



# Changes in Capital Markets

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# AGENDA

- Why are small stocks often mispriced
  - **Limited Awareness** – The Sell Side model is broken
  - **Limited Liquidity** – Where did the buyers go?
- Investing not trading
- Watch out – sharks at shallow end



# DEFINITION – SELL SIDE

## WHO IS THE SELL SIDE?

- Broker/ Dealer analysts
- Institutional Brokers
- Investment Bankers

**Earn Commissions and  
Investment Banking Fees**



# DEFINITION – BUY SIDE

## WHO IS THE BUY SIDE?

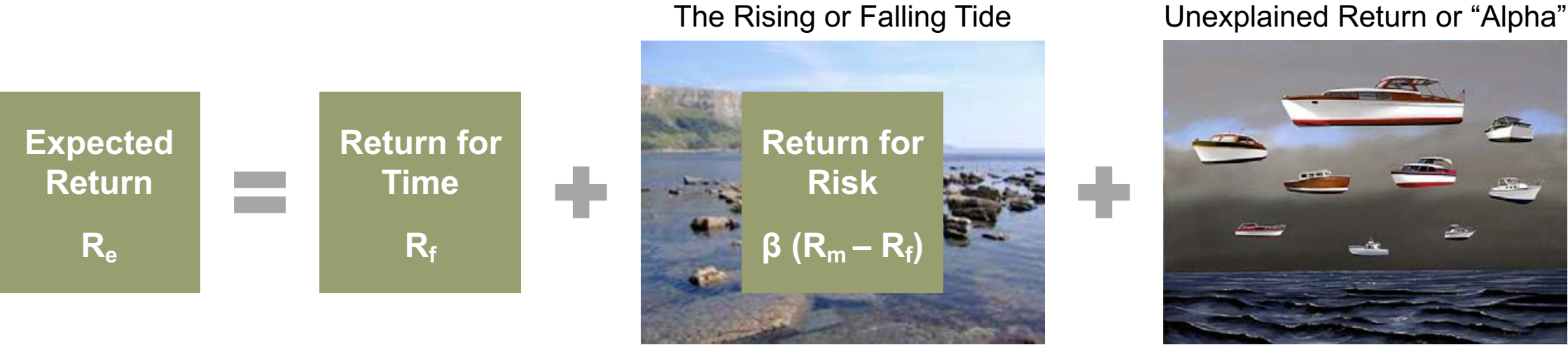
- Money Management Firms
- Hedge Funds

**Earn fees to select and manage a portfolio of individual stocks**



# DEFINITION – “ALPHA” UNEXPLAINED RETURN

## Capital Asset Pricing Model



## Efficient Model Hypothesis (EMH)

It is impossible to "beat the market" due to stock market efficiency

Assumes perfect information

Holds true for large cap stocks

More opportunities for alpha for small cap stocks

# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Awareness – The Sell Side Model is Broken

The Sell Side can't make money covering small companies that don't need to raise money

