OTC Markets Advisor Insights Podcast

ACF Equity Research Season 2 | Episode 2

OTC Markets Group: From OTC Markets' global headquarters in New York City, you are listening to Advisor Insights, where we feature professionals that will address the issues that affect the small-cap companies that trade on the OTC Markets. Today, we have Christopher Nicholson and Renas Sidahmed of ACF Equity Research, a London-based firm that is a provider of corporate research. Christopher, Renas, thank you very much for joining me today. Before we address the question of liquidity and volatility and why does that matter for nano and small-cap companies, can you perhaps provide some background on ACF?

Renas Sidahmed: Yes, we can. Hi, Matt. Thank you for having us on the podcast, and also thank you to the listeners. ACF Equity Research is an independent investment research company. We specialize in the highest specification of equity research for corporate clients. We also have a global footprint and we are a preferred research provider to several exchanges, including the OTC.

Christopher Nicholson: I think, Matt, it's also worth adding that we have a very international culture, and we are forward-thinking, and I think an example of that is that, as Renas said, we provide this institutional-grade investment research, which we then make available to a very wide audience. So a lot of it goes to the retail audience at exactly the same moment that it goes to the institutional audience, and I think that is a key difference given the grade of what we produce.

And I think there's another thing. We have a culture and philosophy in the firm which underpins everything we do. So our aim is to maximize the effectiveness of capital markets for all. So that's for corporates and investors, and in that way, everyone does better, because you have more ideas, you get more innovation, it attracts more capital, you get more growth, which means more jobs and more education, and that, in the end, leads to emancipation. And because we have this global footprint, that philosophy is important to us.

OTC Markets Group: Thank you for that, and as mentioned, today's topic is liquidity and volatility. So with that, I guess the first question is why does liquidity and volatility matter, and why should companies not be taking their eye off the ball?

Renas Sidahmed: So, Matt, I'm going to break it down for the listeners, and start with liquidity and why liquidity is important. So liquidity, which is often measured by the volume of stock traded, and it determines how quickly you can open and close a position, or whether or not you can open and close a position. So a seller, or the company, is actually able to find a buyer or the investor quickly enough without having to change the price of the stock. So the more liquid the stock, the lower the risk in holding it, so the higher the valuation for the company. The more attractive a stock is to longer-term investors, the easier it is for smaller companies to raise their capital to maintain the value of their current business operations and ultimately to increase the valuation of their company.

Higher liquidity is self-reinforcing positive. So this means the increased volume of trades leads to an increase in the supply and demand for the asset or the stock. In other words, if liquidity is improving, more investors are going to be attracted to that stock, which means then the liquidity improves, and so on and so forth. Of course, everything I've mentioned is the theory of why liquidity is important, but in practice, there are points in which even largecap stocks can be illiquid at certain times, and actually the whole market can be illiquid temporarily. Benefits of liquidity, however, are lower transaction costs, so narrower spreads; more frequent trading; and a more realistic trading price; and on average, higher trading volumes for these companies.

So moving on to volatility: so volatility is the degree of variation of the trading price and the volume of stock traded over a given period of time. Volatility is to be avoided, but it should not be confused with liquidity. A liquid stock is one that can be bought or sold in the volumes that investors require without moving the share price, as I touched upon before. Also, volatility suggests that sometimes the stock or the asset is liquid, but sometimes it's not, and that is also what makes it unpredictable. So stock is volatile when the volumes of stock traded suddenly increase dramatically, and this can happen over extended periods of time, or equally, they can fall steeply. As such, too much volatility makes the asset less attractive to investors, which means a higher investment risk for the investors. The price volatility tends to follow trading volume volatility, so this means the larger the standard deviation, again, the higher the investment risk.

However, there is one class of investor that is actually attracted to high price volatility, and these are day traders, which can be retail or professional. An element of short-term trading is often required for liquidity, but too much short-term trading can be extremely dangerous to a public company's future, to their survival and their overall evaluation. Short positions are also damaging, as apart from the obvious issues of driving a stock price to zero or near to zero, successful short positions amount to direct transfer of wealth from company management and supportive long-term investors to the investors with these short positions. So in addition, longer-term supportive investors will avoid stocks with high price and volume volatility.

OTC Markets Group: Very interesting, and in our conversation today, I think we're trying to target the nano and the small-cap companies. They've become increasingly attractive to investors due to what you can call the small firm effect: high capital growth for investors, and an environment of quantitative easing and super-low interest rates in spite of their volatility. Why is volatility such a cause for concern for these smaller companies?

Christopher Nicholson: I think that's a great question, Matt, and it does need addressing, because it isn't clear. But actually, there is a clear answer to it, and it's this. As companies grow, they need a larger number of cornerstone investors to support capital requirements for growth. Put another way, volatility or lack of liquidity are a significant barrier to growth. And this is acute for smaller companies, and this is because longer-term investors, and those with deeper pockets that are needed to supply capital for continued growth as they get bigger, have a vast top of the funnel to pick from. So in other words, if you have high volatility and low liquidity, you get filtered out as a nano-cap, small-cap company. And then the small firm effect comes to a crashing halt without access to growth capital. So you're not getting to the next level of investor that you need to support you.

