

## Active Microcap - A Private Equity Alternative

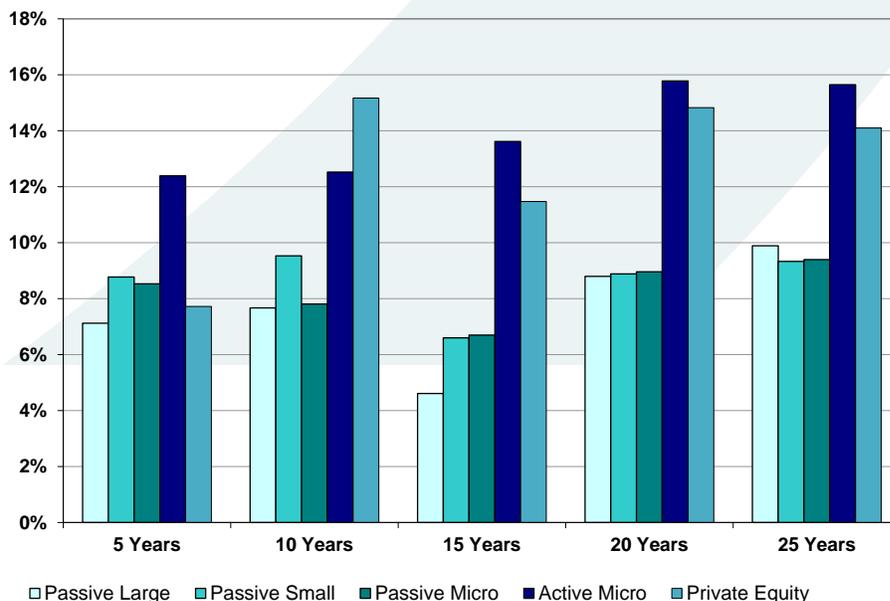
Date: Fourth Quarter 2013

In an era of budgetary setbacks and increased funding requirements, more plan sponsors have been attracted to private equity's historically high absolute returns as a means of alleviating funding challenges. We think that plan sponsors may be overlooking similar promise and potential in active Microcap equities.

### Active Microcap is a reasonable liquid proxy for private equity

The high returns that private equity has offered come with some points of caution, particularly the uncertainty around committed but uncalled capital, and the level of illiquidity. We believe that active Microcap offers an investment experience similar to private equity, while avoiding these drawbacks. Historically, active Microcap has had excellent long-term returns that rival private equity returns (Cambridge Associates' private equity benchmark) and beat passive benchmarks, both large and small. As we have noted in Exhibit 1, on a longer-term basis, active Microcap investors have outperformed private equity as well as the passive indexes. Additionally, the return patterns of active Microcap managers tend to be highly correlated to those of private equity managers due to the similar characteristics of companies that Microcap and private equity managers seek.

### Exhibit 1: Public vs. Private Equity Returns (through 6/30/2013)



Source: Acuitas, Cambridge Associates, Russell Investments, eVestment Alliance

\*The inception of the Russell Microcap Index is 2001. Passive Micro/Small Cap uses the Russell 2000 Index for periods prior to 2001.



### **Active Microcap investors seek private equity characteristics**

Active Microcap investing shares many of the features and advantages of private equity. Like private equity, an active Microcap product can offer a concentrated, high-conviction portfolio from an inefficient, minimally researched pool of companies with great return potential. At the same time, it gives the end investor a level of liquidity, transparency, flexibility, and accessibility that private equity is unable to. The reason for active Microcap's similarity to private equity is that the investment managers naturally tend to buy similar companies. Most notably, private equity managers target small, niche companies similar to those found in Microcap. Indeed, Microcap stocks are a large source of private equity investments. Roughly 8% of the Russell Microcap index was acquired, via buyout or merger, between 6/30/2010 and 5/31/2011.

Beyond capitalization, Microcap and private equity investors share many beliefs about what makes an attractive investment. Active Microcap managers as a group tend to favor strong cash generation, limited leverage, stable business fundamentals; all characteristics that private equity investors favor as well. Many stocks active Microcap managers target also tend to be cheap on the valuation metrics that private equity GPs use to value companies, such as EV/EBITDA.

### **Microcap investors benefit from greater liquidity**

On the liquidity continuum, Microcap sits somewhere between very liquid large cap stocks and very illiquid private equity investments. Some of the return similarities could be attributed to the expected liquidity premiums in private equity and Microcap. However, in our experience, the liquidity benefit from Microcap is significant relative to private equity. In fact, the long-term returns of private equity do not show a return premium commensurate with the illiquidity of the investment as the asset class has underperformed active Microcap. With active Microcap, there are traditionally no lock-up periods and the level of transparency into the underlying portfolio is significantly greater.