## Limited Liquidity – Where did all the Buyers Go

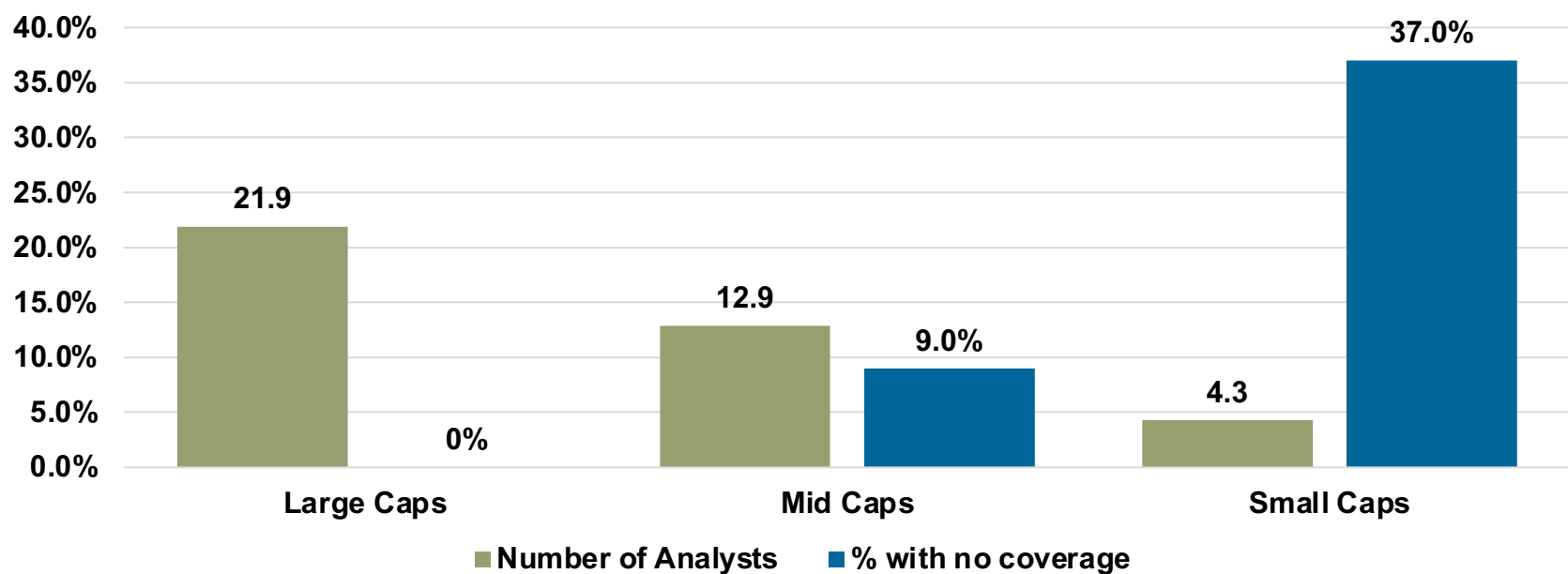
When large positions change hands, lower trading volumes cause significant fluctuation in price

# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Awareness – The Sell Side Model is Broken

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### Limited Sell Side Coverage



# WHY ARE SMALL STOCKS OFTEN MISPRICED?

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## Commissions are Shrinking

- **Pricing** ↓
  - From \$0.125 (1/8th) to less than a penny per share
- **Volumes** ↓
  - Increase in electronic trading (Instinet, Island, others)
- **Reg FD**
- **MiFID II**
- **Widespread availability of information and analytical tools**



# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Awareness – The Sell Side Model is Broken

The Sell Side can't make money covering small companies that don't need to raise money

Small caps  
don't generate  
enough  
commissions

Average Analyst Compensation	\$250,000
Commission \$ needed to cover 10% allocation to research	\$2,500,000
Commissions per share	\$0.01
<b>Number of Shares</b>	<b>250,000,000</b>
Divided by Number Stocks followed	12
Divided by Number of Trading days per year	250
<b>Number of Shares required to trade per day (per stock)</b>	<b>83,333</b>
XYZ Large Cap Company Trading Volume	2,000,000
Number of Analysts that Follow the stock	22
<b>Equal Share of Trading Volume</b>	<b>90,909</b>
ABC small cap company trading volume	100,000
Number of Analysts that follow the stock	4
<b>Equal Share of trading Volume</b>	<b>25,000</b>

# WHY ARE SMALL STOCKS OFTEN MISPRICED?

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## The Sell Side commission model is broken

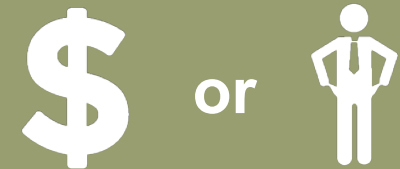
I give you  
a car



Three to six  
months pass



You decide how  
much to pay



# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Awareness – The Sell Side Model is Broken

The Sell Side can't make money covering small companies that don't need to raise money

## Sometimes The Fee Comes Before the IDEA

### Sell Side business model is skewed to banking fees

\$500 million small cap Company with \$20 stock price

#### Investment Banking Fee

6% fee on \$100 million offering generates \$6 million in fees

**vs**

#### Commissions

To generate the same fee requires trading \$12 billion of the company's stock

### Sell Side are incentivized to focus where the fees are...

- Companies that consume equity capital
- Companies that need growth capital

### Dilution decreases opportunities for alpha

# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Liquidity – Where did all the Buyers Go

