fact, this difference has detracted several percentage points from our benchmark-relative performance from June 2017 to March 2018. Let's examine the reasons this occurred.

From a big picture perspective, the first thing we would point out is that biotechs and pharmaceuticals have been on a serious run from a performance perspective, earning a 45% return from June 2017 to March 2018. This return is more than four times the total Russell Microcap Value Index return of 9.5% and more than ten-fold the average return of 3.6% for all other Index sectors. Rising book values, price to book ratios, and a market trend towards buying stocks with negative P/E ratios have all contributed to this return disparity.

With respect to book values, the median biotech and pharmaceutical stock experienced a 36% increase from June 2017 to March 2018. This could be due to higher asset values and decreasing liabilities on their balance sheets, or even capital raising efforts. Regardless of the cause, this is a rather significant increase in book values for such a short period of time.

Beyond this, biotechs and pharmaceuticals have seen a dramatic increase in price-to-book ratios relative to their index. The price to book ratio for the Russell Microcap Value Index biotechs and pharmaceuticals rose from 2.6 to 3.6 from June 2017 to March 2018, whereas the overall Russell Microcap® Index price-to-book ratio remained unchanged at 1.5. As a result, the exposure to biotechs and pharmaceuticals in the Microcap Value Index grew from 6.8% in June 2017 to 10.8% in March 2018.

Finally, the market seems to be rewarding biotech and pharmaceutical stocks with negative earnings. To demonstrate this, all we need to do is look at returns for stocks with negative P/E ratios with and without biotechs and pharmaceuticals. For example, the Russell Microcap Value Index group of stocks with negative P/E ratios for March 2018 returned 3.6%, whereas returns were -6.2% with biotechs and pharmaceuticals excluded. The same is true for the core Russell Microcap Index, where returns shifted from 3.2% to -3.0% for the negative P/E ratio grouping when biotechs and pharmaceuticals were removed.

If we consider all these factors together, it is clear why biotechs and pharmaceuticals have recently caused a headwind to performance. Their index weighting has grown dramatically, book values have risen almost inexplicably fast, price-to-book ratios have increased, and the market is rewarding stocks with negative earnings (a common characteristic of these stocks).

Going forward however, this issue could correct itself when the Russell Microcap Value Index is reconstituted in June, as it is likely many biotechs and pharmaceuticals will no longer be cheap enough for inclusion in the Value indices. Thus, this particular case study in the difficulties of benchmark-agnostic investing may soon come to an end.

Sincerely,

Pacific Ridge Capital Partners

**Small Cap Value
Portfolio Statistics
March 31, 2018**

	PRCP Small Cap Value	Russell 2000® Value
Number of Holdings	100	1,385
Weighted Average Market Cap (\$M)	761	2,013
Average Market Cap (\$M)	718	1,067
Median Market Cap (\$M)	623	718
Price/Earnings	19.7	16.5
Price/Earnings (FY1)	14.2	15.0
Price/Book	1.8	1.9
Dividend Yield	1.2%	2.1%
Beta (vs Russell 3000)	1.2	1.1
L.T. Growth Forecast Median	12.0%	10.0%
Annual Turnover	27.7%	

**Micro Cap Value
Portfolio Statistics
March 31, 2018**

	PRCP Micro Cap Value	Russell Microcap® Value
Number of Holdings	72	1,048
Weighted Average Market Cap (\$M)	341	580
Average Market Cap (\$M)	322	351
Median Market Cap (\$M)	237	261
Price/Earnings	18.8	16.2
Price/Earnings (FY1)	14.3	15.0
Price/Book	1.6	1.7
Dividend Yield	1.4%	1.4%
Beta (vs Russell 3000)	1.1	1.1
L.T. Growth Forecast Median	11.0%	10.0%
Annual Turnover	29.5%	

Composite Performance Tables

Small Cap Value

	Q1'18	YTD	1 Year	3 Years	5 Years	Since Inception
PRCP Small Cap Value - Gross*	(1.8)	(1.8)	4.0	8.1	12.7	13.5
PRCP Small Cap Value - Net*	(2.0)	(2.0)	3.0	7.0	11.6	12.4
Russell 2000® Value	(2.6)	(2.6)	5.1	7.9	10.0	11.9

