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Alternative To An Alternative:
Active Microcap vs. Private Equity

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The current market environment is creating potential opportunities for investors seeking alternative options. These investors can benefit from a discussion comparing active microcap investing and private equity. The topic is a timely one, especially as it pertains to longer-term investment approaches.

Investors look to microcap investments for possible alpha generation tempered with risk management, much like other market sectors. However, they approach the sector with a higher tolerance for some of the unique factors inherent in the microcap space: lower liquidity, longer investment horizons, minimal analyst coverage, 'lumpy' return streams, and a higher risk/reward ratio than has been typical for larger-cap equity strategies.

The returns and underlying investments of microcap securities provide many similarities to private equity. However, the access, liquidity, transparency, low fee structure, and flexibility of the active microcap fund structure may provide a significant advantage for many investors. In a February 12, 2013 article by Bloomberg reporter David Carey, "Buyout-Boom Shakeout Is Seen Leaving One in Four to Starve," the private equity market's current difficulties are explained:

Today, investors are looking for ways to decrease their allocations to private equity, due in large part to languishing fund performance, uncommitted capital, and long periods of lock ups that prevent them from accessing opportunities present currently in the market

> *[Private equity] Firms that attracted an unprecedented $702 billion from investors from 2006 to 2008 must replenish their coffers for future deals and avoid a reduction in fee income when the investment periods on those older funds run out, typically after five years. As many as 708 firms face such deadlines through 2015, according to London-based researcher Preqin Ltd.*
>
> *The combination of underperformance and funding needs has set the stage for a purge as investors pull the plug on the weakest firms. Only the scope of a shake-out is a matter of debate. "The shakeout will be rather massive," said Antoine Drean, chairman of Triago SA, a Paris-based firm that helps private-equity firms raise money. Drean estimates that as many as a quarter of private-equity managers will see their funding pulled by 2018.*

Seeking Opportunities Where They Exist

Today, many investors are looking for ways to decrease their allocations to private equity, due in large part to languishing fund performance, uncommitted capital, and long periods of lock ups that prevent them from accessing opportunities present currently in the market. While they may find their investment monies already committed in private equity to be unavailable for deployment, they are actively seeking new investment options that could provide what they feel is the exposure and upside valuation resident in active microcap.

"Liquidity dominates size as a return predictor," Roger Ibbotson stated in his keynote speech at the first annual Innovative Alternative Investment Strategies conference, held in July 2010 in Chicago. "Public equity markets have gradations of liquidity with different liquidity premiums."

Ibbotson studied 3,500 U.S. stocks by quartile and rebalanced annually from 1972 to 2009. He defined liquidity as total annual trading volume divided by total shares outstanding. One takeaway from his presentation at the conference, which focused on alternative investments, was that investors don't have to go all the way down the liquidity spectrum to private equity to find additional return.[1]

In his co-authored and widely-regarded white paper, Liquidity as an Investment Style, (Zhiwu Chen, Roger Ibbotson, Wendy Hu) last updated in August 2012, Ibbotson notes, "However, it is true that the liquidity effect is the strongest among micro-cap stocks and then declines from micro to small to mid to large-cap stocks ." The paper goes on to conclude that liquidity may be managed "low in cost" by employing a low portfolio turnover strategy.

Investors are finding that active microcap allows for greater flexibility, transparency and liquidity as well as lower fee structures than private equity investments. What follows is a look at some of the opportunities and challenges present when considering the investment alternatives of private equity and active microcap.

Private Equity's Growing Challenge-Liquidity

Long touted as a way for investors to participate in the opportunistic retooling of businesses, private equity has been mired in a protracted slump since 2008. This issue is largely centered on liquidity, or, more accurately, the lack thereof. One of the biggest challenges private equity managers face is when and how to exit the strategies set up in the vintage years of these funds-typically 10-12 years prior.

Valuation issues, lack of buyers, financing challenges, and related financial uncertainties have coalesced into a perfect storm of illiquidity that has given rise to the dreaded 'zombie' fund scenario, where managers find themselves unable to execute attractive exits from previously attractive private equity holdings. They remain running funds well beyond their anticipated lifespan, locking away investors' capital from redeployment and generating fees that arguably offer little value to the investors trapped within the fund. The private equity advisory firm, Triago, reported to PE Manager on April 9 of this year that an estimated $14.5B in capital commitments is expected to reach the end of its investment period in 2013, referring to this situation as a "fuse burning on a dry powder keg ."

