Microcap as an Alternative to Private Equity

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SUMMARY

Private equity has become a central component of many institutional and high-net-worth investment portfolios over the past decade. While private equity offers potential advantages, it also requires taking distinct risks. This paper highlights an alternative to private equity—microcap equities—which mitigates several of these particular risks.

Institutional investors have changed their asset allocation over the past 15 years. The allocation to equities decreased slightly, down 10 percent overall in 15 years, but the split between *private* and *public* equity shifted dramatically, with private equity rising on average from 1.4 percent to 16.0 percent.

Table 1: Equity vs. Non-Equity Allocations

	1998	2003	2008	2013
Equity	60%	56%	52%	50%
Non-Equity	40%	44%	48%	50%

Source: *NACUBO Endowment Study* (1998, 2003, 2008), *NACUBO-Commonfund Study of Endowments* (2013)

Table 2: Equity Allocations—Private vs. Public

	1998	2003	2008	2013
Public Equity	58%	49%	40%	34%
Private Equity	**1%**	**7%**	**12%**	**16%**

Source: *NACUBO Endowment Study* (1998, 2003, 2008), *NACUBO-Commonfund Study of Endowments* (2013)

Private equity offers several advantages, including:

Access to smaller companies
Small companies at the start of their business have higher growth opportunities. With the overall economy slowing down, investors are searching for growth—private equity can offer attractive growth opportunities compared to large cap public equities. While some private equity funds invest in larger businesses, the access they provide to *smaller* businesses is a distinct advantage.

Diversification
The investment companies in a private equity fund are excluded from the investment universe and also from the benchmarks of public equity managers.

Total return
The published returns of private equity look more attractive than public equities. The most commonly cited reason for these higher returns is that investors are capturing an "illiquidity premium."

As we shall see, microcap equities provide similar advantages but without the baggage of illiquidity, highly uneven returns, and higher, more complicated fees. Let's look at these three key *disadvantages* of private equity investments.

Illiquidity

Private equity investments require as much as a 10-year commitment, with an initial up-front payment and capital calls over the first several years. This capital is deployed into private investments that are held for several years, and gains are returned as those profits are realized through liquidity events. The private equity manager fully determines these liquidity events, which presents issues for plan sponsors in redeploying cash and forecasting portfolio cash flows.

For a long-term investor, this seems like a reasonable trade for higher returns. But, for many investors, low liquidity means private equity is often too restrictive. For example, many endowments have been unable or unwilling to build their allocation to the asset class. Data from the *NACUBO-Commonfund Study of Endowments* shows that the increased allocation to private equity has been driven by the largest endowments (see Figure 1 on the following page).

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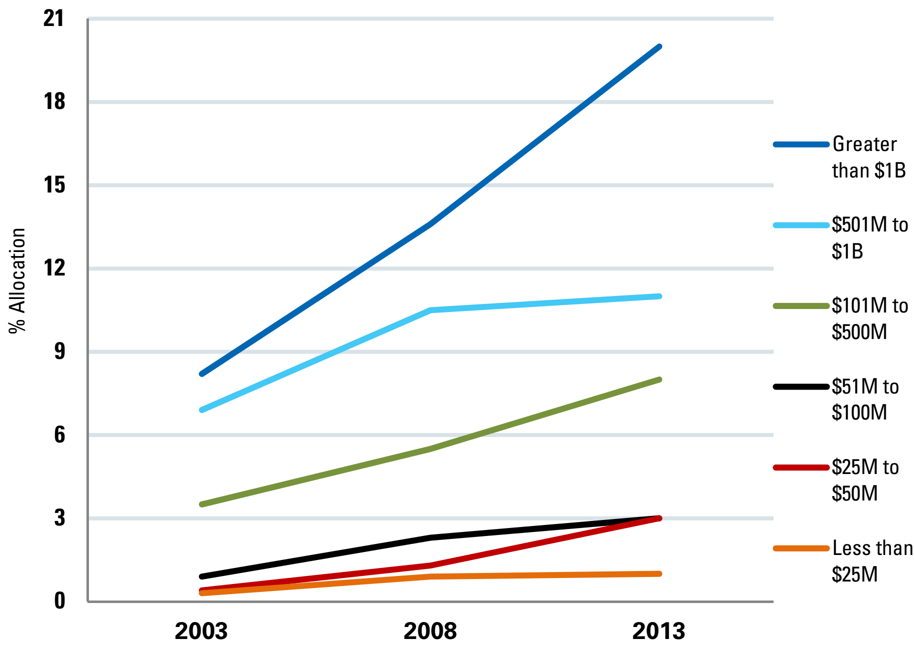
Figure 1: Allocation to Private Equity by Year and Endowment Size