When large positions change hands, lower trading volumes cause significant fluctuation in price

## The Buy Side can't buy small stocks

### Size of Assets

Assets under Management	\$500,000,000	\$100,000,000	\$10,000,000
Number of Positions	120	80	40
Average Position Size	\$4,166,667	\$1,250,000	\$250,000

### Revenue Potential

Fees percentage	1.5%	1.5%	1.5%
Fees Generated	\$7,500,000	\$1,500,000	\$150,000

### Days to Build an average size position

<\$100MM	41.7	12.5	2.5
\$100MM to \$250MM	8.3	2.5	0.5
\$250MM to \$500MM	2.8	0.8	0.2
\$500MM to \$1B	1.0	0.3	0.1



### Average Daily \$ Trading Volume by Market Caps

<\$100MM	\$100,000
\$100MM to \$250MM	\$500,000
\$250MM to \$500MM	\$1,500,000
\$500MM to \$1B	\$4,000,000

# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Liquidity – Where did all the Buyers Go

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## Retail Brokers Can't Recommend Small Stocks

- Retail brokers transition from “stock pickers” to “asset gatherers”
- Compliance departments intense scrutiny





# WHY ARE SMALL STOCKS OFTEN MISPRICED?

## Limited Liquidity – Where did all the Buyers Go

When large positions change hands, lower trading volumes cause significant fluctuation in price

**Less liquidity makes our partner, “Mr. Market” more irrational**

**Mr. Market is our partner and he is manic-depressive**

- **Very pessimistic** – Buy when he is irrational
- **Wildly optimistic** – Sell when he is irrational

**Selling for non-fundamental reasons**

- Tax loss
- Margin calls
- Fund redemptions
- Change in fund manager

**Active Versus Passive Money**

- 70% of Equity flows are into Passive investments (ETF, Index funds)

# INVESTING NOT TRADING

**Expect small cap investments to be very volatile**

**Venture Capital that is “Marked to Market Every Day”**

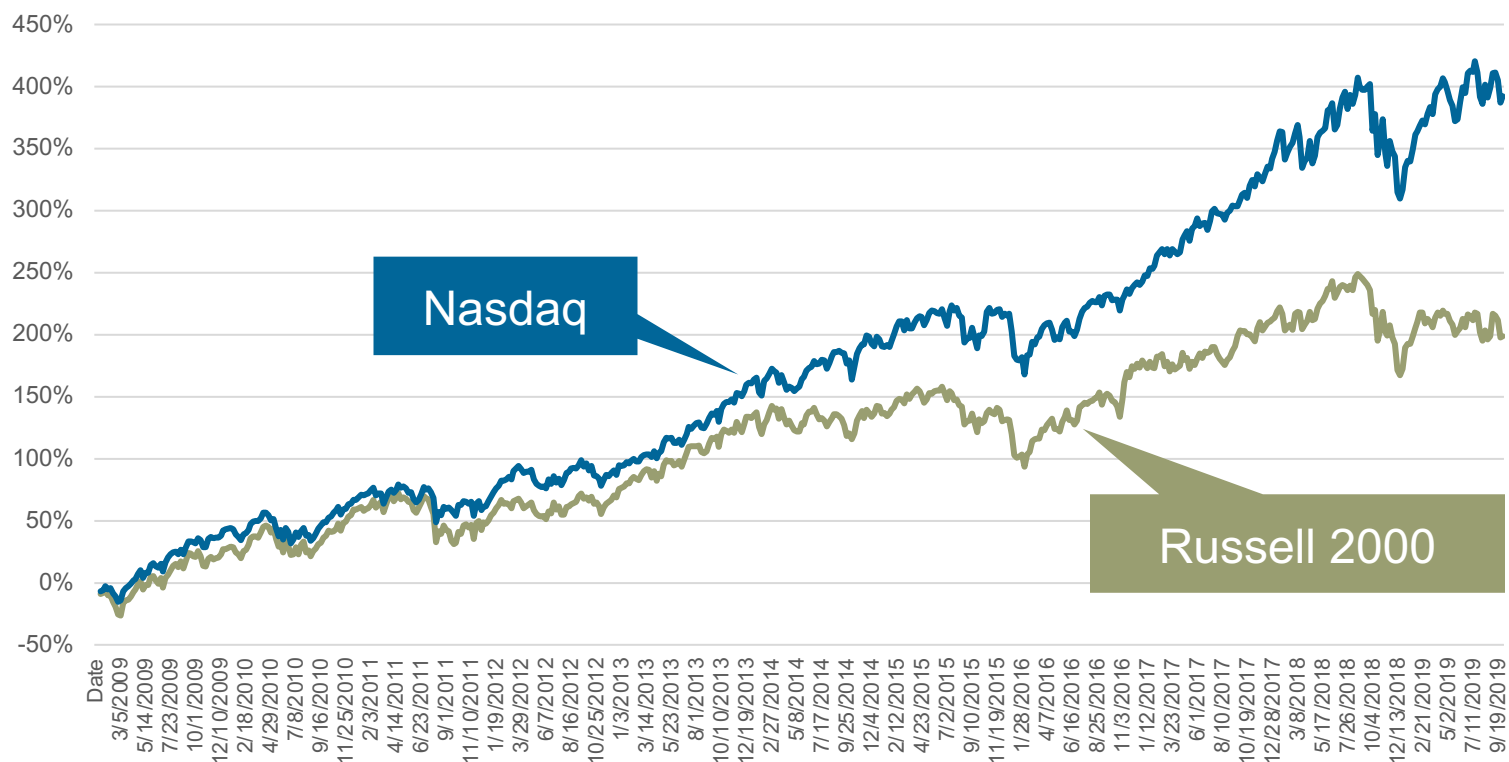
**Expect to invest for 3-5 years, not 3-5 weeks**

