Micro Cap Investing

A Suitable Alternative to Private Equity

The goal of equity investing, whether public or private, is growth of capital. In an era of market volatility and vastly underfunded pensions, many are being enticed by the high historical returns others have experienced in private equity. In that pursuit, investors may be ignoring another asset class with similar potential to enhance portfolio returns — micro cap equities.

Micro Cap Stocks

While micro cap stocks are not revolutionary in nature, they are often overlooked as an asset class, which itself warrants further examination. Micro caps occupy a unique space in the investment spectrum because of lower research coverage, resulting in higher potential for mispricing opportunities.

A strategic allocation to micro cap equities can provide a good complement to a private equity program. Alternatively, from a tactical perspective, investing idle, committed-but-not-called capital earmarked for a private equity investment into a micro cap equity allocation may be a sensible choice, given the lengthy drawdown period for private equity.[1]

Similar to private equity investments, micro cap investing offers the potential for outsized returns through investments in companies on the verge of significantly greater growth and profitability, while providing more transparency and accessibility than a private equity program.

A Closer Look at Private Equity

With private equity managers posting absolute returns above what is expected through investing in public equities, private equity has been garnering increased institutional investor attention as funding needs skyrocket — and deservedly so.

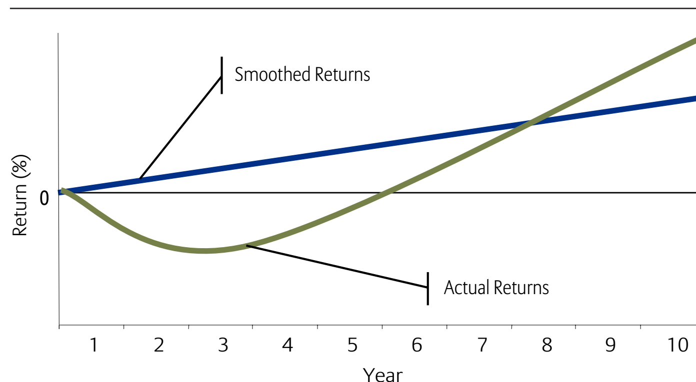
The leveraged buyout boom of the 1980s and venture capital bubble in conjunction with the IPO market frenzy of the 1990s enabled private equity funds, in general, to usher in spectacular returns for the greater part of two decades. Institutional investors seeking diversification and risk-adjusted returns have been gravitating to the asset class in hopes that the historical trend will continue. However, private equity also exhibits some widely acknowledged issues and risks, which investors should consider from today's perspective rather than a decade ago.

The reality is that only a small segment of the institutional investment community has reaped the greatest rewards. The biggest beneficiaries were large endowments who pioneered the space.

We can surmise that as early adopters, they were able to exploit the rise in popularity of private equity investing before a greater number of participants began crowding out the lucrative deals. In addition, private equity investors are hampered by typically high investment minimums and fees as well as liquidity constraints, including multi-year lock-ups and periodic capital commitments. Lastly, certain aspects of timing can influence expected returns.

For example, the J-Curve Effect is one aspect of timing that can influence the return profile of a private equity investment. Frequently, investment performance is back-loaded as investors experience low or negative returns in early years. As companies mature and are gradually exited in later years, investment gains increase. These risks are not a factor when making a public equity investment.

The J-Curve Effect



Source: Allianz Global Investors Capital. See additional disclosure.

[1] The extent to which a plan may make use of this approach is dependent on its ability to meet capital calls in the event of a stock market decline.

Allianz Global Investors

The vintage year, or the year of the first capital drawdown — i.e., investing pledged money — is another aspect of timing that brings certain risks to light. Once a vintage year has been established on a hypothetical 10-year fund, investors have essentially engaged in market timing, both at the time of purchase and sale. It is imperative that investors either get the cycle correct or invest additional private equity monies across cycles to diversify their original allocation.

Understanding Micro cap Investments

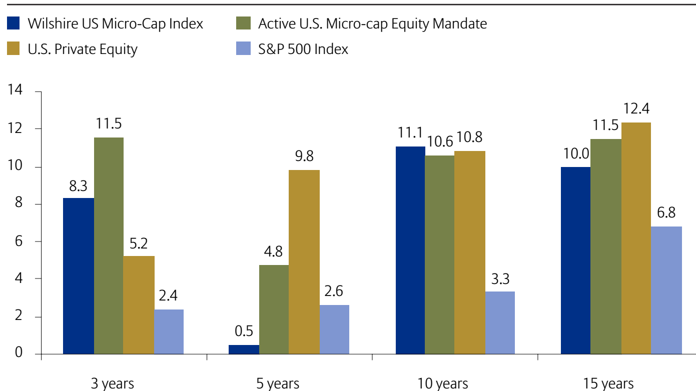
Micro caps provide a similar growth opportunity to private equity investments in that micro cap investing offers the potential for high returns through investments in companies on the brink of appreciably greater revenue and earnings growth. Similar to a venture capital investment, micro cap companies do not yet have a history of success, are less likely to have diverse sales, and exhibit other risks common to young companies. However, these factors are precisely why niche operators can offer the greatest growth opportunity. Micro caps can rival private equity in the potential for strong returns.

