Quarterly Comment - II 2014

Daily share prices are set through the balance of supply and demand. This is quite a simple algorithm. Yet, the forces behind bid and ask prices put forward by market participants to the order book of an individual company are myriad and not always rational.

Ideally, an efficient market would have all investors evenly informed and constitute a share price equal to intrinsic value. However, particularly in the arena of micro and small caps where few institutional investors and financial services institutions engage, information inefficiency can prevail among a small pool of investors as opposed to the large cap arena where sometimes thousands of investors and analysts cover the very same company.

The obvious risk and chance in smaller companies is that sometimes one investor is sufficient to influence share prices considerably up or down. But is this particular investor always better informed? Is this investor only interested in correcting any inefficiency in the share price or has he or she other conflicting interests?

In theory, it can happen that market value corresponds to fair value. But I would argue that there are regular cases in the micro cap and to a lesser extent in the small cap market place in which the share price oscillates too far above or below fair value. By default, special interest is given to opportunities where the share price declines to below intrinsic value. In this case at least one investor misinterprets information, is not well enough informed or follows an agenda that is not connected to a correct valuation. While the first two reasons are very subjective and disputable, the latter can cause an extraordinarily straightforward investment opportunity.

The most obvious category for an investor to sell a position below fair value is that he or she needs cash, a category also dubbed distressed sellers. The classic example is a mutual fund that receives large cash redemptions from clients. Hence, the fund manager must liquidate positions of the portfolio no matter what the intrinsic value. Because of this scenario I am rather wary of large mutual funds having acquired into micro caps. They constitute additional downside risk and higher correlation to the overall equity market. On the other hand, once a large mutual fund decides to buy into a micro cap, the share price usually lifts substantially and offers a quick exit opportunity.

Also, other private investors face occasions in which they need to sell a stake in a company. Private wealth managers are subject to the very same cash redemptions of clients but usually not in the size of mutual funds. Furthermore, rather mundane reasons such as personal needs to buy real estate or transferred estates to heirs with other interests cause supply of shares below fair value. In addition, in the private space decision taking becomes less rational and sometimes dependent on personal interactions and considerations of the involved parties. I have experienced situations in which investors with large stakes paralyzed each other, suppressing not only the share price but also strategic decision taking at a company.

Another reason is rooted in the performance of an investment. Negative returns are not appealing and their origins get often removed by asset managers so that clients don’t realize what went wrong. Moreover, recent good returns – even still below fair value – get realized in order to show strong returns to potential new investors, a feature often seen in private equity for new fund raising activities. Or sometimes an individual company just doesn’t fit into a certain picture or theme that an asset manager needs to window dress for new fundraising.
And last but not least, changes in fund manager or asset manager could easily spawn a portfolio reorganization, in which some former positions just get axed. And there are certainly more examples.

Once such inefficiency or general undervaluation of a company can be discerned, an investment opportunity arises. The tricky part will be to evaluate if and when such a distortion can be resolved. In the case of redemptions or manager changes it is usually a matter of some days or weeks, depending on the scale of the position to be liquidated. In the case of personal disagreements between shareholders and or management, one is probably better off if a solution becomes tangible. Nevertheless, most of the time recognizing an opportunity is not black and white and even if one can identify an undervaluation a catalyst is very rarely waiting to move the share price closer to fair value.

This brings me to the last ingredient for exploiting micro and small cap market inefficiencies, namely long-term investors with the horizon to follow through until market forces correct share prices to intrinsic value. Not much could be more devastating than pro-cyclical investors who pull out at the wrong time, aggravating the situation. Time arbitrage is the concept of taking advantage of the short-term needs of other investors. It can be tough, though, to wait months or possibly a few years until a selling position is cleared or in other words to be outnumbered by higher demand.

Investors need to bring an understanding of these potential distortions to the table and will then be able make the right decision at the right time. Profound knowledge of both companies and investment strategy supports correct decision taking in challenging times, also because risk is often associated with too little information.

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