

Are You Overallocated to Private Equity?

Micro caps might be an alternative you didn't know you were looking for...

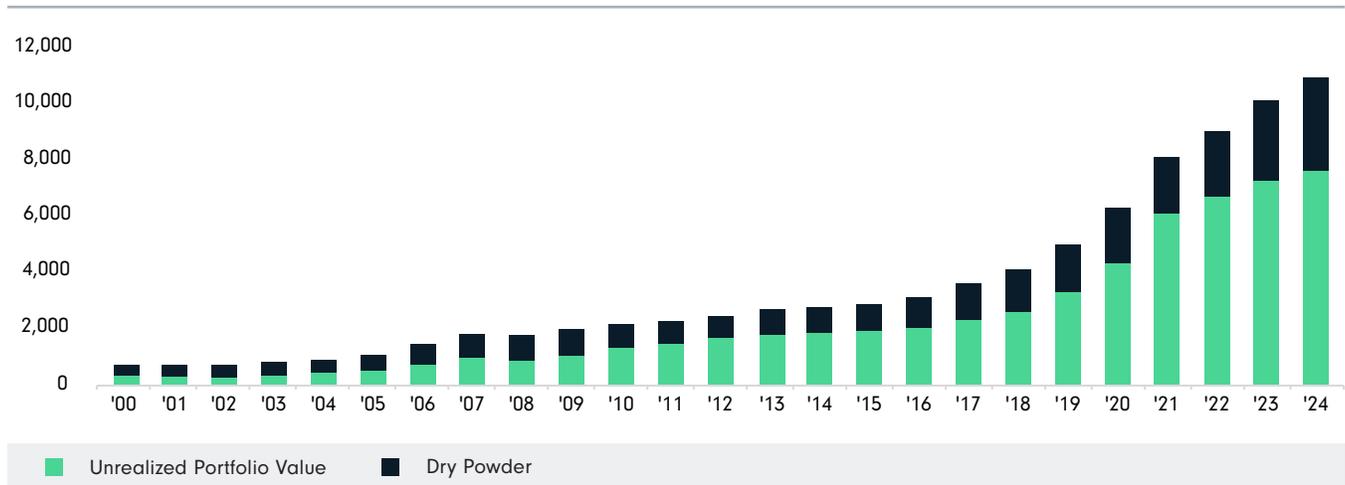
In the ever-evolving landscape of investment opportunities, sophisticated investors constantly seek the optimal balance of risk, return and liquidity. Two asset classes that have garnered attention for their potential to generate outsized returns are private equity (PE) and publicly traded micro-cap stocks. While these investment categories share several characteristics, they also possess fundamental differences that deserve further consideration from institutional investors looking for exposure to this market area.

The private equity paradox

Private equity has experienced explosive growth in recent decades, amassing \$1 trillion in uninvested capital as of June 2024 in US private equity alone (Exhibit 1).

This impressive growth followed what many economists call the “Great Moderation” – a period from the mid-1980s to 2007 characterized by declining interest rates, subdued inflation and relatively stable economic conditions. These factors created an ideal environment for the private equity model, which fundamentally relies on financial engineering through leverage.

Exhibit 1 – Private Equity Assets Under Management (\$B)



Source: Strategas, Preqin. 2024 data are projections. Used with permission.

However, this model could potentially face secular and cyclical challenges that may be overlooked as a mountain of institutional capital finds itself potentially overallocated to private equity:

- **Deployment challenges:** With \$1 trillion in dry powder and nearly a quarter of that capital idle for close to four years, finding attractively priced acquisition targets has become increasingly difficult. This creates a situation where private equity funds bid against each other and strategic acquirers in sourcing deals. This can distort deal pricing at the expense of fund investors.
- **Exit constraints:** PE firms could struggle to exit investments at acceptable valuations despite booming public markets, particularly as interest rates have risen and altered deal economics. PE firms increasingly engage in secondary transactions, selling assets to other PE firms. This circular trading creates an artificial ecosystem where assets rarely face proper market scrutiny, potentially masking underperformance while generating transaction fees at both ends.

