



## *Small Cap ESG Value as an Alternative to Private Equity Impact Investing*

*September 12, 2019*

Private equity investing is often described as a superior alternative to public equity investing with studies citing private equity's historical outperformance vis-a-vis the S&P 500 Index. However, these studies frequently do not adjust for issues such as 1) appropriate benchmark selection, 2) current market valuations, 3) illiquidity, and 4) high fees. Additionally, when studies have examined the performance of impact investing private equity, historic returns have actually underperformed S&P 500 index. For these reasons, we believe that a small cap<sup>1</sup> public equity strategy with value and ESG integration may be a viable alternative to private equity investing particularly when it comes to the area of private equity impact investing.

### **Private Equity Overview**

Private equity funds typically invest directly in private companies or acquire public companies to take them private. These funds are typically structured as partnerships in which a general partner manages the fund and makes investment decisions while the limited partners are passive investors in the fund. Private equity can take many forms, with options ranging from venture capital investments in start-up companies to highly levered buyouts of public companies. Fund managers typically seek to buy companies with the use of leverage, replace existing management, improve profitability, and then sell or take the company public at a higher valuation than they originally paid. Each private equity fund holds a number of individual portfolio companies and a typical fund exists for around a decade. General partners are compensated based on total assets managed and the amount of money they earn for their limited partners.

Academic studies claim that private equity has generated historical total returns 3.0% to 5.0% higher than a large cap equity index such as the S&P 500.<sup>2</sup> However, these statistics leave out a number of important factors that may make public market investing a more attractive and more accessible avenue, particularly in the current investing environment.

### **Concerns for the Private Equity Investor**

#### *Benchmark Selection & Historical Returns*

Private equity investors typically purchase portfolio companies with debt and then subsequently pay down this debt throughout their holding period. While this strategy creates attractive tax advantages, it also makes returns more volatile. Given such high leverage, the typical private equity investment does not look like your average S&P 500 company.

Nonetheless, the returns of private equity funds are often compared favorably to the returns of the S&P 500. However, as discussed in "Performance of buyout funds revisited?"<sup>3</sup>, the S&P 500 is an inappropriate

---

<sup>1</sup> We define "small cap" generally as any company with a market capitalization less than \$5.0 billion.

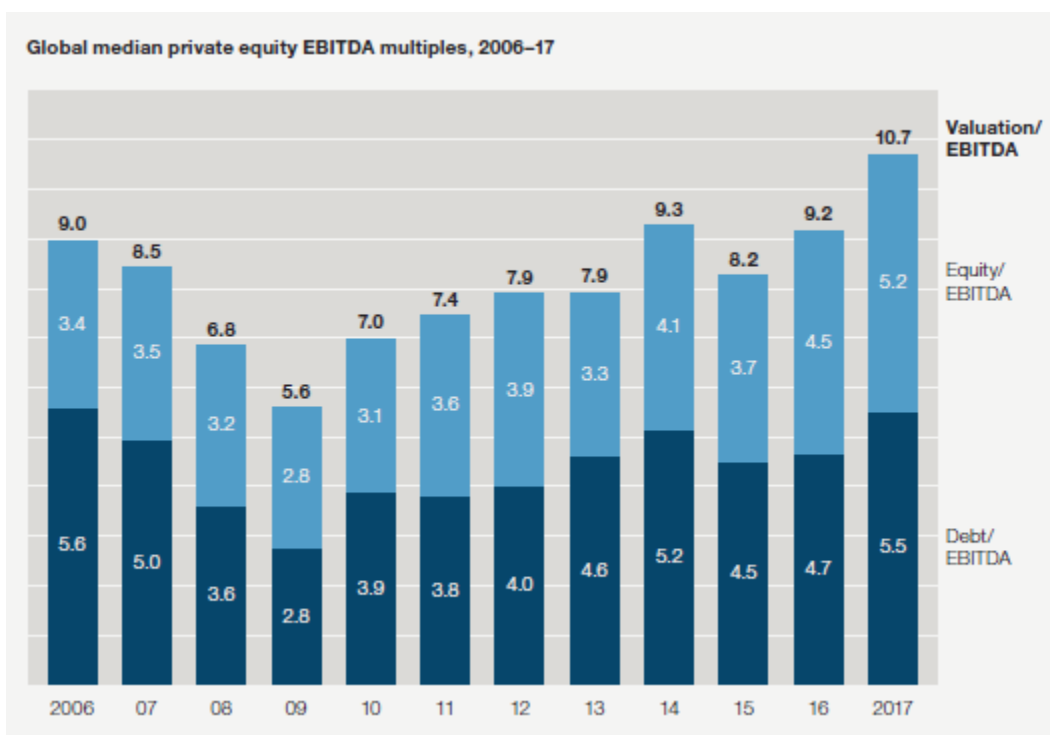
<sup>2</sup> Source: Mercer, "Understanding Private Equity – A Primer," 2015.

