MicroCap Value: A Good *Alternative* to Private Equity?

Private Equity refers to investment partnerships that invest in the debt and equity of private companies. Private Equity generally comes in two forms (1) Buyout Funds, where mature companies are purchased using debt, and (2) Venture Capital Funds, where small companies with large growth potential are purchased. The intent of the Private Equity fund is to eventually sell their investment, either to another fund, company or through initial public offering, for a gain.

For investors with substantial capital to invest, Private Equity funds have become a very popular choice. And why shouldn't they be? After all, Private Equity funds have offered better performance than the S&P 500 with less volatility and low correlation. This certainly sounds like a winning recipe. Indeed, in many cases investing in Private Equity can be a productive choice, but Private Equity is not a homogenous product easily picked off the shelf like a gallon of milk. Manager selection is absolutely critical, even more so than for mutual fund managers. Thankfully, there is another option, an alternative to an alternative if you will…MicroCap stocks.

MicroCap, which Ancora defines as equities having market capitalizations of between $25 million and $500 million, are often overlooked by investors despite their attractive qualities. We outlined those reasons in our whitepaper titled "MicroCap Myths".

In this new paper we explain why MicroCap, particularly MicroCap Value, might be a good alternative for at least a portion of one's Private Equity portfolio allocation:

1. **Returns**: MicroCap Value has earned higher returns over time than Private Equity
2. **Diversification**: An allocation to MicroCap for a portion of your portfolio yields a correlation benefit
3. **Liquidity**: Access to Private Equity is difficult due to large capital requirements on the front-end and on the back-end as a result of lock-up periods. MicroCap, while not as liquid as large cap equity, is significantly more liquid than Private Equity.
4. **Leverage**: Private Equity often uses large amounts of leverage, which while enhancing returns, also increases risk levels.
5. **SmallCap Exposure**: Both Private Equity and MicroCap provide exposure to smaller companies.

MicroCap Value Returns[i]

As we explain in our "MicroCap Myths" paper, all MicroCap stocks are not created equal. MicroCap Value, the two smallest deciles by market capitalization and price-to-book value, has outperformed the market by a significant amount over the past 50 years. Table 1, which is featured at the end of this paper, lists the annual performance of MicroCap Value, Private Equity and the S&P 500 Index from 1988 – 2013. As Table 1 shows, MicroCap Value returns exceed Private Equity by 5% per annum on a standalone basis. To the relative impact, a hypothetical portfolio based on allocations of 90% S&P 500 Index with 10% of Private Equity or MicroCap Value has been created, pictured in Figure 1. The findings:

- The 90%/10% (S&P 500 / MicroCap Value portfolio) achieves superior performance over the 90%/10% (S&P 500 / Private Equity portfolio).
- The 90%/10% (S&P 500 / MicroCap Value portfolio) does exhibit a small increase in risk, but the amount of return added is greater than the amount of risk taken.
- Not captured in the Private Equity returns is a phenomenon known as "survivorship bias". Without getting too technical, this bias may make Private Equity returns appear higher than they actually are by an unknown amount[ii].
- Private Equity typically follows a "J-Curve"[iii] for returns, which means if you're invested in a single fund, your paper wealth will potentially be negative for the first several years. Table 1 demonstrates the performance of a pool of Private Equity funds with varying maturities, which is not characteristic of the normal return pattern of Private Equity.

To the casual observer, the risk and return pictured in Figure 1 may seem very similar. Figure 2 illustrates in dollar terms over time the advantage of the extra return the 90%/10% (S&P 500 / MicroCap Value portfolio) providesbased on the actual annual performance listed in Table 1. Each portfolio starts with $10,000. The small amount of additional volatility in the MicroCap Value enhanced portfolio is well compensated for over the time period. Furthermore, as indicated in Figure 2, rarely did the 90%/10% (S&P 500 / MicroCap Value portfolio) drop below the value of the 90%/10% (S&P 500 / Private Equity portfolio).

Diversification

Due to low correlation with the S&P 500 Index, both Private Equity and MicroCap Value offer diversification benefits to the portfolio. MicroCap Value has a correlation of 0.60 with the S&P 500 and Private Equity actually has a correlation of -0.17. The correlations are displayed in Table 2. While Private Equity correlation is lower than MicroCap Value, this may be the outcome of illiquidity and a lack of market quotations rather than true low correlation. As demonstrated in Figures 1 & 2, despite having higher volatility, the low correlation of MicroCap Value to the S&P 500 increases the risk-adjusted return, resulting in larger wealth accumulation. Figure 3 shows the Sharpe Ratio, the return in excess of the risk-free rate per unit of risk, a standard measure of risk-adjusted return, for each portfolio. As Figure 3 makes clear, adding MicroCap Value or Private Equity increases the Sharpe Ratio of the portfolio, meaning adding a 10% allocation of MicroCap Value or Private Equity would be expected to improve the risk-adjusted return compared to a 100% S&P 500 portfolio only.