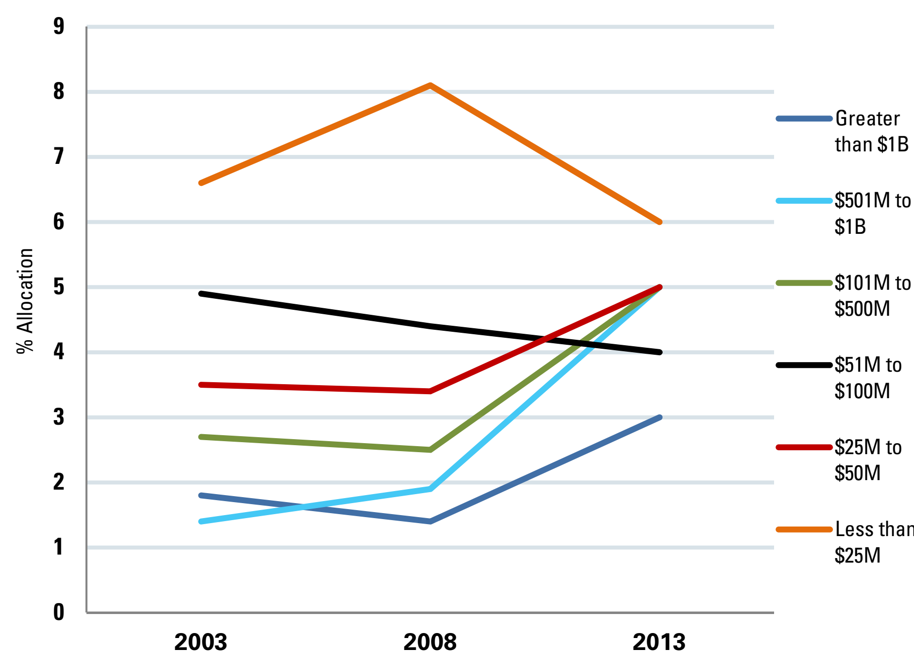


Source: *NACUBO Endowment Study* (2003, 2008), *NACUBO-Commonfund Study of Endowments* (2013)

At the same time, smaller endowments have had much higher average allocations to cash, highlighting the need for (or concerns about) short-term liquidity within the portfolio.

Microcap public equities are less liquid than their larger cap counterparts, but they are still very liquid relative to private equities. Most microcap portfolios can be liquidated

Figure 2: Allocation to Cash by Year and Endowment Size



Source: *NACUBO Endowment Study* (2003, 2008), *NACUBO-Commonfund Study of Endowments* (2013)

Table 3: Portfolio Liquidity

	% Liquidation by Days:				
Asset size:	1	2	3	5	10
$25M	58%	80%	89%	96%	100%
$50M	37%	58%	71%	85%	96%

Source: Daily volume from Bloomberg

in short order. Table 3 (above) shows the estimated time to liquidate microcap portfolios of $25M and $50M, assuming an investment in our microcap model portfolio as of September 2014. These results assume we participate in 25 percent of each day's trading volume for each individual stock. The vast majority of these portfolios could be liquidated within a week—a far cry from the multi-year lockup required by many private equity funds.

Private Equity Managers Have More Uneven Returns

While private equity offers the *prospect of* great returns, the historical results for managers in the asset class have been uneven. Reporting returns for illiquid portfolio companies is difficult, but even if the stated returns of private equity managers accurately reflect the valuation of their holdings, private equity managers still show wide dispersion in their ability to generate consistent returns.

Table 4 (on the following page) compares the dispersion between the top and bottom quartile performers over the past five years for equity managers both private and public.

Such high dispersion makes access to top managers a critical component in establishing a private equity

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allocation—but identifying those managers *ahead of time* is difficult. The highest quartile private equity manager had a five-year return of 14.6 percent, which is nearly three times higher than the return for the lowest quartile manager (5.0 percent). In contrast, the highest quartile microcap manager had a return of 34.0 percent, which is only 1.25 times the return earned by the bottom quartile manager (27.0 percent).