<sup>3</sup> Source: Ludovic Phalippou, "Performance of Buyout Funds Revisited?" 2014.

benchmark for private equity funds which typically contain small, highly levered companies. Instead, the author argues that it is more appropriate to compare the performance of private equity funds to a small cap index (such as the Russell 2000 or, in the author’s case, the Dimensional Fund Advisors U.S. Small Cap Value Fund). After adjusting the benchmark, the paper notes that private equity funds *underperform* by 1.2% annually. Further, after adjusting for both the benchmark and the leverage of the individual portfolio companies, private equity funds in this study actually underperformed a small-value index used by researchers by 3.1% annually.<sup>4</sup>

#### High Asset Valuation

A key determinant in the return earned by a private equity fund is the initial price paid for each portfolio company. As an example, a Wells Fargo study shows that funds originated in 2009 (when purchase prices were low) outperformed those funds originated in 2006 (when purchase prices occurred at a much higher level) with median fund IRRs of 13.0% and 8.0%, respectively.<sup>5</sup>



As it stands today, McKinsey reported that purchase price multiples in U.S. leveraged buyout transactions rose to an all-time high of almost 11.0x EBITDA in 2017. These acquisition multiples are well above even those for funds originating in the years prior to the Great Recession. In addition, McKinsey reports that private equity funds hold record amounts of “dry powder,” or unused capital, meaning that the committed capital chasing attractively valued companies is at an all-time high. As multiples rise in private equity purchases, it becomes harder to imagine that an already highly-valued asset will achieve an even higher

<sup>4</sup> The benchmarks used in this calculation were the six Fama-French indices, which are portfolios assembled by firm size (small or large) and book-to-market ratios (growth, mid, and value). In particular, the 3.1% underperformance was calculated against the small value-weighted index. These research portfolios are available on Ken French’s website.

<sup>5</sup> Source: Wells Fargo, “How Have Private Equity Funds Performed Across Cycles,” 2018.

multiple when its owner eventually looks to sell. Summarizing, it is our belief that the current investment environment makes it difficult to achieve the attractive returns often cited in private equity historical studies.

### *Illiquidity*

Private equity is an illiquid investment with funds that generally have a term of 10 years,<sup>6</sup> and, once invested, an investor cannot get capital back except at the manager’s discretion. This lack of liquidity stands in stark contrast to the daily liquidity offered by public markets. Illiquidity might be a good reason that private equity funds *should* generate a better return than comparable public stocks. However, as discussed in “Performance of buyout funds revisited,” this isn’t necessarily the case.

### *High Fees*

Private equity has some of the highest fees of any asset class. Private equity firms primarily make money through both management fees, based on the size of the fund, and performance fees, based on profits generated by the fund. The management fees are most commonly in the range of 1.76% to 2.0% with performance fees typically 20.0%<sup>7</sup> of profits once a hurdle return is achieved. These fees greatly reduce a limited partner’s net returns.

## **Concerns for the ESG Focused Private Equity Investor**

### *Historical Returns on Impact Funds*

According to research by Cambridge Associates and the Global Impact Investing Network (GIIN), the historical returns (as of September 30, 2018) for impact investing private funds have paled in comparison to public benchmarks such as the small cap Russell 2000 and the large cap S&P 500.<sup>8</sup> For the impact-focused investor, private equity may not offer the return potential that so often attracts investors to the asset class.