By definition, micro cap equities offer exposure to the smallest public companies traded on the major exchanges — stocks with market capitalizations between $50 and $500 million. Do not mistake these companies for penny or pink sheet stocks. In fact, many micro caps generate annual revenues in the hundreds of millions (USD) or greater.

Typically, micro caps have provided returns comparable to private equity over numerous time frames without the performance inconsistencies and timing effects that characterize private equity returns. For example, U.S. private equity funds have posted gains of 5.2%, 9.8%, 10.8% and 12.4% over the 3-, 5-, 10- and 15-year periods, respectively.[2]

Correspondingly, Wilshire's US Micro-Cap Index recorded gains of 8.3%, 0.5%, 11.1% and 10.0% while the average actively managed micro cap equity strategy (net of fees) performed even better over the same time frames.[3]

Annualized Returns (%)



As of March 31, 2011. Source: Allianz Global Investors Capital. See additional disclosure.

Further analysis reveals additional advantages of micro cap investing relative to private equity. Micro cap strategies typically offer lower fees, ample liquidity and full transparency in the form of daily holdings and pricing. Additionally, clients are not burdened with capital calls and long-term commitments. Indeed, investing in micro caps is no more onerous than making a small cap allocation — an easily accessible option for institutional investors, both large and small.

Although philosophies may vary, most micro cap investment approaches seek to uncover companies on the threshold or in the midst of a robust earnings growth cycle, primarily focused on capturing the "sweet spot" growth phase, which can last several quarters or more, but typically not years (at least not as a micro cap stock).

Consequently, private equity investors may find this investment opportunity actually complements early stage, highly levered, or distressed investments. In addition, that same allocation in micro cap equities may also act as a good supplement to a small cap equity allocation by residing in the space in the small cap spectrum where even greater market inefficiencies tend to exist. By being "small", many micro cap companies garner less sell-side attention.

Indeed, micro caps are the small caps of the 1990s. To be sure, the weighted average market capitalization of the Russell Microcap Index, which stands at approximately $400 million[4], is consistent with the Russell 2000 Index in the early 1990s. Fast forward twenty years and the weighted average market capitalization of the Russell 2000 Index has grown to approximately $1.4 billion[5] .

With this expansion, managers of small cap equities have been forced to move up the market cap spectrum alongside the index (evidenced by an even higher $1.8 billion weighted average market capitalization among U.S. small cap equity mandates).[6]

Consequently, funds allocated to small caps are less exposed to lower capitalization stocks. A micro cap allocation can solve this issue, by "completing" a small cap allocation. Concisely, micro caps are a distinct asset class, not a small cap subset, and therefore should be recognized as such. Vast inefficiencies are present in the micro cap space because it is under followed and under owned, allowing active managers to achieve potentially strong relative returns. There are two factors at play.

A decline in analyst coverage is consistent with a move down the market capitalization spectrum; however, the most dramatic falloff in coverage occurs below $500 million in market capitalization. The other factor is a function of liquidity; as small cap portfolio managers increase their assets under management, they are more likely to move up the market capitalization spectrum and purchase larger companies than move down and invest in smaller ones.

[2] As of March 31, 2011, U.S. Private Equity Index; pooled end-to-end return, net of fees, expenses and carried interest; Source: Cambridge Associates LLC.

[3] As of March 31, 2011. U.S. Micro Cap Equity Universe; average "net of fee" return of all populated mandates. Source: eVestment Alliance.

[4] As of March 31, 2011.

[5] As of March 31, 2011.

[6] As of March 31, 2011. U.S. Small Cap Equity Universe; average weighted average market capitalization of all populated mandates. Source: eVestment Alliance.

Today's Opportunity

Investors in search of the most suitable micro cap manager or private equity fund will find the latter to be a more challenging task. Large performance disparities exist among private equity funds and superior performance has largely been confined to the earliest adopters. This raises the question: Do new entrants have the ability to record comparable returns?

Despite recent regulatory initiatives, private equity managers have historically been exempt from most disclosure requirements. Therefore, examining performance and operational risk is difficult at best due to this lack of available data. How persistent is performance — do better-performing funds continue to do well, while underperformers continue to lag? Is a fund's internal rate of return negatively correlated to its asset base growth? If so, would this lead to barriers to entry in the form of higher fees or outright closures for top performing funds?

By contrast, finding an appropriate micro cap manager is a more certain endeavor as performance dispersion among products is significantly tighter and more importantly, publicly available.

Finally, private equity fees are significantly higher than those of micro cap managers. A typical private equity investment is subjected to a 2% annual fee and a 20% performance fee. On the other hand, the average fee for a separate account micro cap equity mandate is 115 basis points — a far cry from private equity. [7]

Private equity investors faced with aggressive return targets and unwieldy features could potentially benefit from an investment in micro caps. Micro caps are a practical supplement or complement to private equity due to the asset class's comparable return expectations, combined with greater flexibility and transparency, attractive fee structure and lower risk profile.

[7] As of August 19, 2011. U.S. Micro Cap Equity Universe; average fee at $50 M of all populated mandates. Source: eVestment Alliance.

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