



Active Microcap: A Liquid, Transparent Private Equity Alternative

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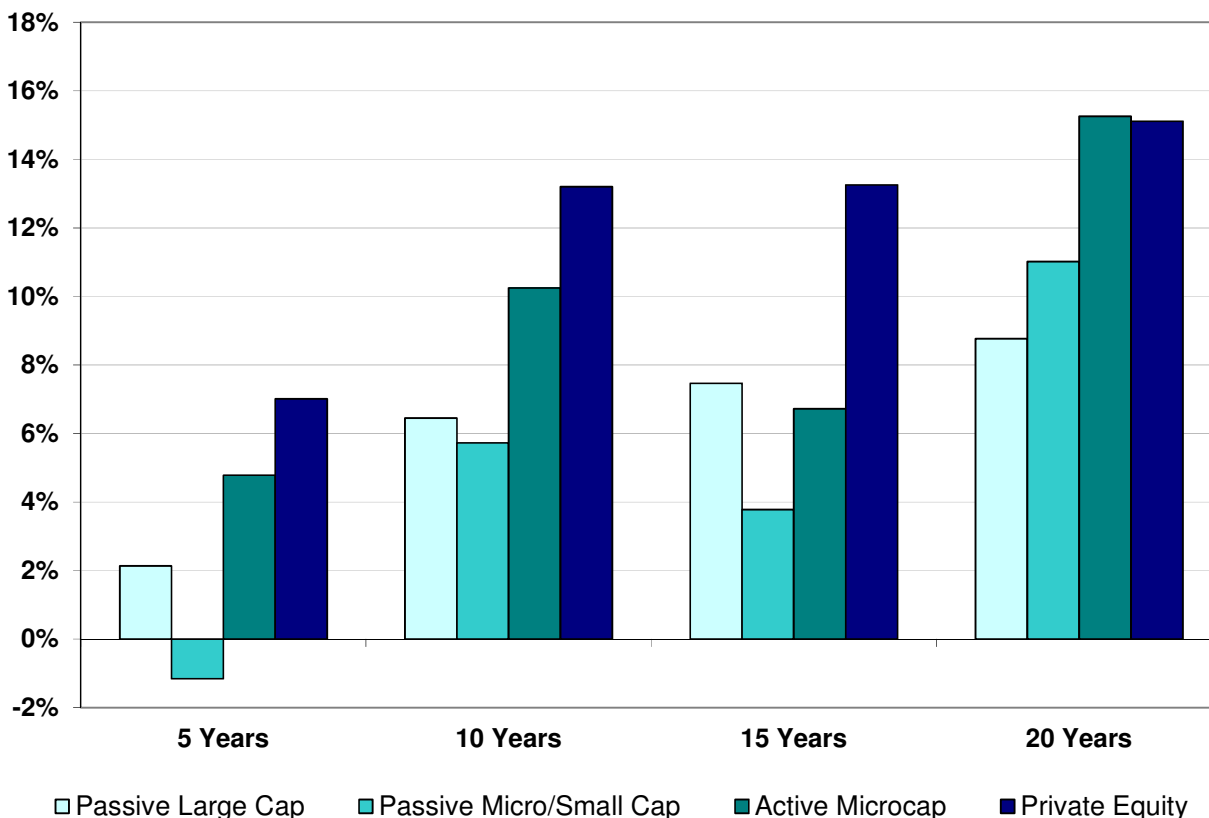
In an era of tightening budgetary constraints and increased pension funding requirements, more plan sponsors have been attracted to private equity's historically high absolute returns as a means of alleviating funding challenges. We think that plan sponsors may be overlooking similar promise and potential 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 3/31/2012)



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. According to MergerStat, approximately 8% of the Russell Microcap index was acquired, via buyout or merger, between 6/30/2011 and 6/30/2012.



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 spectrum, 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.

