Active Microcap - A Private Equity Alternative

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Introduction

Over the last few decades the assets allocated to private equity strategies have increased significantly. What began as a strategy primarily utilized by large and sophisticated endowments increasingly became more prominent in public plans, corporate plans, and even among high net worth investors. An era of budgetary setbacks and increased funding requirements pushed more plan sponsors to seek private equity's historically high absolute returns as a means of alleviating funding challenges.

Unfortunately, private equity has failed to deliver the expected returns in more recent history. Additionally, private equity strategies come with several risks and challenges, including less transparency, limited liquidity, and higher fees. Compounding the challenges, effective investing in private equity requires additional expertise and resources that can be difficult to come by. Given the additional hurdles and risks involved in investing in private equity, it should be expected that private equity would provide a meaningful return premium over public equities. Unfortunately, for many investors that outperformance has not been realized.

On the other hand, we believe microcap stocks share many of the similar return advantages that make private equity appealing to investors, but without most of the associated risks. Microcap stocks are underfollowed by institutional investors and sell side brokers, making the microcap space an attractive place for active managers to be able to generate strong returns. In fact, active microcap managers invest in many of the same stocks that private equity managers target. Given the comparable return patterns that active microcap managers have delivered, along with significantly fewer risks than private equity, we think active microcap provides an appealing alternative to private equity.

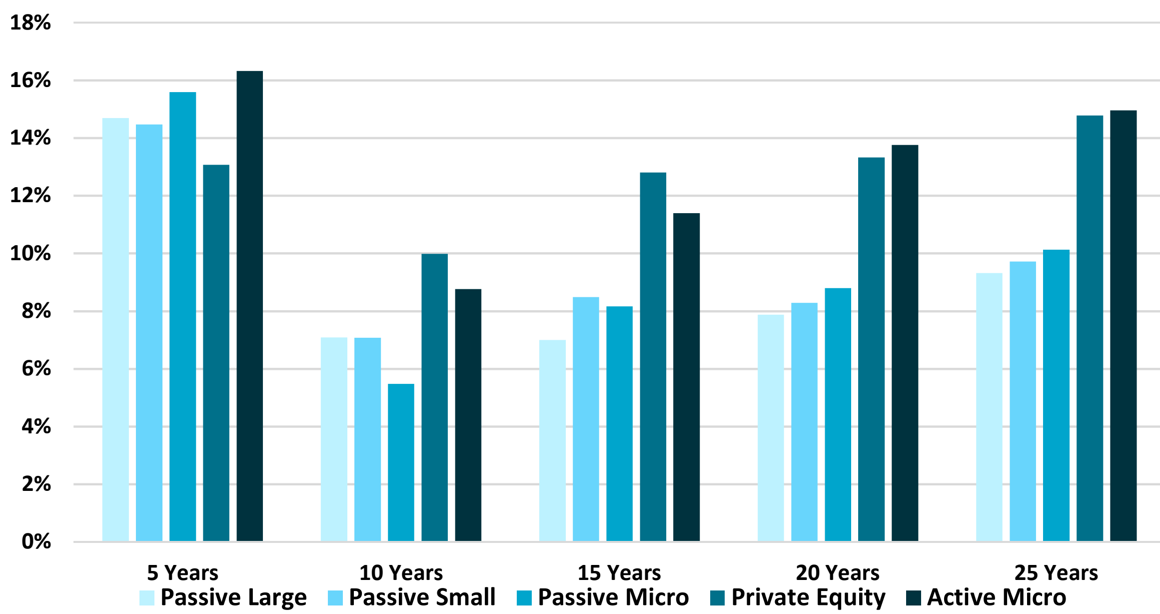
Active Microcap as a Proxy for Private Equity – Similar Historical Returns

For many years investors that were early to embrace private equity were rewarded with appealing returns. Many of the early adopters were large endowments with absolute return investment policies. Over time private equity has received increasing allocations from public and corporate pension plans, resulting in large flows into private equity. As a result, private equity returns have not held up against those delivered by public equity in recent periods. We believe one of the difficulties that private equity has faced in recent history is overcrowding, with too much money competing for too few attractive investment opportunities. This has left large amounts of capital on the sidelines and the net effect has been a deterioration of returns relative to public equity markets.

