<u>QUARTERLY COMMENT – IV 2017</u>

On 3 January 2018, the new financial legislation MiFID II became effective. While it was predominantly meant to strengthen investor protection, it will have serious side effects on the inefficiency of small & micro cap markets.
Even though the European Securities and Markets Authority claimed that MiFID II would improve the functioning of financial markets, making them more efficient, resilient and transparent – particularly with respect to so-called dark pools – it will likely have the opposite effect on niche markets such as the smallest segment of equities – at least in the short to mid-term.

In the past, more than 90% of the sell-side research coverage on small and micro cap companies was paid by the companies themselves – thus not really being independent opinions. But everybody knew and that was fine because it was available for free and everybody could make his or her own adjustments (beware of the anchoring bias).

Now, the asset/fund manager must pay for sell-side research otherwise he or she would be deemed conflicted, having received a service for free (and for which he or she will have to compensate in some way not transparent to investors). Sell-side brokers/research providers used to get orders in return, which generated transactions fees that covered the outlays for research in the first place. But now this chain is broken by MiFID II – probably for the right reasons. However, what has become transparent in the past few weeks is that very few asset/fund managers will pay for small & micro cap research. Brokers/research providers will soon adjust their offering accordingly and the information inefficiency of this market segment will increase.

Needless to say that I find this development encouraging, offering an enhanced potential to gain information advantages by primary in-house research. It will mean a lot more direct contact with small cap companies to attain the same level of information as compared to just having an inundated email inbox with myriad research reports. Moreover, it will take the small & micro cap companies to pick up the slack and professionalize their investor relation’s endeavors.

It looks like some form of “intermediation” will get lost though, where a broker/research house mediated between companies and asset/fund managers. Even though the company paid the broker for his or her research, the latter did important sanity checks and had a reputation responsibility on his own. After all, if the asset/fund manager deemed the research useless, no follow-up business was possible from the other side. In the future, research looks like to get paid for solely by the companies, a fact that reduces further the independent quality of research reports.

Eventually, I think the changes bring opportunities to our investment strategy, which has been and will be based on information not being attained by research reports. Investor competition might further drop and thus offering additional return potential.

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