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Mackenzie Europe Team

MIFID II leads to new opportunities in European SMID caps

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Introduction

International small and mid (SMID) cap equities have become a bright spot in institutional allocations, delivering outsized returns relative to their large cap peers. The outperformance of the asset class [relative to international large cap equities] can largely be attributed to its relative informational inefficiency. In that context, Europe's implementation of MIFID II, the largest regulatory overhaul of its financial services regime in more than a decade, has had a significant impact on the research landscape for SMID cap companies.

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While the aim of the regulations has been to deliver greater value and transparency for investors, MIFID II has sharply polarized opinions. Many within the European investment community believe the unintended consequences significantly outweigh any benefits. In this paper, we explore the practical implications of MIFID II on European SMID caps since its introduction. We also make the case for why these changes have increased market inefficiencies, making it increasingly fertile ground for experienced, disciplined and well-resourced active managers to continue delivering favourable risk-adjusted returns.

What is MIFID II?

The introduction of the Markets in Financial Instruments Directive (MIFID II) on January 3, 2018, represented the largest regulatory overhaul of the European financial services industry in more than a decade. Central to the change was the requirement among providers of research, such as investment banks and brokers, to separate prices and charges for research from trading costs (commissions and spreads).

The motivation for introducing these rules was to alleviate potential conflicts of interest between investment managers and their clients when transacting with brokers. As we pass the two-year anniversary of MIFID II's introduction, the legislation has been adjudged to have had many unintended consequences, particularly on SMID cap investing. These implications could spread far beyond Europe's borders, with the U.S. Securities and Exchange Commission under pressure to adopt similar regulations.

European SMID cap research landscape

European SMID cap equities have historically been subject to lower research coverage relative to their larger cap peers. As can be seen from Figure 1, large cap stocks in continental Europe are covered 4.5-to-1 over SMID caps, and 3.5-to-1 for the UK. That lack of coverage stems from the business model of sell-side firms where trading volumes in large cap stocks generate the bulk of bank and broker commissions.

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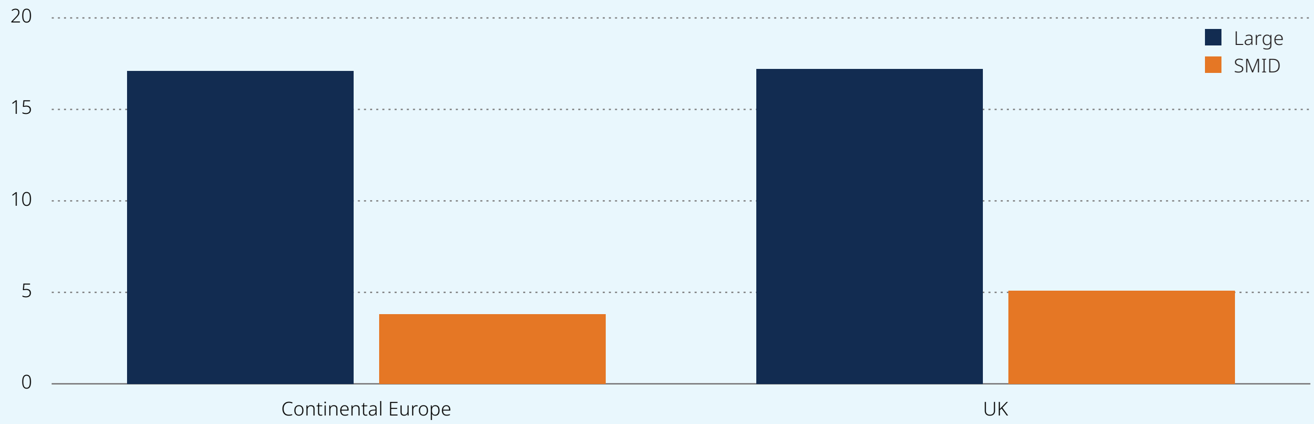
Figure 1 | Average analyst coverage per company by market cap

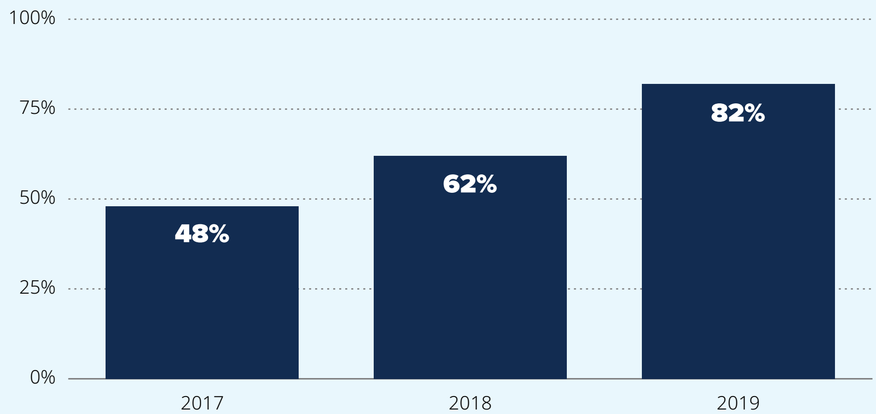


Source: JP Morgan 2019, Mackenzie Investments Europe

However, many market participants have bemoaned a perceived reduction in coverage following the introduction of MIFID II. A recent study by YouGov (2020), found that 82% of 150 fund managers surveyed noted MIFID II had led to a reduction in SMID cap research coverage. This was a sharp increase from the 48% recorded in the same survey in 2017 (Figure 2).