Given that private equity returns have not compensated investors for the additional risks inherent in private equity investments in recent years, institutional investors have sought alternatives. From an asset class perspective, we believe that microcap is the market segment that most closely mirrors private equity. However, we believe it is *active* microcap managers that offer an investment experience most similar to private equity, more specifically capturing the return advantages, while avoiding the associated risks.

Over the long run, active microcap managers have had long-term returns that rival private equity returns and beat passive benchmarks, both large and small. Additionally, as we have noted in Exhibit 1, over the majority of time periods, active microcap investors have outperformed private equity as well as the passive indexes. 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, Net of Fee (Annualized through 12/31/2016)

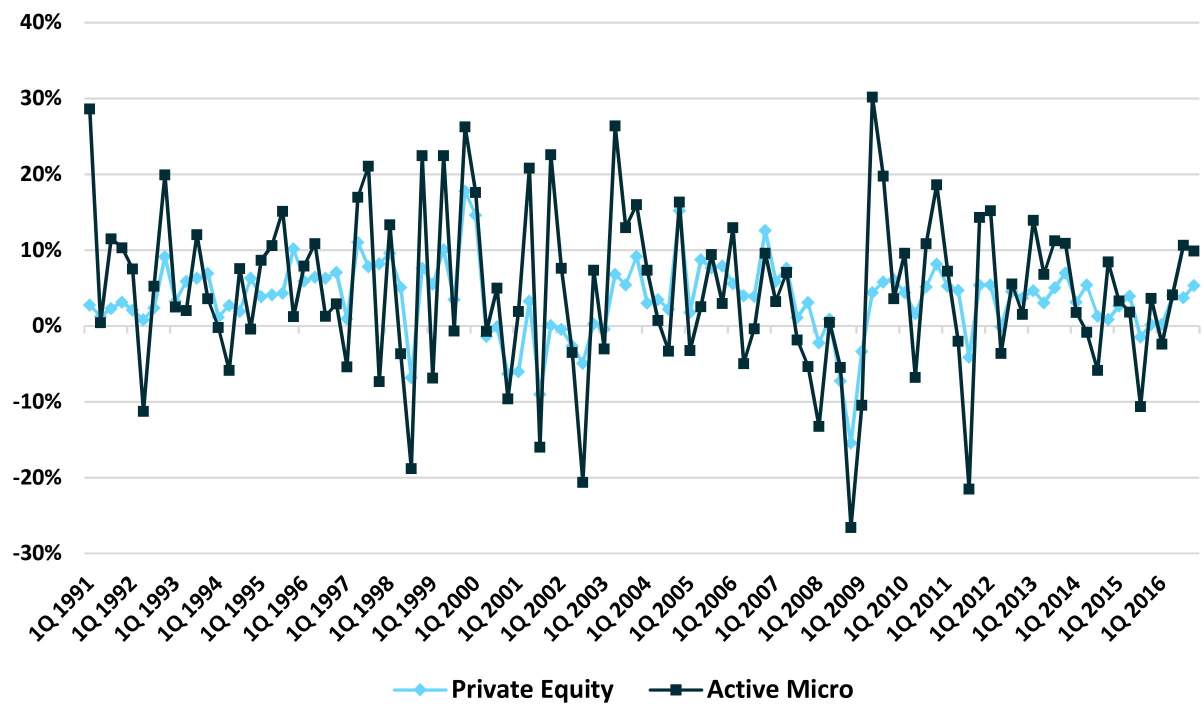


Source: Acuitas, Cambridge Associates, FTSE Russell, eVestment Alliance, FactSet
Private Equity returns are reported by Cambridge Associates net of management fee.
Active Micro returns assume an estimated 1% annual management fee.
The inception of the Russell Microcap Index is 2001. Passive Micro/Small Cap uses the Russell 2000 Index for periods prior to 2001.

