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*"If you're not aware that you're not supposed to be able do something, the barriers to doing it are dramatically lessened."*

*- Sam Zell*

Over the past decade, there has been an increasing demand for private equity fund investment as investors have looked to diversify their portfolios and seek higher risk-adjusted returns. The demand has created a multitude of private equity funds – so much so that these funds are now competing and bidding up the prices of potential takeover targets. The preference of investors for private equity funds over traditional small cap investing is puzzling.

While some private equity transactions can be large – the Onex Corp $5 billion purchase of WestJet, for example – most of the transactions tend to be smaller companies in the early stages of development or undergoing a significant transformation. More importantly, acquisitions tend to use an LBO strategy ("leveraged buy-out") which is an efficient method of acquisition without investing much capital. The book Barbarians at the Gate documents the LBO battle between KKR, RJR management, and Shearson Lehman Hutton for control of the company, leaving the eventual company mired in debt. This type of investment introduces exposure in the face of economic turmoil, evident during the financial crisis of 2008. That leads to a higher degree of uncertainty around the future prospects of the investment.

Private equity firms typically charge a management fee and a carried interest, a share of the profits earned by the fund. This can create a misalignment of incentives between the private equity firm and its investors, as the firm may prioritize its own interests over those of the investors. The private equity firm may also have relationships with the companies in which they invest, such as providing consulting services or sitting on the board of directors, which can cause conflicts of interest if the private equity firm's interests are not aligned with those of their investors. The transparency of publicly listed small cap companies avoids this disclosure issue.

Despite the frequent use of debt and recurrent involvement with early-stage companies, private equity funds are frequently referred to as less volatile than traditional public market small cap investments. Yet, private equity funds do not reflect 'general market conditions' in their underlying investments - like the effect of 2022 market conditions on public market equities - and are typically calculated gross of performance fees (including carried interest charges noted below).

Private equity funds have a long investment horizon up to 7-10 years and, during that time, investors' capital is tied up in the fund. Unlike publicly traded small cap securities, which can be bought and sold on an exchange, private equity investments are not easily tradable. Investors may not be able to access their capital when they need it, which can be particularly problematic during times of market volatility or economic uncertainty. Which makes private equity investing more suited to institutional investors with long term liability structures but less so for individuals.

In conclusion, while private equity investing may provide investors with the potential for high returns, it also comes with its own set of risks. These risks include illiquidity, high levels of leverage, conflicts of interest, and transparency. We contend that institutional investors should place more emphasis on the traditional small cap investment class, which avoids many of these issues.

Small cap investing focuses on certainty – strong management teams and competitive advantage, combined with proven cash flow generation – to maximize the potential investment opportunity. Investors typically target companies with attractive free cash flow generation to eliminate corporate debt over time, and charge transparent management fees, typically a fraction of those charged by private equity funds. Finally, with public market liquidity, the investor can reduce their exposure when markets become over-valued, as they did in 2021, or increase exposure as markets begin to exit the trough, as they are doing currently. By these measures, as a new market cycle unfolds, investors should give more credence to small cap investing.

Smaller companies will be key core equity investments through the next market cycle. But more on that later.