The transition from small to medium stock never occurs, and so the companies effectively fail. They become zombie stocks. They're surviving, but they're not growing, so you're losing that fabulous small firm effect. And the zombie stocks, they tend to be trapped in a neverending need for small amounts of new capital, which is inefficient and usually is expensive as a result, relative to competitors, to keep. And they're doing this just to keep going rather than to prosper and grow.

And at this point, such firms become a daily target for day traders. Whether it's being in a long position or a short position, it's a very short-term position and you get this downward spiral, which is extremely difficult to break. So how do you solve the problem? Well, you want liquidity without the volatility, and you need to increase volumes to increase the share price. And of course, this sounds like an obvious statement, given what we've said, but there are answers to the problem.

OTC Markets Group: So what can these companies do to increase their volumes that you speak of?

Renas Sidahmed: Yeah. So there are several ways that companies can increase their volumes. They can widen their reach, which means broadening their investor base, so this will attract long-term investors and squeeze out the short term traders. These investors must be alerted to and fully understand the company story. The company must have a cogent story. They must deliver a credible business plan or have a pivoted story. They need to also engage in governance and deliver those metrics to the markets. The analysis in the market needs to be delivered by credible third parties. Companies also need to engage in the fullest possible transparency within in the markets. Of course, they need to be commercially rational about what kind of information they put out in the markets, but this information needs to be verified by third parties.

They need to discourage day traders and short-position investors, especially naked shorts, by making their story and position unappetizing to day traders. In doing so, they need to kill the volatility by squeezing out short-term trading, and this is done by having a consistent, mid- and long-run increases in the share price. It also requires liquidity without volatility, but at the same time, they are widening the reach of their story. Companies need to have a more ambitious view of the number and geographical breadth of investors they're trying to reach. It is great to be in the deepest pool in the globe, but everyone knows this, and so it is also the most competitive capital pool in the world. Capital markets are constantly evolving and they are constantly broadening, but companies still have to be able to reach these pools of capital, and as it stands, the traditional broker model does not work to that effect.

OTC Markets Group: So let's talk about that for a second. When you say the traditional broker model does not work, what do you mean by that?

Renas Sidahmed: So with the traditional broker model, the analyst coverage is actually limited. So what that means is that analysts are limited to their client base, which is the portfolio managers or collective retail funds who are considered to be clients of the broker or the investment bank. So these are clients that are actually putting trays through the broker or investment bank, or perhaps increasingly paying a retainer in one form or another. So they have an agenda that the analyst actually needs to work towards. In addition, brokers are steeped in a culture of personal interaction, and while this still has tremendous value when it is possible to do so, the reach of small and medium houses is actually extremely limited, and in addition, the influx of millennials into both professional and retail investing is generating a very different dynamic with very different needs.

OTC Markets Group: That's all very interesting, and that leads me to my next question. What can companies do that they aren't already doing to increase their reach to this large pool of investors, whether old or new?

Renas Sidahmed: Yes. Well, I might be singing our own praises here...

OTC Markets Group: And there's nothing wrong with that, Renas.

Renas Sidahmed: Good. Thank you, Matt. But the solution to that is research, but the research needs to be creative, consistent, and strategic. Companies need to implement a highly effective distribution strategy so that the research is able to reach a key audience and a wider investor base.

OTC Markets Group: So when you're talking about that audience, how does research provide more transparency for the investors, and how does that differ from what they are already doing with regulatory news reporting?

Christopher Nicholson: So, Matt, I'm going to take this on in my Head of Research function here. So the investor community needs transparency before making an investment decision, and they can get that through good-quality research from trusted sources. So what investors want is they want company transparency so they can carry out their own diligence, but they have neither the time, desire or resources in most cases to carry out stock-specific, comprehensive investment research. In addition, investors want to hear about prospects of the company as filtered by a third party that is not IR, the PR or the broker. These parties are all still very important and valuable, and they have important roles to play, but it is not the role of these advisors to provide a third-party opinion of the investment case.

So retail investors are increasing in number. This is driven by economic developments across the globe and the rise of the middle classes across the globe. Millennial investors in particular are coming into their own now, and they're not interested in the traditional broker model. They like to do things differently. Investors want to make their own decisions. They don't want to make decisions based on what the companies say about themselves, but they want to use information from third-party assessments and interpretations. How companies relay that information is crucial, and the relationship between analyst and company has always got to remain somewhat at arms' length. That's even if you are our corporate client. And there's a subtle balance to be achieved, and it's about building trust and respect between our client and what the market needs. And that's how clients will get the best return on investment from the research and how investors will get the best return on investment from their time in reading our research.

OTC Markets Group: Christopher, Renas, thank you very much for joining me today. It's been great to have you. I hope our issuers learned as much as I did.

Renas Sidahmed: Thank you, Matt, and OTC for having us on this podcast, and thank you again to all of our listeners. If you would like to find out more about ACF and read some of our research, please visit us on our website at www.acfequityresearch.com. Thank you.

OTC Markets Group: You can also find ACF Equity Research listed under the research provider section on the premium provider directory.

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