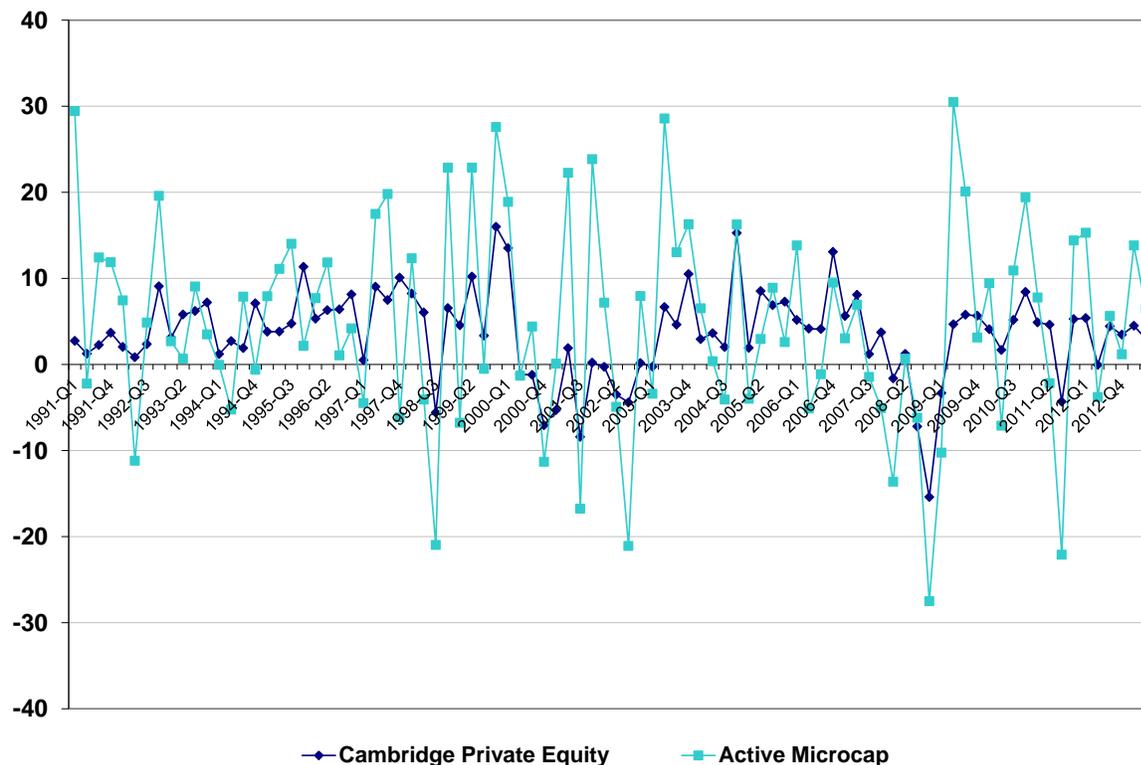
### **Microcap is a sensible choice for uncalled capital**

The liquidity of Microcap makes it a flexible investment that can serve as a long-term strategic allocation or a short-term proxy. In a recent paper on Microcap, Allianz suggests that (depending on a plan's ability to meet capital calls in the event of a decline) "due to the lengthy vesting period [of private equity], a sensible choice may be to temporarily invest idle, committed but not called capital in a micro-cap strategy." We concur with this assessment. For plans that desire a similar return pattern to private equity with the benefit of greater liquidity, Microcap makes a reasonable temporary investment. Of course investors must assess their ability to meet capital calls in the event of a decline in the market. But since capital can sit idle for long periods of time, active Microcap provides the best proxy for private equity returns and keeps the investor's asset allocation closest to its target.

### Microcap and private equity tend to move together

In the chart below (Exhibit 2) we have demonstrated that the investments trend in the same direction and enjoy similar periods of difficulty and success. The primary differences between the two return series are a function of peaks and valleys. This apparent lower volatility of the private equity returns is misleading, as it can be partially explained by the infrequent and stale pricing in the asset class. Importantly, while private equity doesn't experience the same level of volatility as Microcap, the returns are still highly correlated.

**Exhibit 2: Quarterly Returns of Private Equity vs. Active Small/Micro (1991 to 2Q 2013)**



Source: Acuitas, Cambridge Associates, Russell Investments, eVestment Alliance

### Active Growth Microcap is a strong proxy for venture capital.

Even more than buyout-oriented private equity, the limited capacity and opportunities makes venture capital an area where investors have difficulty accessing strong partners. The correlation matrix below (Exhibit 3) shows that active management in Microcap Growth offers a superior proxy for venture capital than does passive investing in either small or large cap. This is a result of the characteristics of both Microcap



Growth stocks and active management in microcap. Microcap growth stocks are the most similar to early-stage venture capital investments, and active growth managers in microcap seek the growth and valuation characteristics as we highlighted earlier. The result is that the return patterns reflect the greater similarity between the investment opportunities in active growth microcap and venture capital.

### **Exhibit 3: Correlation with Venture Capital Returns (Quarterly, 1990 to 2Q 2013)**

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	<b>Correlation with Cambridge VC</b>
Cambridge Associates Venture Capital Index	1.0
Passive Large Cap (Russell 1000)	0.44
Passive Small Cap (Russell 2000)	0.38
<b>Active Microcap Growth</b>	<b>0.53</b>

Source: Acuitas, Cambridge Associates, Russell, eVestment Alliance.

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### **Summary**

We believe that an allocation to active Microcap has a place for both investors making a strategic allocation as well as investors using it as a temporary proxy for private equity. Many of the advantages of private equity, such as the ability of skilled managers to generate strong returns through concentrated positions in high confidence investments, can be found with greater liquidity, transparency, and flexibility in active Microcap investing.

### **References**

Allianz Global Investors Capital, "Micro-Cap Investing: A Suitable Alternative to Private Equity." 2010.

Bruce Grantier, "Is Small Cap a Viable Alternative to U.S. Private Equity?" April 2009.

Zhiwu Chen, Roger Ibbotson, Wendy Hu. "Liquidity as an Investment Style." September 2010.

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