Micro Cap Value

	Q1'18	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception
PRCP Micro Cap Value - Gross*	(2.1)	(2.1)	13.5	15.9	19.0	16.5	12.0
PRCP Micro Cap Value - Net*	(2.5)	(2.5)	11.8	14.2	17.2	14.8	10.4
Russell Microcap® Value	0.5	0.5	12.7	10.4	12.3	8.8	5.7

* Preliminary figures

The firm maintains composites on both its strategies. The Small Cap Value Composite inceptioned on August 1, 2010. The Micro Cap Value inceptioned on April 1, 2007. All returns greater than one year are annualized. The performance results of the Micro Cap Value strategy includes accounts managed at another advisor. The Firm maintains a complete list and description of composites and a presentation that complies with the requirements of GIPS® standards, which is available upon request by contacting Peter Trumbo, Chief Compliance Officer at (503) 886-8972 or Peter.Trumbo@PacificRidgeCapital.com. The portfolio statistics are shown as supplemental information only and complements the full disclosure presentation (fully compliant GIPS presentation).

About Pacific Ridge Capital Partners, LLC

Pacific Ridge Capital Partners is an employee-owned firm. We generate our own investment ideas using fundamental analysis and bottom-up stock picking. The investment team applies a consistent, patient and disciplined process that results in low turnover and stability. Our proven philosophy has performed well over many investment cycles and it is the consistent application of this strategy that makes Pacific Ridge unique.

The principals of Pacific Ridge Capital Partners are invested along with our clients in each of our strategies.

PRCP Small Cap Value – Our Small Cap Value strategy generally purchases stocks in the bottom three-quarters of the Russell 2000® Index. This smaller capitalization segment has a large number of underfollowed companies, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 75 and 110.

PRCP Micro Cap Value – Our Micro Cap Value strategy generally purchases stocks in the Russell Microcap® Index. This segment is widely underfollowed, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 50 and 80.

We believe these market cap segments offer great potential returns and additional diversification for our clients.

For further information about Pacific Ridge Capital Partners and our investment strategies, we invite you to contact Tammy Wood via email at Tammy.Wood@PacificRidgeCapital.com or by phone at (503) 878-8502.

Disclosures

Pacific Ridge Capital Partners, LLC (“Pacific Ridge”, “PRCP”, or “the Firm”) is an employee-owned investment advisor registered with the Securities and Exchange Commission under the Investment Advisor Act of 1940. The Firm was established in June 2010, and has one office located in Lake Oswego, Oregon. Pacific Ridge claims compliance with the Global Investment Performance Standards (GIPS®).

Sources: Pacific Ridge; FactSet Research Systems (“FactSet”); and Russell Investment Group (“Russell”) who is the source and owner of the Russell Index data.

The current annual investment advisory fees for the portfolios managed in the Firm’s Small and Micro Cap Value strategies are 1.00% and 1.50% of assets, respectively. Returns for the composites are presented gross and net of management fees and other expenses and includes realized and unrealized gains and losses, cash and cash equivalents and related interest income, and accrued based dividends. The Firm calculates time weighted rates of return by geometrically linking portfolio simple rates of return at least monthly, with adjustments made for significant external cash flows. The composite returns are calculated by asset weighting the individual portfolio returns using beginning of the period values. All returns are calculated after the deduction of the actual trading expenses incurred during the period.

The information provided should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in our strategy at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the holdings discussed herein were or will be profitable or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. Past performance is no guarantee of future results.

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The Russell 2000® Value Index measures the performance of the Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. For comparison purposes, the index is fully invested, which includes the reinvestment of income. The return for the index does not include any transaction costs, management fees or other costs.

The Russell Microcap® Value Index measures the performance of the microcap segment of the U.S. equity market. For comparison purposes, the index is fully invested, which includes the reinvestment of income. The return for the index does not include any transaction costs, management fees or other costs.

Returns and asset values are stated in US dollars.