A Case for Micro-cap Investing, the Alternative to Private Equity

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It is no surprise to institutional investors that returns in the private equity and venture capital arenas have been dismal in the last ten years. In a “Heard on the Street” article in the Wall Street Journal (July 19, 2010), research firm Preqin points out “it has been shown that U.S. venture capital funds raised from the years 1999 to 2007 have posted median annualized returns ranging from a .3% gain to a 7.7% loss”[i]. Buyout Funds have fared only slightly better and far below historical trends. Early indications of returns in the last few years suggest that private equity has even underperformed the public markets as leverage and lack of price discovery has led to severe portfolio company write-downs. It has led institutional investors wondering how they will meet actuarial rates of return without the high-return engine of private equity. It has also led to disillusionment of the product with high fees and aggressive behavior on committed capital leading many executives wondering if investing in the space is worth the cost.

To be sure, the hidden costs of private equity are substantial – well beyond the stated high management and carried interest fees. The single largest hidden cost comes from the timing of the committed capital investment. Given the uncertain nature of the timing of draw-downs on committed capital, it is difficult for institutional investors to properly invest during the drawdown phase, as liquidity becomes the driving factor. So while fund returns may seem worth the risk, when the entire return pattern is analyzed from commitment to the final closing, the early returns of having committed capital invested in short-term instruments significantly dampens the real return of the fund. This timing difference also hinders the investor’s ability to be opportunistic with their capital allocations - decisions today may not translate into investments for several years.

In addition to these quantifiable costs, there are other costs to private equity investing as well. While there is a perception that private equity reduces volatility, this is only due to semi-annual or annual valuations and an inherent bias on the part of valuation firms to provide conservative valuations, both on the up and downside. As such, reported returns look much more muted than is the case. If generating higher aggregate returns with lower risk sounds “too good to be true”, it probably is. One could argue that private equity returns generate as much volatility as publicly traded micro-cap stocks when you apply a more realistic valuation practice.

The hidden liquidity and timing costs associated with private equity investing combined with the flawed valuation methodology has begun to overshadow the meager returns. Investors continue to be disappointed by private equity returns that have fallen well short of the 20%+ returns advertised by private equity fund managers. The 2008-2009 market crisis has also highlighted new risks associated with private equity investments.

Investors are now considering micro-cap stocks as a replacement or proxy for private equity investments. The most obvious advantage of micro-cap investing is the liquidity and transparency of the asset class. Skillful micro-cap investors can chose from over 4000 publicly traded securities with a market cap of less than $300MM. These smaller, publicly traded securities often share the same characteristics of private equity investments given their status as emerging businesses and their lack of coverage by Wall Street. A careful look at long-term investment results for both micro-cap stocks and private equity investments further supports the case for micro-cap investing. Unlike public market returns, information on private equity returns is fragmented at best. Standardization of reported results is left up to the consolidator of the data, often an industry participant themselves. Cambridge Associates has assembled one of the most comprehensive databases; however, it is subject to quarterly revisions as new data from recent years is collected. In any case, we attempted to gather as much data as possible on what long-term returns looked like relative to micro-cap

stocks over the same period. The data we uncovered gave us a good idea of what long-term returns have been. The data is shown in the table below:

As of 12/31/2012

	10 Years	20 Years
Wilshire Micro Cap Index	9.71%	10.28%
eVestment Alliance US Micro Cap Equity Universe Median Active Manager – Gross of Fees (Average Micro manager fee is 1.00% annually)	11.75%	11.63%
Cambridge Private Equity Index	14.06%	13.44%

Source: www.cambridgeassociates.com, www.wilshire.com, eVestment Alliance.

Private equity returns have fallen short of the premium over smaller publicly traded securities typically demanded by investors and often quoted by private equity firms. This short fall is even more exacerbated when you consider that most actively traded micro-cap portfolios have exceeded their benchmark returns.

In addition to competitive investment returns, the advantages to micro-cap investing as a proxy for private equity are numerous. Liquidity is the single most important and obvious factor. In the 2008-2009 market crisis, many institutional funds found their hands tied with respect to asset allocation decisions. As the market value of existing equity and fixed income investments fell, and their commitment to their private equity fund remained the same, the de-facto asset allocation to private equity rose substantially. Negotiations with private equity firms often ended with the harsh reality of forgoing the next capital call at the risk of forfeiting the existing invested capital or the liquidation of marketable investments at an untimely level to raise cash for the call. A rebound in capital markets relieved the pressure for some, however it revealed a risk few thought existed prior to 2008. While micro-cap stocks certainly reflected the distressed nature of the market, investors in this area were not faced with the dual threat of managers demanding they dramatically increase their exposure to the asset class. While investors never like the unpleasant experience of selling at or near the bottom, micro-cap stocks at least provide the investor the option to liquidate should the fund find itself in need of cash to fulfill other obligations.

Micro-cap stocks would allow committed capital to be invested in a timely manner, consistent with the perceived opportunity by the institutional decision-maker. The returns generated would be fully transparent, with timely and proper “marks” on the portfolio. Because no leverage would be used, there would be no risk of Unrelated Business Taxable Income (UBTI) to tax-exempt funds. And finally, the investment thesis and outcome would be 100% transparent to the investor, allowing an appropriate timeline for assessment of the manager’s abilities.

In summary, active management in the micro-cap market, performed by experienced portfolio managers can result in high portfolio returns without the associated risks and costs of private equity.

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Past performance is no guarantee of future results.

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[i] John Jannarone, "HEARD ON THE STREET: Venture Capital Should Shrivel Away," The Wall Street Journal, July 19, 2010.