Figure 1

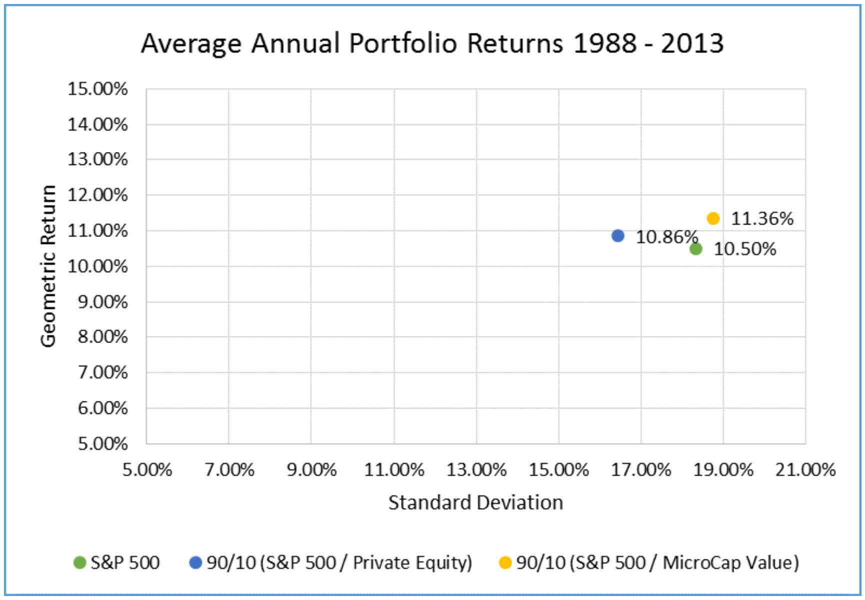
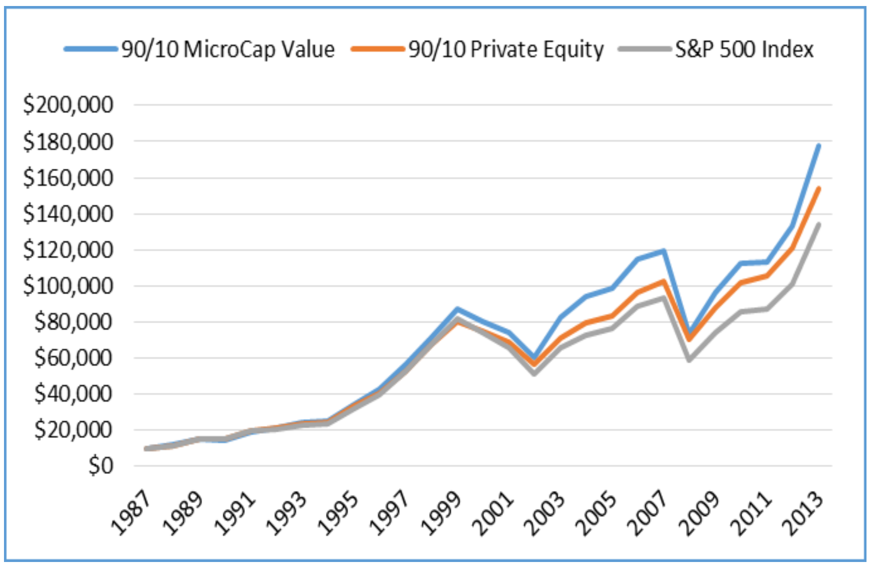


Figure 2



[i]*Figure 3*

	S&P 500 Index	90/10 MicroCap Value	90/10 Private Equity
Sharpe Ratio	0.43	0.47	0.51

Liquidity

Private Equity funds are known for requiring long lock-up periods for their investors, often 7 to 10 years. Because Private Equity generally follows a J-Curve, Private Equity funds prevent investors from accessing their capital during this period. In many cases, the lock-up period is not a problem and investors in Private Equity potentially have the means to defer accessing their capital, but unexpected events can change that. Another potential disadvantage of Private Equity due to lack of liquidity is the inability to replace poorly performing managers due to the lock-up feature.

The difference between upper quartile and lower quartile Private Equity managers is striking. Table 3 demonstrates the average difference in annual returns is 15.52%. The consequence of being in an underperforming Private Equity fund is that capital is likely stuck in it for the long haul unless one is willing to take a haircut in the secondary market.

Therefore, liquidity becomes a major advantage for MicroCap, where money can be accessed in short order and managers can be replaced due to poor performance. Investors certainly hold more control over their investment with MicroCap than Private Equity. Lastly, MicroCap can accept large and small investments, whereas Private Equity requires such large up-front commitments that many investors are ineligible to participate.

Leverage

A byproduct of investing in Private Equity, particularly for buyout funds, is the use of leverage. This can result in unintended sources of risk in a portfolio. The Wall Street Journal reported that 40% of U.S. Private Equity deals in 2014 used leverage above ratios the Federal Reserve and the Office of the Comptroller of the Currency consider safe[iv]. Not only does this introduce additional interest rate risk, but it also brings additional credit risk. For instance, if interest rates rise and a company has too much leverage, they may not be able to afford the interest payments at the higher rates if their debt is variable or if they need to refinance. Leverage is easy to avoid and diversify away with MicroCap Value.