This highlights the fact that in the eyes of many investors, the implications of MIFID II on the research landscape is more of a journey than a one-time event.

Figure 2 | Percentage of fund managers who believed MIFID II had led to a reduction in SMID cap research coverage



82% of 150 fund managers surveyed noted MIFID II had led to a reduction in SMID cap research coverage.

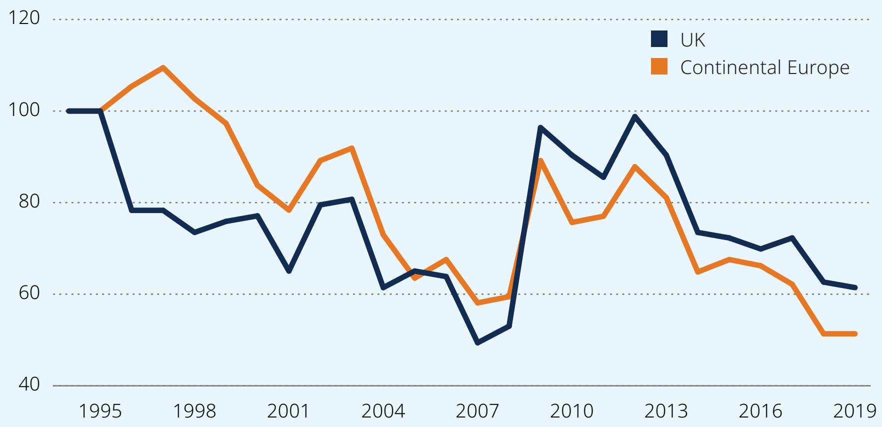
Source: YouGov QCA/Peel Hunt Mid and Small Cap Survey 2020

Fund manager perceptions on the decline in the quantity of European SMID cap research is supported by numbers. A study by Fang, Hope, Huang and Moldovan (2019) found that up to 334 European firms have completely lost their analyst coverage[1] since the introduction of MIFID II. Furthermore, estimates from JP Morgan serve to highlight that the number of analyst recommendations per stock on continental European SMID caps has declined by 22% since the end of 2016 and is down 12% in the UK over the same period.

What's more striking however, is that MIFID II has merely marked an acceleration in a trend among sell-side firms retrenching from SMID cap investment research over recent years, primarily on the back of falling commission pools and increasing regulation.

[1] Fang, Hope, Huang and Moldovan (2019) 'The Effects of MIFID II on Sell-Side Analysts, Buy-Side Analysts, and Firms', Rotman School of Management Working Paper, University of Toronto

Figure 3 | Marked decline in European sell-side analyst coverage

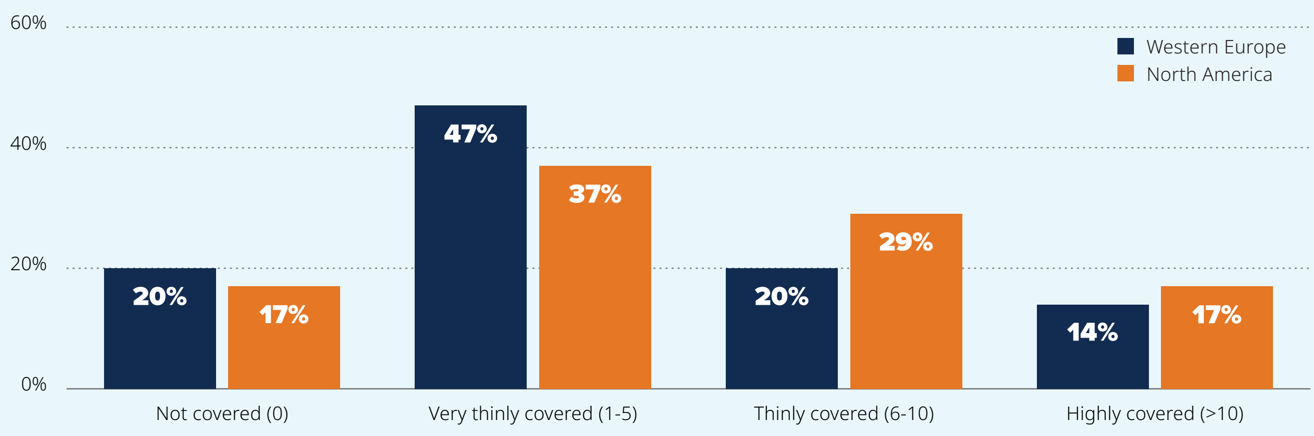


Source: JP Morgan, Mackenzie Investments Europe, Avg no. of analyst recommendations per stock <$5bn

The average number of analyst recommendations per stock is now 49% below that seen in the mid-'90s with respect to Continental Europe and 39% below in the UK.