**FUND INDEX SUMMARY: HORIZON POOLED RETURN**  
Net to Limited Partners

INDEX	1-QUARTER	YTD	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR
<b>CAMBRIDGE ASSOCIATES LLC PE/VC IMPACT INVESTING INDEX<sup>6</sup></b>	<b>0.58</b>	<b>3.52</b>	<b>6.31</b>	<b>5.90</b>	<b>6.05</b>	<b>5.81</b>	<b>6.19</b>
Bloomberg Barclays Capital Government/Credit Bond Index	0.06	-1.85	-1.37	1.45	2.23	3.95	3.75
MSCI World ex US Index (net)	1.31	-1.50	2.67	9.32	4.24	5.18	6.85
MSCI World Index (net)	4.98	5.43	11.24	13.54	9.28	8.56	8.15
MSCI Emerging Markets Index (gross)	-0.95	-7.39	-0.44	12.77	3.99	5.76	10.02
Russell 1000 <sup>9</sup> Index	7.42	10.49	17.76	17.07	13.67	12.09	9.85
Russell 2000 <sup>9</sup> Index	3.58	11.51	15.24	17.12	11.07	11.11	10.12
S&P 500 Index	7.71	10.56	17.91	17.31	13.95	11.97	9.65

## **Is an ESG Equity Strategy that Invests in Small-Cap, Levered, Value Stocks a Viable Solution?**

We believe that a small cap public equity strategy with value and ESG integration may be a viable alternative to private equity investing, particularly when it comes to the area of private equity impact

<sup>6</sup> Source: Mercer, “Understanding Private Equity – A Primer,” 2015.

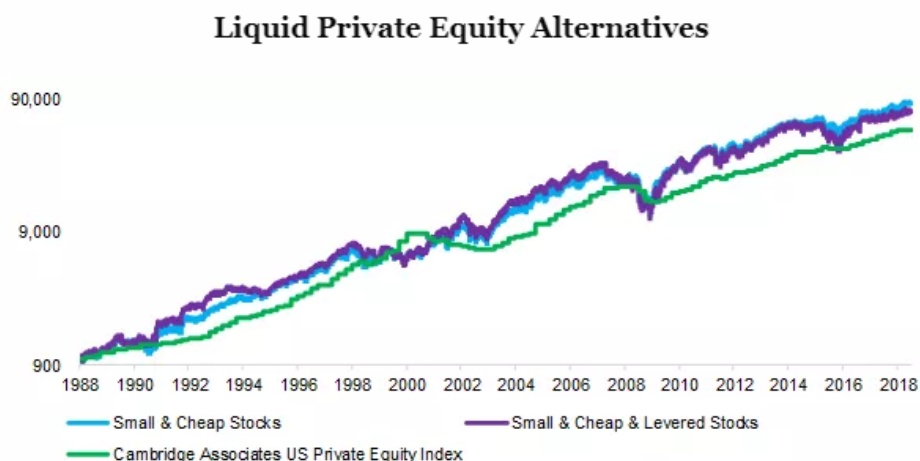
<sup>7</sup> Source: MJ Hudson, “Private Equity Fund Terms Research,” 2018.

<sup>8</sup> Source: Cambridge Associates, “Private Equity & Venture Capital Impact Investing,” 2018.

investing. In the public markets, an investor could pursue this strategy via mutual funds and ETFs or other investment vehicles that focus on levered small cap stocks with good ESG characteristics.

#### *Historical Returns on Private Equity versus Small, Levered Stocks*

FactorResearch in conjunction with the CFA Institute recently published a study that puts data to many of the points discussed above.<sup>9</sup> They looked at the performance of the Cambridge Associates U.S. Private Equity Index from 1988 to 2018. They then compared this performance with portfolios of “Small & Cheap Stocks” and “Small & Cheap & Levered Stocks” that they tracked over this period. This study found that in both instances, the portfolio of small cap value stocks outperformed the private equity index as seen in the chart below.



#### *High Asset Valuation*

While private equity funds are purchasing companies at all-time high valuations, public company funds have options to invest in sustainable companies trading at much cheaper levels. There are more than 2,000 publicly traded developed market small cap companies that trade at less than 7.0x EV/EBITDA. In fact, the average company in this universe trades at just 4.7x EV/EBITDA. Therefore, it is quite feasible for a fund invested in global small cap value stocks to be entirely composed of stocks with valuations that are less than half the level at which private equity funds are paying today. With the valuation level being a key determinant in future returns, the ability of a public fund to invest in companies trading at a fraction of the average private equity purchase multiple is an enormous advantage for the public equity investor.