Small Cap Exposure

Most Private Equity deals are made in the small cap arena with many done in even smaller MicroCap sized companies. Utilizing public MicroCap stocks exposes a portfolio to many of the same benefits of small cap inefficiency which Private Equity funds seek to exploit. This inefficiency is known as the “Small Cap Premium”, which may be more pronounced in MicroCap stocks which frequently have an even lower average market capitalization than Private Equity.

In conclusion, the popularity of Private Equity is partly attributable to the club like access to the asset class and partly to the exceptional returns of the upper quartile managers. However, as discussed, Private Equity is not a homogenous group and accessing those excellent managers can be difficult. Few stop to ask if there is an alternative to Private Equity which does not have the associated liquidity risks and additional costs. MicroCap Value, in addition to yielding greater return enhancement, also offers significant diversification benefits and most importantly, gives the investor precious access to liquidity.

[i]Table 1

Year	MicroCap Value	Private Equity	S&P 500 Index
1988	25.42%	14.35%	16.61%
1989	7.59%	22.99%	31.69%
1990	-24.90%	14.89%	-3.10%
1991	59.18%	30.24%	30.47%
1992	59.12%	24.51%	7.62%
1993	43.40%	22.95%	10.08%
1994	8.53%	14.05%	1.32%
1995	37.15%	18.69%	37.58%
1996	29.43%	8.83%	22.96%
1997	36.00%	6.75%	33.36%
1998	-5.69%	12.36%	28.58%
1999	38.32%	13.18%	21.04%
2000	-0.36%	13.35%	-9.10%
2001	37.14%	21.94%	-11.89%
2002	6.09%	17.53%	-22.10%
2003	118.31%	13.78%	28.68%
2004	34.11%	11.77%	10.88%
2005	7.34%	10.06%	4.91%
2006	23.85%	11.42%	15.79%
2007	-14.39%	12.97%	5.49%
2008	-52.88%	16.32%	-37.00%
2009	80.45%	21.15%	26.46%
2010	30.66%	21.82%	15.06%
2011	-9.13%	14.79%	2.11%
2012	28.28%	4.35%	16.00%
2013	44.81%	-19.05%	32.39%
CAGR	**19.06%**	**14.08%**	**10.50%**

[i]Table 3

Year	Upper Quartile	Lower Quartile	Difference
1988	15.48%	9.99%	5.49%
1989	29.18%	12.57%	16.61%
1990	19.24%	10.61%	8.63%
1991	44.23%	16.57%	27.66%
1992	26.99%	11.51%	15.48%
1993	33.54%	8.73%	24.81%
1994	23.40%	1.02%	22.38%
1995	30.90%	0.64%	30.26%
1996	12.30%	1.75%	10.55%
1997	13.06%	-0.65%	13.71%
1998	15.18%	4.72%	10.46%
1999	17.99%	6.17%	11.82%
2000	20.85%	7.58%	13.27%
2001	35.31%	11.08%	24.23%
2002	27.12%	8.74%	18.38%
2003	17.12%	6.55%	10.57%
2004	13.88%	7.52%	6.36%
2005	13.93%	4.69%	9.24%
2006	15.64%	7.32%	8.32%
2007	19.22%	8.28%	10.94%
2008	21.98%	8.34%	13.64%
2009	23.94%	8.48%	15.46%
2010	23.03%	9.22%	13.81%
2011	18.75%	5.50%	13.25%
2012	11.53%	-9.31%	20.84%
2013	1.28%	-26.00%	27.28%
Average			**15.52%**

[i]Table 2

Correlation Matrix

	MicroCap Value	Private Equity	S&P 500 Index
MicroCap Value	1.00	0.07	0.60
Private Equity		1.00	-0.17
S&P 500 Index			1.00

Footnotes:

[i]Private Equity returns source: Cambridge Associates, "US Private Equity Index and Selected Benchmark Statistics". December 31, 2014. US Private Equity: Since Inception IRR & Multiples by Vintage Year. Net to Limited Partners. Page 8. http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2015/05/Public-USPE-Benchmark-2014-Q4.pdf

MicroCap returns Source: French, Kenneth, 100 Portfolios Formed on Size and Book-to-market (10x10). The returns presented are an average of the smallest two deciles by market capitalization and price-to-book value. Ancora has deducted an annual fee of 1.26% for comparison purposes. We used an average of the fees of ten MicroCap mutual funds with at least $100 million of asset under management. http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#BookEquity

S&P 500 source: http://us.spindices.com/indices/equity/sp-500

[ii]When fund managers stop reporting before their fund's return history is complete, an element of "survivorship bias" may be introduced to a performance database, which could skew the reported returns upwards if the funds dropping out had poorer returns than those funds that remained.

[iii]J-Curve: illustrates the tendency of private equity funds to deliver negative returns and cash flows in the early years and investment gains and positive cash flows later in the investment fund's life as the portfolio companies mature and are gradually exited.

[iv]The Wall Street Journal, "Debt Rises in Leveraged Buyouts Despite Warnings" May 20, 2014. http://www.wsj.com/articles/SB10001424052702304422704579574184101045614

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