

How To Profit From Loopholes In The Efficient Market

Stock picker Ken Farsalas at Oberweis Asset Management is proving that the best way to trounce index funds is to fill your portfolio up with little known, earnings-beating companies.

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Eugene Fama, University of Chicago economist and father of the efficient market hypothesis, has long been a thorn in the side of active stock managers. His Nobel Prize-winning research dating back to 1970 argues that stock prices reflect all available information and are therefore fairly priced. In other words, trying to beat the market is futile over the long term.

However, even Fama has trouble explaining one disturbing pattern. In a 1998 paper in the *Journal of Financial Economics*, he addressed the phenomenon that stock prices continue to move up or down in the direction of an earnings surprise for as much as a year, describing it as the “granddaddy of under-reaction events.”

Fama dismissed this challenge to his efficient market hypothesis attributing it to pure chance, but a quarter-century later, the effect known as “post-earnings announcement drift” (PEAD) stubbornly persists. Nowhere is the proof greater than right in Fama’s backyard, 25 miles west of Chicago in Lisle, Illinois, at a firm specializing in small- and micro-cap stocks called Oberweis Asset Management.

Check out these returns: For the decade ending September 2023, Oberweis’ \$400 million Micro-Cap Growth fund has had an average annual return of 14% versus 3% for its Russell Micro-Cap Growth index. Its Small Cap Opportunities fund, also around \$400



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Ken Farsalas, a 19-year Oberweis veteran, has been fascinated with investing since he started buying stocks through his father’s account as a middle schooler.

million in assets, has returned 12% annually versus 6.7% for the Russell 2000 Growth index. All at a time when small caps funds have been largely left for dead by investors. The recent results are even better. Over the last three years, its micro-cap and small cap funds have generated 27% and 21% returns, respectively. Oberweis' secret? Ferreting out tiny companies with positive earnings or revenue surprises.

"Investors tend to cling to preconceived beliefs and notions and disregard new information that shows up in an earnings surprise," says Ken Farsalas, 52, lead portfolio manager and director of U.S. equities at Oberweis. "Investors are guilty of anchoring bias, confirmation bias, commitment bias, herding bias, groupthink—all of these different biases come into play. They mess with investors' ability to make effective decisions."

Ironically, Farsalas and Oberweis president, James W. Oberweis, and his father, firm founder James D. Oberweis, all received their MBAs from the University of Chicago's Booth School of Business.

"We kind of got brainwashed into the market efficiency stuff there," says the younger Oberweis, 49. "It's mostly efficient, but there are these pockets of inefficiencies in small asset classes where our stock selection process has been able to add value."

Oberweis Asset Management was founded in 1989 by Oberweis Sr., a former teacher and stockbroker who began publishing a stock newsletter, *The Oberweis Report* in 1976. In 2001, Oberweis Sr. went into Illinois politics and son Jim W. took over. Initially the firm's approach followed what it called the "Oberweis Octagon," investing in stocks with sales and earnings growth of at least 30% in the most recent quarter, among other metrics. Then, beginning in 2015, Oberweis handed the reins of the U.S. funds to Farsalas, who overhauled the strategy to revolve around growth relative to expectations rather than absolute growth to produce better diversification and less volatility.

Farsalas, his co-portfolio manager David Covas and senior analyst Kevin Cowell find ideas exclusively from a daily screen of every small-cap and micro-cap stock that reported earnings in the previous 24 hours. If a company's earnings or sales significantly beat Wall Street analysts' consensus expectations, it enters a 17-step process. Farsalas' team combs through the company's last few earnings reports, reads conference call



PHOTO BY NATE RYAN FOR FORBES

transcripts and ensures that it has a strong balance sheet and positive free cash flow. Then the team looks at valuation multiples like price-to-earnings and enterprise value-to-Ebitda multiples to decide if the price is right.

Farsalas comes up with an "Oberweis estimate" for how much a stock will earn in the ensuing one to two years based on that research and compares it to the street's consensus estimate, which is slower to react to earnings results. The larger the gap between the two estimates, the more enticing the stock. Oberweis' funds end up investing in about 15% to 20% of the stocks that make it through the screen, which Farsalas says typically align with one of four categories: an under-appreciated new product cycle or application, a change in management, a stimulus infusion from "good old Uncle Sam" or a recent acquisition that's performing better than expected. Earnings surprises that the team can attribute to fleeting or insignificant events get discarded.

Recently Farsalas has been finding earnings surprise stocks in the semiconductor business. Take the case of **Axcelis Technologies (ACLS)**, a \$4 billion (market cap) company which specializes in ion implantation, a key part of chip manufacturing. In the third quarter of 2019, the Beverly, Massachusetts company reported earnings of two cents per share to beat consensus analyst expectations of a one-cent loss per share, with new bookings accelerating. After the

stock popped up on Farsalas' daily screen, research revealed that silicon carbide semiconductors, which conduct electricity more efficiently than regular silicon chips, were becoming the product of choice for electric vehicles and have exponentially higher ion implant requirements, heightening demand for Axcelis' services. He invested in the stock in November 2019 at around \$20 per share, and it's still one of his top holdings after growing more than 500% to \$126 today.