**Risk is permanent loss of capital – not stock price volatility**

# SMALL CAPS RELATIVE PERFORMANCE

## Russell 2000 versus Nasdaq Since 2009

Period of small cap underperformance near longest in history



**1926 to 2019**

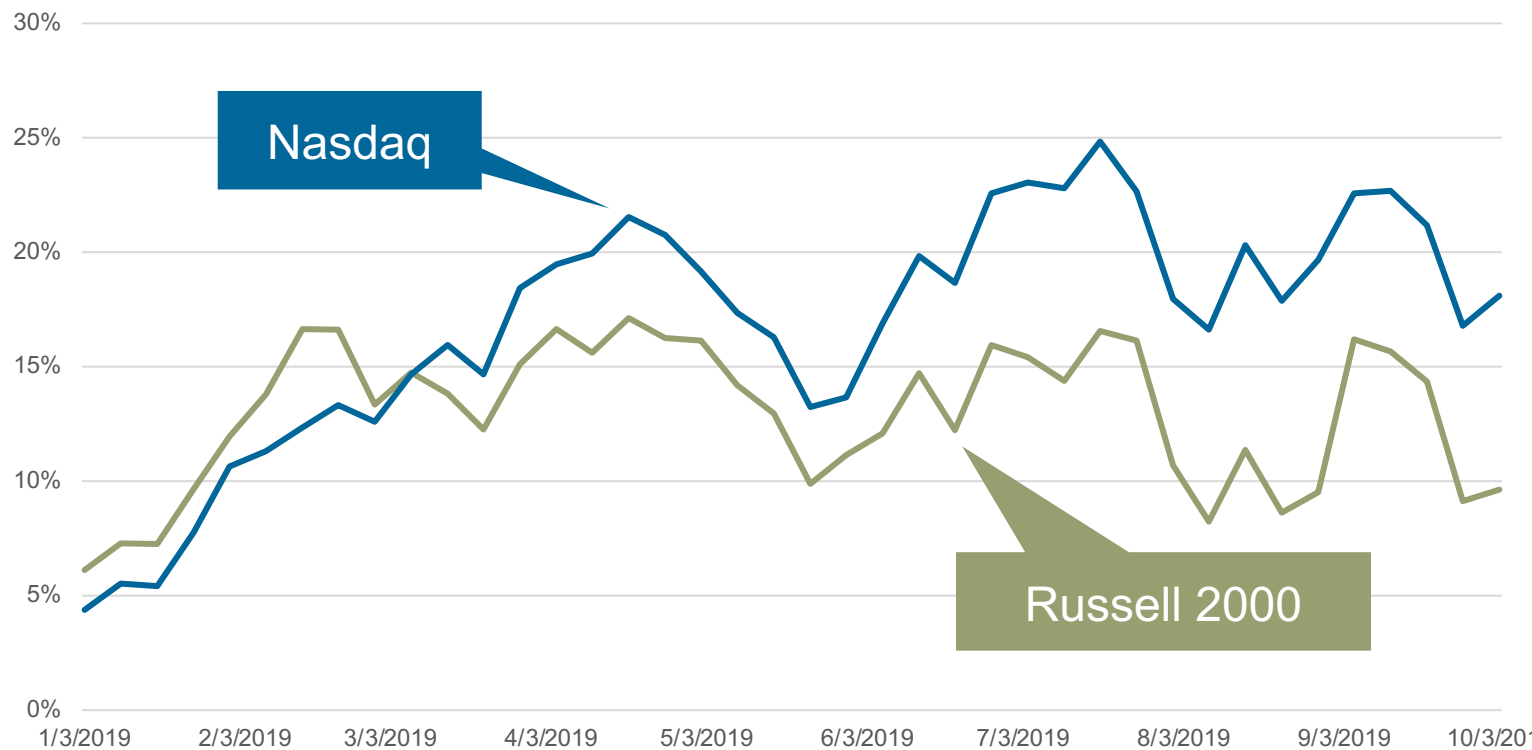
Small Cap Stocks –12%

Large Stocks – 10%

# SMALL CAPS RELATIVE PERFORMANCE

## 2019 YTD Russell 2000 versus Nasdaq

Small Cap underperform 8% YTD



**Potential for  
reversion to  
the mean**

**Small Caps have  
less international  
exposure  
(China Europe)**

# WATCH OUT – SHARKS AT SHALLOW END

## **Toxic Financiers**

Offer convertible, or preferred securities  
with toxic terms

## **Serial Capital Raisers**

## **Overly promotional IR marketing**

## **Overly optimistic management**

They are not sharks but they  
have a hard time tempering expectations





## **We are a source of IDEAS**

- Investor Relations Consulting
- IDEAS Investor Conferences

## **We believe...**

- The IDEA comes before the Fee
- There are opportunities for above average returns with small companies
- It is important to remain independent – No referral fees, or Quid Pro Quo from referral sources

### **IDEAS Track Record**

1 in 8 acquired  
at 50% premium

6 in 10 outperform  
Russell 2000

Outperformed  
Russell 2000  
2 percentage  
points annually



# THREE PART ADVISORS

## We like...

- Names that don't get a lot of attention from Wall Street
- “Capital light” business models
- IDEA suggestions from well-informed buy side investors

## We avoid...

- Serial Capital Raisers
- Overly promotional management teams
- Industries where you only have to be right 1x out of 10 to win (biotech, E&P)
- IDEA suggestions from investment bankers

# THREE PART ADVISORS, LLC – CURRENT CLIENTS



# Why Three Part Advisors?

## Investors Trust us to Generate Great IDEAS

### IDEAS Investor Conferences

Our conferences are sponsored by buy-side money management firms and held annually in Boston, Chicago, and Dallas. Attendees are limited to presenting company's management teams and professional investors only. Each conference has an average attendance of 350 investors and 70 presenting companies per event.

### We structure our IDEAS conferences to outperform the market over time

**“Sponsored By Investors. For Investors.”** – We leverage the brain power of our money of smart investors to find the best companies to invite to present

**Focus on under-followed and under-appreciated companies** – This is the pool of companies that is most likely to produce alpha. Not companies that need to raise money

**Having the discipline to say “no”** – We turn down companies that do not fit our criteria

**Collectively, six out of ten companies that we have interacted with have outperformed the market.**

# Recap

**The best  
place to look  
for alpha**



**Small Cap  
Stocks**

**Opportunities for small investor to outperform**





**THANK YOU**

**[threepartadvisors.com](http://threepartadvisors.com)**