Northern Trust, in its Spring 2010 Point of View Managing Liquidity in the Private Equity Market elaborated on the issue. "Private equity investors accept that the timing of both the funding of their investments, as well as the distributions of any returns, is difficult to forecast and largely out of their control. Yet even the most knowledgeable investors still seek better ways to understand the likely behavior of their holdings of these long-term obligations." In the article, Northern Trust's Vice President of Private Equity, Raj Vora, points out one of the unattractive features surrounding private equity investments: "The timing of these 'exit strategies' depends on a range of factors, such as the vagaries of the markets for public offerings and acquisitions.[2]

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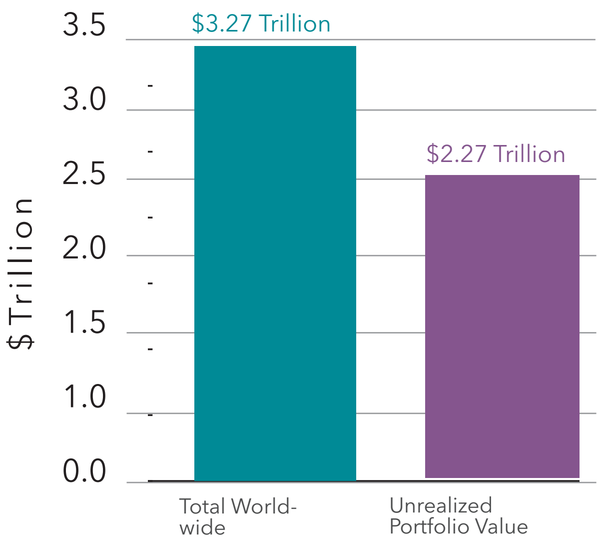
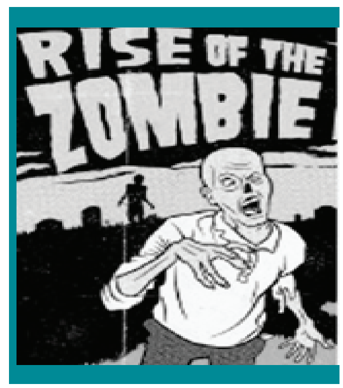
Of the roughly 10,000 private-equity funds raised in the decade spanning 2002-2012, at least 200 now qualify as zombie funds. Even more alarming: the amount of assets in zombie funds could reach $500 billion over the next several years, according to the advisory firm Triago, as reported in the Wall Street Journal in June, 2012.

69% OF PRIVATE EQUITY FIRMS' ASSETS IN UNSOLD COMPANIES





Source: Pension & Investments April 1, 2013 article.

"What will happen to them? Who will buy them? When will they get sold? What will happen to the returns of the industry when they do get sold."

Michael G. Fisch, president and CEO of American Securities LLC

Pensions & Investments provided a recent update on this pressing issue in an April 1, 2013 article, "69% of Private Equity Firms' Assets in Unsold Companies." Of the more than $3.27 trillion in total worldwide private equity assets under management as of Sept. 30, $2.27 trillion is "unrealized portfolio value" or unsold portfolio companies, according to data prepared for Pensions & Investments by Preqin.

Active Microcap as a Proxy for Private Equity

Let's return to the discussion of microcap companies and their potential to deliver value. Both active microcap managers and private equity managers are attracted to microcap companies for many of the same reasons: there are high-potential companies resident in the sector with what they believe is strong cash generation, typically low leverage, established on highly functional business and operational processes, and a niche focus that allows for concentrated strategic growth if the environment provides for it.

Because active microcap and private equity managers both seek these types of company profiles, their respective performance tends to track and therefore has provided a similar return stream to investors. It is important to note, however, a critical distinction between the two: Active microcap managers with the requisite skills have generated these results for investors with greater liquidity and transparency than private equity managers, and often have done so without relying on companies that are highly leveraged.