Microcap and Private Equity Offer Similar Return Patterns

In addition to providing absolute returns that are most comparable to private equity over the long-term, active microcap managers also tend to deliver a return pattern that is most similar to private equity. 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 mostly explained by the infrequent and stale pricing in the asset class, self-reporting of returns, and survivorship bias. Conversely, microcap stocks are priced every day. Importantly, while private equity doesn't appear to experience the same level of volatility as microcap, the returns are still highly correlated.

Exhibit 2: Quarterly Returns of Private Equity vs. Active Micro (1Q 1991 to 4Q 2016)



Source: Acuitas, Cambridge Associates, FTSE Russell, FactSet

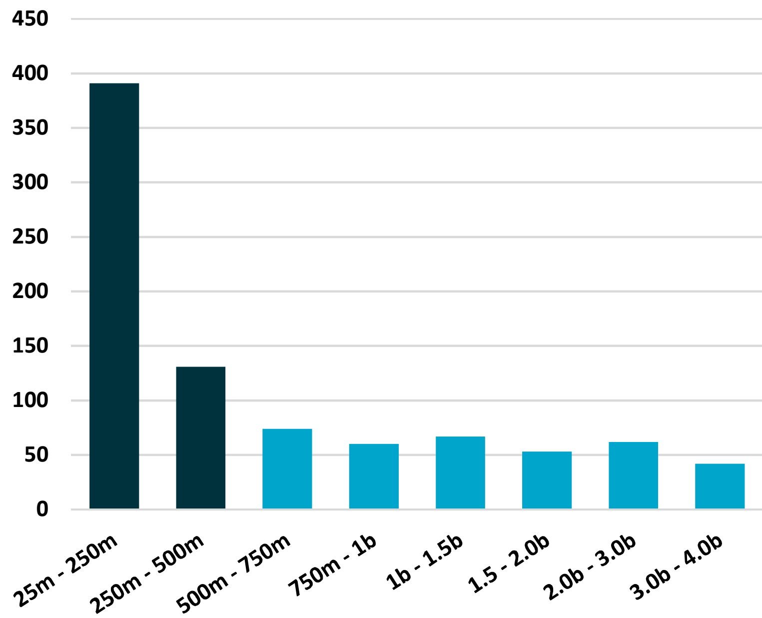
Microcap and Private Equity Managers Seek Similar Investment Characteristics

One reason that active microcap returns most closely mirror private equity is that microcap and private equity investors naturally tend to buy similar companies. Most notably, private equity managers target small, niche companies like those found in microcap. Like private equity, an active microcap product can offer a concentrated, high-conviction portfolio from an inefficient, minimally researched pool of companies with meaningful return potential. Additionally, they share many beliefs about what makes an attractive investment. Active microcap managers as a group tend to favor strong cash generation, limited leverage, and stable business fundamentals; all characteristics that private equity managers favor as well. Many stocks active microcap managers target also tend to be inexpensive based on valuation metrics that private equity general partners use to value companies, such as EV/EBITDA.

Additionally, it is important to note that both asset classes have been beneficiaries of the flood of capital into private equity. As private equity allocations have increased, private equity investors are seeing more competition for their target companies, resulting in higher purchase prices. According to Bain & Company in their 2017 Global Private Equity Report, ”Capital superabundance and the tide of recent exits drove dry powder to yet another record high in 2016.” Active microcap managers who owned stocks that are targeted by acquirers have benefitted from the higher prices paid by investors. As we outline below, merger and acquisition activity has been a meaningful boost to returns in microcap.

