Title:
Rags & Riches: The Small Cap Maze

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Summary:
Conventional wisdom dictates that the early stages of a corporation’s growth cycle offer substantially more compelling risk-reward profiles than advanced stage investments. But that is exactly where the reality of that proposition ends. In actual fact, the Medium and Small Capital matrix has accumulated so many unsustainable business models over the previous decade that major brokerage houses have little or no problem in persuading hundreds of thousands of investors, both institutional and retail, to keep their money in companies with a proven past.

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The junior markets are plagued by a number of fundamental issues. At one end of the junior spectrum, e.g. the Pink Sheet marketplace, corporate disclosure is so limited that a stock purchase is akin to gambling in a casino. Moving to a slightly higher level, the OTC Bulletin Board system continues to struggle between demanding greater public information on one hand and increasing the sheer numbers of listed counters on the other. The OTC Bulletin Board does require companies to report accounts and material developments on an ongoing basis but as many investors have found out to their cost, regular filings do not necessarily translate into quality.

All that said, there is no question that the senior markets do not, as a general rule, offer exponential returns. For instance, credible returns in excess of 1000% per annum are periodically recorded over the Pink Sheets and OTCBB trading system. The problem, therefore, lies in the selection process. How does one pick the winners?

Again, conventional wisdom suggests that the process of picking winners (and dropping losers) should have become a relatively straightforward exercise with the advent of the Internet. After all, as many believed in the late 1990s, the web-based information explosion should have led to a higher degree of informed decision-making.

That, however, has not been the case. On the contrary, as a New York-based hedge fund manager wrote in a client report last week, “there are too many websites and too many emails throwing up all kinds of untested ideas, so we have decided to refrain from participating in anything outside the established stock exchanges.” An executive of the London Stock Exchange was less charitable at a recent investor presentation. “Junior companies are making all kinds of ridiculous claims on websites and in emails, and investors should wait until the regulators have a handle over all that, whenever that will be,” she said, stressing the “whenever” portion of her statement.

But that “whenever” might be too far away, as a survey indicates. And that is because the selection basics that separate the good from the bad are not in dispute. The first selection priority is the availability of comprehensive information. The second is the willingness of listed companies to generate audited financial statements with extensive notes, despite the fact that certain trading systems do not require such data. The third important issue relates to the nature of the press releases: notably, are the press releases saying anything of value in relation to a corporation’s business model?

Finally, has an independent analyst (or researcher) provided any detailed assessment of the assumptions which drive the business model? As has become evident in recent years, many juniors are selling dreams; unfortunately, in more than a few cases, managements sincerely believe that they are involved in a “stock play”, not in the usually painful exercise of building shareholder and corporate value. And, also unfortunately, hundreds of fairly decent business strategies are seriously constrained by recourse to adequate financing.

To conclude, while there is no doubt that investors must access the internet if they are indeed looking for above-average returns, the methodology involved in a web-based analysis needs to be clearly understood.