The correlation comparison for active microcap and private equity is an important factor for investors to consider. While both asset classes historically have exhibited a high positive correlation to each other, they have shown relatively low correlation to the broader equity markets, and active microcap has achieved its results with a lower fee structure than was typical for private equity investments. The table on the following page illustrates this active microcap correlation comparison with private equity returns.

CORRELATION WITH PRIVATE EQUITY RETURNS (QUARTERLY, JANUARY 1, 1991 TO MARCH 31, 2013)[3]

	Correlation with Cambridge PE
Cambridge Associates Private Equity Index	1.00
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.
Active microcaps is defined as a group of investment managers which focus solely on micro-cap investing, as constructed by Acuitas Investments.
Note: Russell Microcap is used from its inception (2001 and on). Russell 2000 is used prior to the availability of the Microcap index.

Steven N. Kaplan, author of Reassessing Private Equity (ChicagoBooth.edu), offers a relevant observation on the illiquid nature of private equity investments when considering the relative value of such investment tactics:

> *One of the controversies surrounding private equity is whether investors are getting a good return on their investment, particularly when compared with investing in the overall stock market. Private equity firms are not required to disclose their funds' returns and they invest only in companies that are not publicly traded, making it harder to get an accurate picture of their performance. The tremendous success of venture capital funds in the 1990s attracted a huge amount of capital in the early 2000s that subsequently contributed to lower returns. This boom and bust cycle has been a recurring feature of private equity-returns tends to fall with more capital, but go back up again when less money is invested in private equity .*

The following table shows a comparison of performance of private investments to public markets, so investors can judge for themselves the decision to take on the risks (e.g., illiquidity) associated with private investments.

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U.S. PRIVATE EQUITY FUND INDEX SUMMARY: END-TO-END POOLED RETURN DATA AS OF MARCH 31, 2013 (NET TO LIMITED PARTNERS) %

INDEX	1-YR	3-YR	5-YR	10-YR	15-YR	20-YR	25-YR
Cambridge Associates Private Equity Index	12.84	15.08	7.46	15.67	12.08	15.31	14.38
Passive Large Cap (Russell 1000)	14.43	12.93	6.15	8.97	4.60	8.69	10.06
Passive Micro/Small Cap (Russell Microcap (2000)	16.93	12.80	6.68	9.99	6.10	8.88	9.52
Active Microcap	16.25	15.89	10.26	13.66	11.82	14.38	14.72

Past performance does not guarantee future results.

The Cambridge Associates LLC U.S. Private Equity Index® is an end-to-end calculation based on data compiled from 1,045 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2012. 1 Pooled end-to-end return, net of fees, expenses, and carried interest. Sources: Cambridge Associates LLC, Russell Indexes. You cannot invest directly in an index.

Active Microcap: The Glass Half Full

In seeking desirable opportunities within the microcap equity asset class, some investors found active microcap provided them with the ability to maintain a level of flexibility and accessibility in investment capital not matched by a private equity structure.

For example, microcap companies are required to produce regulatory filings and reporting; microcap management teams often consist of company founders with substantial personal investments in their firms and eager to discuss their business with potential institutional investors; and the smaller firm's business focus tends to be on niche or single product lines, minimizing the tendency for over-diversification that can dampen a company's overall returns.

While both private equity and active microcap have been able to exploit the investment advantages presented by microcap companies, the latter has done so with greater investment flexibility and at reduced fee cost. Some of the exploitable factors are shown in the table which follows.

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Active Microcap: Illiquidity Premium With Less Illiquidity

- **Data:** Research analysts, who are keyed on the mid and large-cap sectors where information is plentiful and investment banking opportunities exist, fail to adequately cover the smaller firms, and therefore often miss the microcap opportunities managers focused on the sector discover and exploit.

- **Investment Universe:** Approximately $183 billion in micro-cap stocks are available for the investing public, an amount that is less than 50% of the market value of Apple, Inc.

- **Interest Gap:** The size of the investment appetite, both buyers and sellers, is much more limited, as many cannot engage in the micro and small sectors due to liquidity and size constraints and investment mandates.