Fees

Taken together, these issues around illiquidity and uneven returns raise concerns about allocations to private equity in the coming decade. But perhaps the most notable difference between private equity and microcaps are the fees required to access the market. As John Bogle is fond of saying, "In investing, you get what you *don't* pay for." Private equity funds can charge capital on three types of assets: committed capital, called capital, and invested assets (including leveraged assets). A flat fee of 100 bps to access the microcap market is much lower—and less complicated—than private equity fees. These cost savings compound to significant amounts over time.

The Alternative: Microcap Equity

Microcap public equities provide the same advantages as allocations to private equity, and do so without some of the baggage associated with private equity. With microcaps, there are few concerns about accurately measuring returns or multi-year illiquidity—and fees are significantly lower.

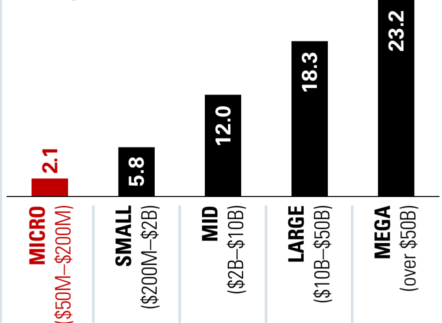
The total market cap of the microcap space, which we define as one having a market cap between $50M and $200M, is $146B—the same size as The Walt Disney Company's market cap. This means that microcaps are a scarce opportunity, which is good because larger institutional asset managers (and, in turn, Wall Street) often neglect them. The typical microcap stock is covered by only 2.1 analysts on average, and many have no analyst coverage at all. Additionally, whereas the largest cap public equities have an average of 1,740 different institutional owners, microcaps only have an average of 50. The lack of attention to these stocks offers up a greater chance to find attractive investments.

How to Invest in Microcaps

Microcaps themselves often earn higher returns than the broader equity market. For the five years ending March 2014 (see Table 5 below), the median microcap manager outperformed the median large cap manager by 9.3 percent *annualized.*

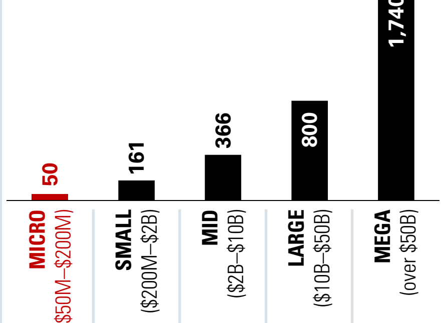
But the real advantage of investing in microcaps is systematically buying stocks with very cheap valuations, high-quality balance sheets and earnings, and strong recent price trends (momentum). These themes—Value, Quality, Financial Strength, and Momentum—have worked even in the largest cap portion of the public equity markets. And they are much more effective and predictive in the microcap market, which is neglected and therefore less efficient.

Figure 3: Average Number of Analyst EPS Estimates



Source: FactSet LionShares (as of 10/31/15)

Figure 4: Average Number of Institutional Owners



Source: FactSet LionShares (as of 10/31/15)

Table 4: IRR (Internal Rate of Return) for All Private Equity

Year:	# of Companies	Top Quartile	Median	Bottom Quartile
2010	190	19.0	13.3	8.0
2009	161	20.0	13.6	6.7
2008	341	16.3	11.2	6.4
2007	378	12.7	8.4	4.2
2006	351	10.1	6.9	2.0
Last 5 Years	1,421	**14.6**	9.9	**5.0**

Source: *2014 Preqin Private Equity Performance Monitor* (www.preqin.com)

Table 5: Trailing 5-Year Peer Performance

(As of March 2014)	Number of Companies	Top Quartile	Median	Bottom Quartile
Large Cap Core	328	21.9	19.3	16.9
Microcap	18	**34.0**	28.6	**27.0**

Source: Envestnet

Here is how we measure these key stock selection themes:

VALUE

We favor stocks that trade at cheap multiples of their sales, earnings, free cash flows, and EBITDA. We also favor companies with higher shareholder yields (dividends + net buybacks). Though shareholder yield is less common for microcap stocks, we still favor those companies that are buying back shares while avoiding the ones that are issuing large amounts of new equity.