- **Changing market dynamics:** The decline of long-only active managers has made IPOs a less reliable exit channel, while stricter antitrust scrutiny has complicated strategic sales.
- **Changing economic regime:** Higher inflation, increased volatility and rising term premiums may fundamentally challenge the premise that most companies should carry more debt than they traditionally have.

The micro-cap alternative

Publicly traded micro-cap stocks — defined as companies with market capitalizations under \$1 billion for purposes of this discussion — offer a compelling alternative that captures many of the benefits and advantages that attract investors to private equity while avoiding several key drawbacks.

Some of these **shared advantages** include:

- Access to smaller, high-growth companies still in the early stages of their development cycle. Oftentimes, these are businesses that operate in specialized niches with significant room for expansion and value creation.
- Both investment approaches target potentially higher returns than the broader market by capitalizing on inefficiencies and information asymmetries that are more prevalent in smaller, less-followed market segments.
- Diversification from large-cap public equities, with return patterns that can differ from major indices due to their unique market dynamics and company-specific growth drivers.

There are also critical differences that, in combination with the shared advantages, can tip the scales in favor of investing in publicly-traded micro caps, including:

- **Valuation frequency:** While micro-cap investors benefit from the visibility and price discovery of public markets that are marked to market daily, private equity investors must contend with opaque, subjective valuations that can mask actual volatility and performance issues. This fundamental valuation problem is often referred to as “volatility laundering.” This lack of transparency creates additional difficulties for investors who cannot accurately assess their portfolio’s true value or risk exposure until it’s too late. In contrast, public micro-cap stocks reflect real-time market sentiment and economic realities.
- **Lower, simpler fees:** Private equity’s fee structure — typically 2% management fees plus 20% of profits — can significantly erode investor returns. In contrast, actively managed micro-cap strategies generally charge much lower fees, allowing investors to retain more of the value created.
- **Liquidity without compromise:** While private equity typically locks up capital for 7-10 years, investors in publicly traded micro-caps can adjust positions as needed without sacrificing return potential. The ability to dynamically position the investment portfolio to changing conditions isn’t merely a convenience — it’s a strategic advantage that allows investors to be opportunistic during market dislocations.
- **No deployment challenges:** There are roughly 1,400 US micro-cap companies (using the Russell Microcap Index as a proxy), providing an ample opportunity set for building a focused portfolio of high-conviction investments. While private equity firms may struggle to deploy capital, investors in publicly traded micro-cap stocks can efficiently allocate to their best ideas without compromising standards.
- **Transparency, business performance focus:** Micro-cap investing success derives primarily from business performance and valuation expansion — this stands in stark contrast to private equity, where returns are driven substantially by leverage. Public companies must adhere to disclosure requirements and governance standards. This transparency reduces information asymmetry and principal-agent problems that can plague private investments.

Navigating the new economic reality

As we potentially transition to a new economic regime characterized by higher inflation, volatility and rising term premiums, the micro-cap segment may offer more resilience than private equity. Without the structural need for excessive leverage, micro-cap companies can potentially navigate changing economic conditions with greater flexibility.

Most importantly, micro-cap investing allows for responsive portfolio management. While private equity funds may struggle with deployment and exit challenges in changing markets, active micro-cap managers can adjust positions as economic conditions evolve.

Conclusion

Private equity's impressive growth during the Great Moderation era demonstrated investors' appetite for strategies targeting smaller companies with growth potential. However, the changing economic landscape could expose structural challenges in the private equity model.

For investors seeking that growth potential, many of whom are potentially overallocated to private equity, publicly traded micro-cap stocks offer a compelling alternative. An overlooked aspect of the explosion in private equity and the decline in active management is that many portfolios are underallocated to this space – creating a well-stocked pond without many looking to fish. With advantages in liquidity, transparency, fee structure and adaptability, active micro-cap investing provides the opportunity to capture private equity-like returns without many of its inherent limitations. This approach may offer the optimal combination of risk, return and flexibility for investors navigating today's complex markets.

Russell Microcap Index measures the performance of the microcap segment of the US equity market. The index is unmanaged, market capitalization weighted, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: London Stock Exchange Group PLC. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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