#### *Illiquidity*

As discussed, private equity funds on average have 10-year lock ups. In contrast, public market strategies such as ESG mutual funds or ETFs typically offer investors daily liquidity or more frequent redemption options. Other investment vehicles can provide a middle ground for liquidity: for example, customized strategies might create a one-year lock up and allow for quarterly withdrawals. While not as liquid as a mutual fund or ETF, a strategy deploying a short-term lock up instead offers some protection of the strategy and its investors by limiting forced selling in times of market volatility. Whether executed via mutual funds

---

<sup>9</sup> Source: CFA Institute, “Private Equity: The Emperor Has No Clothes,” 2018.

and ETFs or other investment vehicles, a public market strategy would provide much greater liquidity than the typical private equity fund.

#### *High Fees*

Alternatives to private equity are available at a fraction of the cost of private equity funds. According to Morningstar, U.S. open-ended mutual funds and ETFs have an asset-weighted average expense ratio of 0.67%.<sup>10</sup> Other investment vehicles may have higher fees than mutual funds or ETFs, but they still are typically lower than private equity; for example, the average limited partnership public equity fund charges a 1.5% management fee and a 17.0% performance fee.<sup>11</sup> Both of these options provide investors access to investment strategies at a discount to the typical private equity fees of 1.76% to 2.0% in management fees and a 20.0% performance fee.<sup>6</sup>

#### *Historical Returns on Impact Funds*

We discussed above how private equity impact funds have trailed public equity benchmarks such as the Russell 2000 and the S&P 500 and concluded that, for impact investors, private equity may not provide the returns that so often draw investors to the sector. However, a small cap ESG value strategy may allow these same investors the opportunity to invest in sustainable companies without sacrificing returns and liquidity or being subject to higher fund fees.

### **Conclusion**

In our view, a portfolio of levered, small cap stocks screened for ESG characteristics could be an attractive alternative to a more expensive, less liquid, and harder to access private equity impact fund. We believe that an ESG small cap value strategy has the potential to outperform impact private equity strategies moving forward, particularly given the elevated valuation levels of transactions occurring in the private equity industry today and the historically sub-par returns of impact investing funds. Such a strategy applying both quantitative and fundamental valuation methods to identify small cap, levered public equities with the willingness and ability to pay down debt should be able to replicate a private equity style strategy in the public markets.

Key screening criteria:

- Developed markets
- Favorable ESG characteristics
- Cheap valuations
- Significant financial leverage
- Ability and willingness to de-lever

When combining these factors such a portfolio will seek to have lower valuations, better liquidity, and competitive long-term performance, in our view.

---

<sup>10</sup> Source: Morningstar, "US Annual Fund Fee Survey," 2018.

<sup>11</sup> Source: Jefferies Capital Consulting, 2018.

## **Disclosure**

*The strategy's inception date was 5/1/2019. Fees for the strategy are 2.0%. The S&P 500 Index is a widely recognized, unmanaged group of stocks that is representative of a broad market. The Russell 2000 Index is a widely recognized unmanaged index that measures the performance of the small-cap segment of the US equity universe.*

*You should consider the strategy's investment objectives, risks, and fees carefully before you invest. This document is not an offer to buy or sell, nor a solicitation of an offer to buy or sell an interest in any security or other financial instrument. This document is intended for authorized recipients and must be held strictly confidential. Certain information contained herein has been obtained from third parties. While such information is believed to be reliable, Pekin Hardy Strauss Inc. assumes no responsibility for the accuracy of the information.*

*An investment in the Strategy is speculative and involves a high degree of risk. Investors could lose their entire investment. Investments in international markets present special risks, including currency fluctuation, the potential for diplomatic and political instability, regulatory and liquidity risk. Investments in commodities may be affected by overall market movements, changes in interest rates and other factors, such as weather, disease, embargoes and international, economic, and political developments. The Strategy may focus on a limited number of companies or sectors, and the poor performance of these companies or sectors may have a greater negative impact on the Strategy's performance. Investments in commodities may be affected by overall market movements, changes in interest rates and other factors, such as weather, disease, embargoes and international, economic, and political developments. Some of the assets in which the strategy invests may be illiquid and/or speculative, and thus difficult to sell in order to limit a loss. These statements do not cover all of the risks involved in an investment in the strategy. The investment process may change at any time without notice.*

*This document is intended for authorized recipients and must be held strictly confidential. Appleseed Capital is the impact investing arm of Pekin Hardy Strauss, Inc. This document may not be reproduced or distributed in any format without the prior written approval of Pekin Hardy Strauss, Inc. There are no assurances that any predicted results will actually occur. Past performance is no guarantee of future results.*