MOMENTUM

We favor stocks with strong recent price trends. Those stocks that have been strong relative performers over the past three to nine months tend to continue to outperform the market.

FINANCIAL STRENGTH

We favor stocks with higher-quality balance sheets, meaning reasonable amounts of leverage, strong cash flows to support debt, and low reliance on external sources of financing.

EARNINGS QUALITY

We favor stocks with conservative principles in reporting earnings, meaning low accruals and conservative accounting choices (*e.g.*, high depreciation-to-capital expenditures).

In Figure 5, we show the historical excess return (1969–2014) earned by the highest and lowest deciles of stocks ranked by Value, Quality, and Momentum. We show these results in two universes: All Stocks ($200M market cap and higher) and Microcaps ($50M to $200M).

SUMMARY

Because the total value of all microcaps is small, its market represents a scarce investment opportunity (we estimate total capacity at a few hundred million dollars). But for those who are able to take a position, microcap equities can solve the original goals of private equity while eliminating investment issues associated with the asset class:

Better liquidity
A microcap portfolio can be liquidated in short order—in part or in full. Private equity investments are far less liquid.

Access to smaller high-growth companies
Similar to companies in private equity portfolios, many microcap companies are in the very early (and high growth) stages of their development. These companies have the potential to deliver higher returns than established large cap equities.

Diversification
Like private equity, microcap portfolios have little to no overlap with the constituents of larger public equity benchmarks.

(SUMMARY continued on following page.)

Figure 5: Excess Return — Highest/Lowest Deciles vs. Universe (1973–2014)

Source: Compustat, OSAM Calculations

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O'Shaughnessy ASSET MANAGEMENT

SUMMARY (continued)

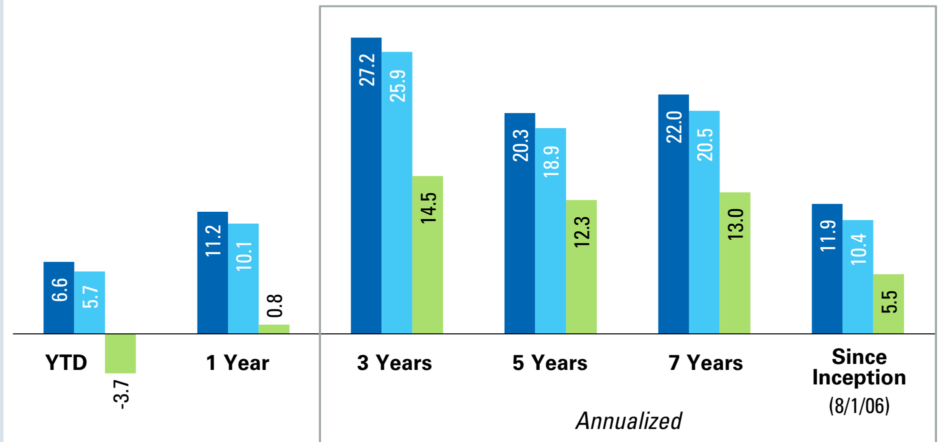
Strong returns

While the asset class itself offers attractive returns, a strategy that focuses only on those microcap stocks with outstanding quality, valuation, and momentum offers even better prospective returns. Shown to the right are the live historical results (2006–present) of the O'Shaughnessy Micro Cap strategy versus its benchmark.

Given its potential benefits, microcap equities can be a critical piece of a diversified portfolio.

Figure 6: Rates of Return (%) — Strategy vs. Benchmark

Livetime (8/1/06–10/31/15)



O'Shaughnessy Micro Cap: Gross Net Russell Microcap® Index

For the compliant composite performance presentation of the O'Shaughnessy Micro Cap strategy, please see http://www.osam.com/pdf/osam_factsheet_mc.pdf

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The risk-free rate used in the calculation of Sortino, Sharpe, and Treynor ratios is 5%, consistently applied across time.

The universe of All Stocks consists of all securities in the Chicago Research in Security Prices (CRSP) dataset or S&P Compustat Database (or other, as noted) with inflation-adjusted market capitalization greater than $200 million as of most recent year-end. The universe of Large Stocks consists of all securities in the Chicago Research in Security Prices (CRSP) dataset or S&P Compustat Database (or other, as noted) with inflation-adjusted market capitalization greater than the universe average as of most recent year-end. The stocks are equally weighted and generally rebalanced annually.

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