Axcelis is not the only semiconductor firm to have passed Oberweis' earnings surprise screen. Other top holdings include Fremont, California's **Aehr Test Systems (AEHR)**, which does "burn-in testing" for silicon carbide semiconductors, a rigorous process that tests for defects for as long as 24 hours. Its shares have gained 30% this year to lift its market cap to \$700 million, though it has slipped since doubling in the first half. Both Aehr Test and Axcelis were down sharply Monday after large cap chipmaker ON Semiconductor, a customer of both, offered weak fourth-quarter guidance, but Farsalas viewed this move as an overreaction. Israel's **Camtek (CAMT)**, another stock in his portfolio which performs inspections of layers added onto "advanced packaging" semiconductors, has more than doubled this year.

"The wonderful thing about micro-cap and small-cap companies is they can attack niche markets," says Farsalas. "Applied Materials and Lam Research are the 800-pound gorillas in the semiconductor capital equipment space. The silicon carbide testing market for those companies is too small to bother with, but it's not too small for Aehr Test [2023 sales: \$65 million]. It's huge and it's very meaningful."

Tech stocks make up 22% of Oberweis' small cap fund and 29% of its micro-cap fund and have helped drive its strong returns, but the firm also has large exposure to healthcare and industrials, not always mainstays in a growth stock portfolio. In February, Oberweis invested in school bus manufacturer **Blue Bird Corp. (BLBD)**, one of the top five holdings in its micro-cap fund as of the end of June. A fourth-quarter 2022 revenue beat with \$236 million in quarterly revenues sent the stock soaring by 30% in one day, and though performance has been stagnant since then, Farsalas figures it still has more room to run.

"You had two-plus years during Covid where school districts weren't buying new



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David Covas, 48 (left), works as a co-portfolio manager with Farsalas, while Kevin Cowell, 40, is a senior analyst specializing in researching healthcare and medical tech stocks.

buses, so there was some pent up demand. On top of that you have the government really pushing an electric vehicle effort for school buses,” says Farsalas. “Blue Bird has about 33% share of the school bus market. We think they’ll take similar market share with electric vehicle orders.”

Farsalas shuns the riskiest areas of the market like small-cap biotech stocks, which often don’t even have any revenues to compare to expectations and can crumble in an instant if data from clinical trials is poor. The

vast majority of the businesses he buys are profitable or self-sustaining and operating around break-even to continue investing in new products. He’s quick to sell if a stock in his portfolio misses earnings expectations—PEAD goes both ways, and investors typically underreact to negative news as well. The sooner the better to cut bait, says Farsalas.

Despite micro-caps’ notorious volatility, this approach has helped Farsalas avoid steep drawdowns like many growth investors suffered through last year. His micro-cap

fund fell 10.4% in 2022, preserving most of its 54% gain from 2021, while the Russell 2000 Micro-Cap Growth Index plummeted 30% last year after only gaining 1% in 2021. Performance numbers for Oberweis’ small-cap fund were similar.

Even though Farsalas’ funds have been on a tear recently, he is more proud of his performance in 2019 and 2020, when his micro-cap fund gained 22% and 30%, respectively, lagging its benchmark. During 2019 and 2020 the Russell Micro-Cap Growth index was up 23% and 40%, respectively, but according to Farsalas it was chock full of tiny unprofitable companies trading at outrageous multiples.

“A lot of my peers in the growth space either never learned that valuation was important, or just chose to ignore it. I guess it was easy to do when we were in a zero interest rate environment, but now we have a cost of capital again,” he says. “We weren’t paying 30 times sales for software companies. To me, that was the biggest bubble I had seen since 1999 and 2000 at the very start of my career.”

With small caps still unloved by the market and lagging large caps, Farsalas continues to believe there are earnings-beating bargains to be had. Small caps represent less than 4% of the market capitalization of the total U.S. stock market, the lowest level since the 1930s. Farsalas points to the 1970s and early 1980s, when inflation and interest rates were high and small caps outperformed.

“Valuations of small caps relative to large caps are the most compelling they’ve been since the late 1990s,” says Farsalas. “Small caps will whip large caps over the next decade. I don’t even think it’s going to be close.”



**Average Annual Total Returns
as of 09/30/23**

<i>Oberweis Fund Name/Ticker/Share Class</i>	<i>1 Year</i>	<i>5 Year</i>	<i>10 Year</i>	<i>Gross/Net Expense Ratio*</i>
<i>Micro-Cap Fund (OBMCX) -Investor Class</i>	21.66%	12.13%	13.58%	1.53%/1.52%
<i>Micro-Cap Fund (OMCIX) -Institutional Class</i>	21.94%	12.43%	14.13%	1.28%/1.27%
<i>Small-Cap Opportunities Fund (OBSOX) – Investor Class</i>	19.63%	12.56%	12.14%	1.45%/1.25%
<i>Small-Cap Opportunities Fund (OBSIX) - Institutional Class</i>	19.93%	12.84%	12.42%	1.20%/1.00%

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.

**Audited data as of December 31, 2022. Oberweis Asset Management, Inc. (OAM), the Fund's investment advisor is contractually obligated through April 30, 2024 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. OAM is also contractually obligated through April 30, 2024 to reduce its management fees or reimburse OBSOX to the extent that total ordinary operating expenses exceed in any one year 1.25% expressed as a percentage of the Fund's average daily net assets and for OBSIX to the extent that total ordinary operating expenses exceed in any one year 1.00% expressed as a percentage of the Fund's average daily net assets.*

Institutional Class shares OMCIX and OBSIX 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. Investor Class share OBSOX inception date 9/15/96.

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