Small-caps:

the private equity alternative

More and more investors are turning to private equity. But this unlisted form of investment has some drawbacks. Small-cap investing offers the same benefits without the drawbacks.

The advantages of investing in private equity

The American banker J.P. Morgan took over the steel company Carnegie Co, now U.S. Steel, in 1901 with his own money and a bank loan. Morgan saw how he could make the company more profitable by expanding production lines, improving distribution and reducing transportation costs. An example of private equity from the old days, but private equity is all the rage these days.

Private equity is a form of investment in which investors provide capital directly to unlisted companies. This capital can be used for business expansion, product development, restructuring, professionalisation, succession and/or acquisitions. Private equity investments have long been part of the investment portfolios of professional investors, but are now increasingly becoming part of the portfolios of retail investors.

And this seems a logical step, as private equity investment offers a number of advantages: investment in promising companies (mostly small companies with high growth potential), outside the stock market, risk diversification and higher returns than public equities. Not surprisingly, the allocation of professional investors to private equity is increasing at the expense of the allocation to public equity (listed shares), as the following table illustrates.

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)

Disadvantages of investing in private equity

While there are certainly advantages, there are also some disadvantages to investing in private equity, the main ones being:

- **Long investment horizon**
  Private equity investments often have long investment horizons of between 5 and 10 years before investors can realise returns. Investors must be prepared to tie up their capital for an extended period of time without immediate access to their money.
- **Liquidity constraints**
  Private equity investments are illiquid (poorly tradable); there is no active market as there is for listed shares, making it difficult to buy and sell investments early.
- **Transparency**
  There is less transparency and regulatory oversight compared to listed companies. It is also more difficult to determine the value of the investment and therefore the return.
- **High entry costs and fees**
  Many private equity investments are only accessible to investors with a minimum investment of €100,000 or even €1 million. Those who want to diversify within private equity also need (to be able) to invest in several private equity companies. In addition, high fees are often charged for managing these investments in fund structures.

However, it is also possible to invest in publicly traded stocks, which retains the advantages of private equity investing and reduces the disadvantages.

A good alternative: small-cap investing

Micro-cap and small-cap investments are investments in listed companies with a relatively small market capitalisation. Although different definitions are used, micro-cap stocks have a market capitalisation of up to $300 million and small-cap stocks have a market capitalisation of between $300 million and $2 billion. However, some have only one definition for small-caps: stocks with a market capitalisation of up to $2 billion.

Micro-cap and the bigger (in terms of market capitalisation) small-cap investments offer the same advantages as private equity investments, but without the disadvantages. With publicly traded stocks, there are few concerns about measuring returns, liquidity is much better, buying and selling can be done any time the stock market is open, and at lower amounts and fees. For most stocks, there is enough liquidity to sell positions immediately without much impact on the price. In less liquid stocks, it may take several days to sell large positions without putting too much pressure on the price. This is a far cry from the often several years required for trading private equity investments.

In addition, returns on micro-cap investments are equal to, or better than private equity returns. According to a study by PGIM[1] covering the period 2007-2023, the returns of these two asset classes are similar. A comparison by O'Shaughnessy Asset Management[2] shows that micro-cap managers in the top 25% on average generated a return of 34% vs 15% for the private equity managers in the first quartile and that the bottom 25% micro-cap managers generated 27% on average vs 5% for the private equity managers (over five years) indicating a clear outperformance for small-caps over private equity.

One advantage of micro-cap stocks is that they are unfamiliar territory for large professional investors. Many micro-cap stocks are not researched by analysts on an ongoing basis, so they are often ignored by large institutional investors. This is in contrast to large companies. Microsoft, one of the largest companies in the stock market, has over 6,800 institutional investors. Micro-cap companies often

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[1] PGIM Quantitative Solutions (2023) – *Micro caps vs. private equity: unshackle your returns*

[2] O'Shaughnessy Asset Management (2016) – *Micro-cap as an alternative to private equity*

have zero to a few dozen institutional investors at most. The lack of attention to these small companies provides a greater opportunity to find attractive investments.

Conclusion

Investing in private equity has its advantages, and its popularity has grown recently. But it also has its drawbacks. Investing in micro- and small-cap stocks offers the same advantages as private equity without the well-known disadvantages. These listed stocks offer huge upside potential, with returns at least comparable to private equity, but with good liquidity, better transparency and lower costs.