Asset allocators have historically expected private equity to generate returns of 3% – 5% over public equity, net of fees. What investors often overlook is the existence of a return premium in microcap. Between July 31, 2011 and December 31, 2016, according to FactSet, there have been over 500 mergers and acquisitions of companies below $500 million in market cap. Exhibit 3 shows the number of takeouts within a variety of market cap buckets. Of course, there are more securities in the smallest market cap buckets, so the larger number of takeouts on an absolute basis is to be expected. That said, as the table below demonstrates, when we compare the total takeouts in each market cap group (over the same 7/31/11 – 12/31/16 time frame) to the total number of securities in the Russell 3000E Index (as of 12/31/16), it is clear that microcap stocks are acquired more frequently.

Exhibit 3: Completed and Pending Mergers/Acquisitions by Market Capitalization (7/31/2011 – 12/31/2016)

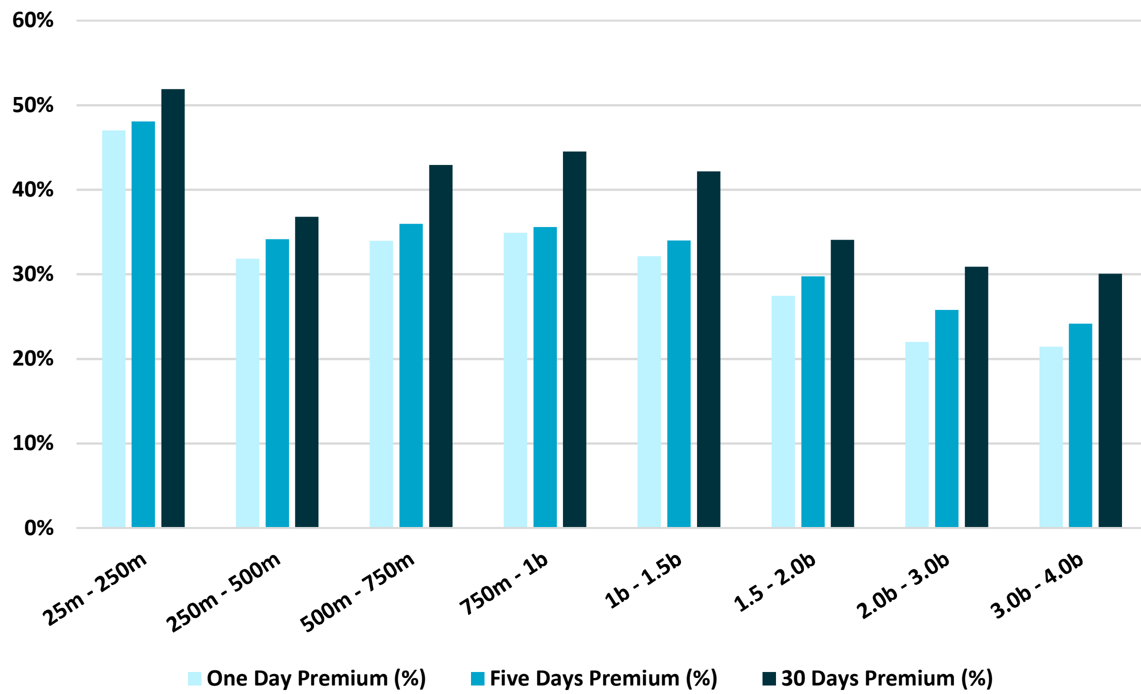


7/31/11 - 12/31/16 Takeouts as a % of Securities in the Russell 3000E Index (12/31/2016)	
25m - 250m	50%
250m - 500m	32%
500m - 750m	26%
750m - 1b	32%
1 - 1.5b	22%
1.5b - 2b	26%
2b - 3b	23%
3b - 4b	22%

Source: Acuitas, FactSet. Percentages in the table are based on the total number of takeouts between 7/31/2011 and 12/31/2016 relative to the total number of securities for the corresponding market cap bucket within the Russell 3000E Index as of 12/31/2016.