- **Price Movement:** The typical stock return profile in this underserved sector has been lackluster unless there was a compelling development or event that triggered performance and discovery, keeping a large majority of the sector's potential 'under-the-radar'.

- **Investments With Less Leverage:** Unlike private equity, which often has embedded investment assump tions based upon a debt-laden company, active microcap investment company balance sheets generally have had more than adequate cash and have not been burdened with excessive debt obligations.

Private Equity: The Glass Half Empty

Returning to the pressing issue of private equity's zombie funds, we observe the protracted investor dissatisfaction with their illiquidity, and the growing concern that we have not seen the bottom of this particular glass. An industry mainstay, Pensions & Investments, pointed out the growing problem in January 2012:

> *And these funds are multiplying. Already, a number of venture capital funds raised in 1999 and 2000, especially those formed to invest in internet-related companies, can be classified as zombie funds. And in three to five years, industry insiders expect more private equity funds that were raised just before the 2008 credit crisis to join the ranks of the living dead.*[4]

In the Pensions & Investments article from April 1, 2013, "69% of Private Equity Firms' Assets in Unsold Companies," Michael G. Fisch, president and CEO of American Securities LLC, a private equity firm in New York, posed some of the questions weighing heavily on investors and managers minds alike: "What will happen to them? Who will buy them? When will they get sold? What will happen to the returns of the industry when they do get sold ?"

Investors already invested in or contemplating future private equity investments may be facing more of these same issues down the road, with limited recourse either to access their committed capital or to avoid additional capital calls on their locked-up investments.

David I. Fann, president and CEO of TorreyCove Capital Partners LLC, a private equity consulting firm, stated on pionline.com that investors are loath to pursue litigious or other similar hostile takeover options to exit these zombie funds. "The practical reality is that there are no good alternatives and it is hard for anyone to herd together multiple limited partners to take an adverse stance against a general partner of a fund," he said.[5]

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An Alternative Worth Considering: Active Microcap

The returns and underlying investments of microcap securities provide many similarities to private equity. However, the access, liquidity, transparency, low fee structure, and flexibility of the active microcap fund structure may provide a significant advantage for many investors. As active managers in the microcap space since 1987 through multiple market cycles, we believe these attractive alternative investment opportunities currently exist in active microcap.

The returns and underlying investments of microcap securities provide many similarities to private equity.

Few would argue that the past five years have posed challenges unprecedented in the equity markets, both domestic and global. Active microcap managers with the skill set and expertise to capitalize on this value may be able to provide returns with the added benefit of liquidity and transparency to investors dissatisfied by years of illiquidity and lack of choice.

Perritt Capital Management, Inc. is an independent and registered investment advisor located in Chicago's Financial District. The firm manages approximately $450 million of client assets including two no-load mutual funds and separately managed accounts. Since its establishment in 1987, the firm has specialized in small company investing for individual and institutional investors. In addition, the company offers asset allocation portfolio management to individual investors.

Visit us at: www.perrittcap.com

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[5] www.pionline.com, Jan 2012

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company and may be obtained by calling 1-800-331-8936. Read carefully before investing .

Mutual fund investing involves risk. Principal loss is possible. The Funds invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Funds invest in microcap companies which tend to perform poorly in times of economic stress.

Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. Correlation is a statistical measure of how two securities move in relation to each other. End-to-end pooled return is a method of calculating the overall internal rate of return (IRR) of a portfolio of several projects by combining their individual cashflows during the period from initial purchase through exit.

Private Equity is capital that is not quoted on a public exchange. Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as an IPO or sale to a public company. Active microcap portfolios invest in companies that are often targeted by private equity investors due to their business characteristics and small market capitalizations. However active microcap portfolios only invests in companies that are listed on public exchanges.

The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity markets The Russell 2,000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization. The Russell Microcap index is a capitalization weighted index of 2,000 small cap and micro cap stocks that captures the smallest 1,000 companies in the Russell 2000, plus 1,000 smaller U.S.-based listed stocks. You cannot invest directly in an index. As of 6/30/2013, the Perritt MicroCap Opportunity Fund and the Perritt Ultra MicroCap Fund did not hold a position in Apple, Inc. Fund holdings are subject to change and are not recommendations to buy or sell any security.

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