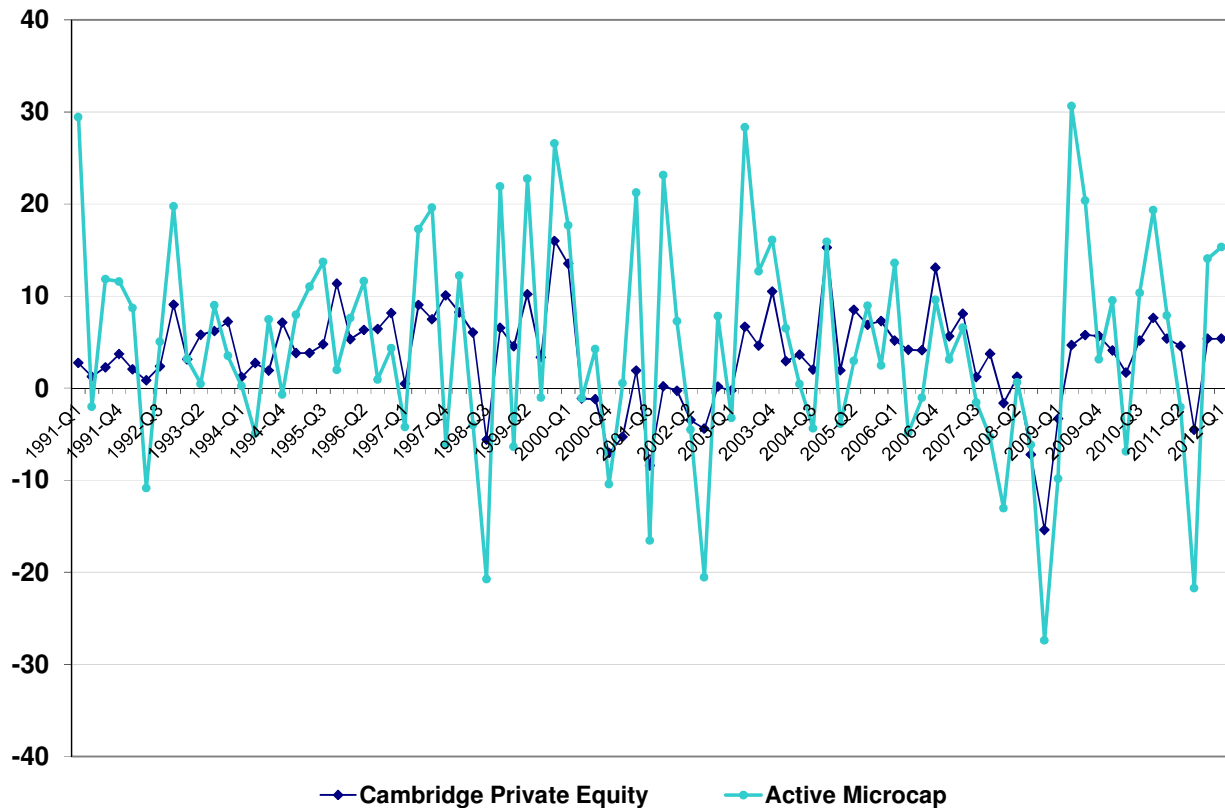
Microcap is a sensible choice for uncalled capital

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 report 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 March 2012)



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

Active Microcap has less leverage than private equity

A characteristic that is masked by the superficially more volatile returns of Active Microcap is that the underlying companies carry far less leverage. Leveraged buyouts are typically financed with between 60% and 90% debt (Kaplan 2008). Meanwhile, as of June 2012, the median Debt/Enterprise Value ratio of the companies in the Russell Microcap index is only 17.4%. Over 28% of the companies have no debt on their balance sheets at all.

Active Microcap is a superior proxy to passive.

The correlation matrix below (Exhibit 3) shows that active management in Microcap offers a superior proxy for private equity than does passive investing in either small or large cap. This is a result of the characteristics investors seek. Active investors seek



private equity-like characteristics as we highlighted earlier and the return patterns reflect the similar nature of the securities.

Exhibit 3: Correlation with Private Equity Returns (Quarterly, 1991 to March 2012)

	Correlation with Cambridge PE
Cambridge Associates Private Equity Index	1.0
Passive Large Cap (Russell 1000)	0.65
Passive Micro/Small Cap (Russell Microcap/2000)	0.63
Active Microcap	0.73

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

Note: Russell Microcap is used from its inception (2001 and on). Russell 2000 is used prior to the availability of the Microcap index.

Summary

We believe that an allocation to active Microcap has a place for both investors making a strategic allocation as well as investors seeking 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

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Disclosures

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