In addition to the increased frequency of takeouts within the microcap space, the premiums paid tend to be meaningfully larger as well. This is particularly true for those companies below $250 million in market cap, where the 30-day premium has averaged nearly 52% from July 31, 2011 through December 31, 2016.

Exhibit 4: Merger/Acquisition Premiums by Market Capitalization (7/31/2011 – 12/31/2016)



Source: Acuitas, FactSet.

Active Microcap Avoids Risks Associated with Private Equity

There are many risks and unique challenges inherent in private equity investing that a microcap allocation allows investors to avoid. Most notable of these are the lack of liquidity, transparency, flexibility, and accessibility. Additionally, private equity managers charge significantly higher fees than microcap managers. While each of these are factors that drive investors to demand significant return premiums for private equity investments over public equities, the flood of capital into private equity and a limited opportunity set is diluting the return opportunity and pushing out the investment horizon.

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, the liquidity benefit from microcap is significant relative to private equity. Sizeable microcap portfolios can be invested in a matter of days or weeks, usually with no lockup, while private equity portfolios take years to get fully invested and can have lockups of up to a decade or more. The liquidity difference allows investors the flexibility to adjust asset allocations to microcap over time, to raise capital when needed, and to upgrade their portfolios to keep them invested in their highest confidence investments. 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 on an annualized basis over the past 25 years.

Furthermore, most active microcap mandates offer transparency into the underlying portfolios, including the holdings, transactions, and risk characteristics. Investors are able to discuss the investment process with the manager, and gain insights into when and why managers make portfolio investments. This is not the case with many private equity allocations.

Historical Success - Realized Private Equity Returns Vary

Less tangible, but equally important to having success in private equity is whether investors have skill at identifying strong private equity managers. Specialized experience, strong networks, and access to the best private equity managers are critical drivers of successful investment in private equity. These characteristics are what can differentiate successful private equity investors from those that deliver mediocre or poor returns. In Josh Kosman's book "The Buyout of America", David Thomas, a Managing Partner of Court Square Capital Partners, said "The reason everyone focuses on top quartile is because if you are in the high end of the second quartile, you might as well be in bonds. And if you are in the middle or low end of the second quartile, you might as well be in a CD. And anything below that [median/50 percent] and you are losing money."

A study by Lerner, Schoar, and Wong (2005) attempted to identify success characteristics for various subsets of private equity investors, While the study is admittedly dated, it identified an interesting dynamic. It found that between 1991 and 2001 endowments earned an average of 20.5% in their private equity portfolios, while public pensions and corporate pensions earned 7.6% and 5.1%, respectively. This supports the idea that endowments, as the early wide-scale adopters of private equity, were able to build up superior expertise, experience, and networks that led to success in private equity. It is difficult for newer entrants to replicate the level of skill those institutions have, particularly in today's crowded private equity space. We think organizations that have developed superior skill in private equity investing can still have success in private equity, but it has become increasingly difficult for most institutions to develop the skill necessary.

Microcap is a Sensible Choice for Uncalled Capital

A final point to make about the potential value of microcap as a proxy for private equity is as a placeholder for uncalled capital. Often there is a significant lag between the commitment of capital in private equity investments and the time the capital is called. 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 2010 paper on microcap, Allianz suggested 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, we believe 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, we feel that active microcap provides the best proxy for private equity returns while keeping the investor’s asset allocation closest to its target.

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. Active microcap managers have generated similar returns, in terms of absolute returns and return patterns, to private equity, but at significantly less risk and costs. 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. Additionally, there are reasons to believe that it has become increasingly difficult to replicate the private equity returns of the past, including the large amounts of assets that have flown to private equity funds, and the difficulty of organizations to build the skills necessary to be successful in private equity investing. Meanwhile, active microcap stocks and managers are positioned to be beneficiaries of the large amount of private equity competing for potential investments. As such, we think for most investors an allocation to active microcap has better chances of long-term success at lower levels of risk than private equity.

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