The sharp decline in research coverage, combined with a large investment universe, has left a large proportion of European SMID cap companies with limited coverage. As can been seen from Figure 4, within Western Europe, 67% of stocks are either not covered or have very thin research coverage compared to 54% of those in North America.

Figure 4 | Dispersion in SMID cap research coverage in Western Europe and North America

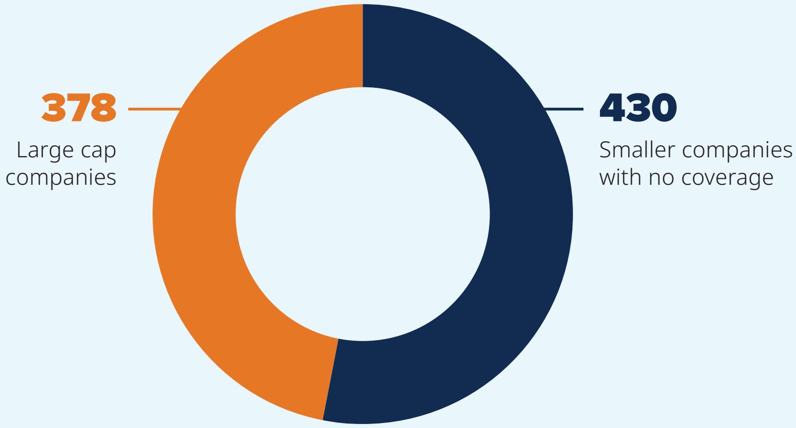


Source: JP Morgan, The SMID View – May 2020, Mackenzie Investments Europe

European SMID cap equities

In our experience, it's not uncommon to find quality, well-positioned companies that are neglected or not yet covered by sell-side research analysts. When such companies are ignored, underappreciated or misunderstood, it can take longer for fundamental news to be priced into the value of the stock and for the investment case for an active manager to play out. Overall, the lower level of research coverage on European SMID cap companies presents a competitive advantage for fundamental active managers with the resources and skills to navigate the asset class, as does the broader decline in the quality of said research.

Figure 5 | Smaller caps with no coverage vs. large cap companies



The number of SMID cap stocks in Western Europe with no coverage is greater than the number of large cap stocks overall.

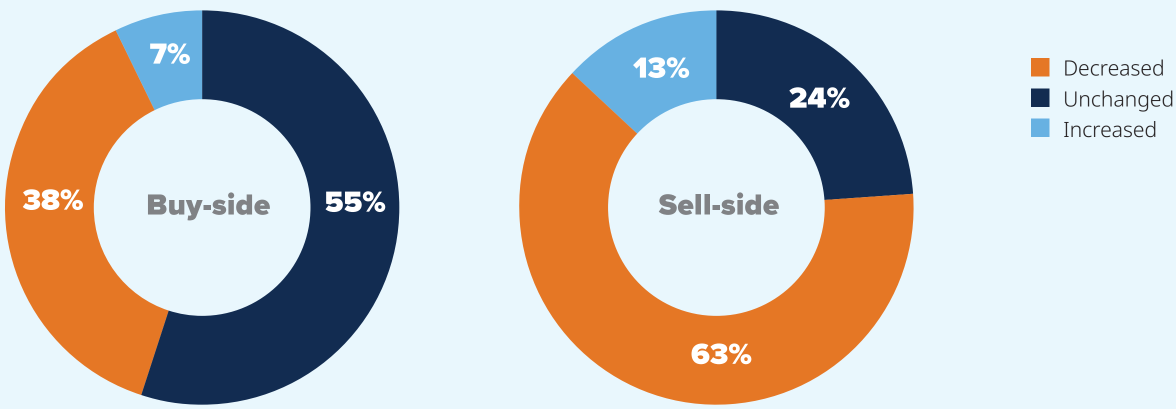
Source: JP Morgan, The SMID View – May 2020, Mackenzie Investments Europe, Data relates to Western Europe

Declining research quality and independence

While any analysis of the quality of sell-side coverage is clearly a subjective matter, recent empirical evidence infers a decline in quality. Research by the CFA institute (2019) found that 38% of buy-side professionals[2] surveyed believed research quality in the SMID cap space has declined since the introduction of MIFID II, compared to just 30% for large caps. The picture painted by sell-side professionals was bleaker, with 63% believing research quality for SMID caps had declined after the introduction of MIFID II, compared to just 40% for large caps.

The CFA findings are supported by research from Lang, Pinto, and Sul (2019), which concluded that MIFID II had 'an overall negative effect on the information environment' for investment research. In particularly, they noted that, after the introduction of MIFID II, "in terms of relationships with management, analysts appear to curry favor by biasing their recommendations upwards and issuing beatable forecasts."[3]

Figure 6 | Perception of a decline in research quality since the introduction of MIFID II



Source: CFA Institute (Unsure opinions excluded), Mackenzie Investments Europe

2 CFA Institute (2019), 'MIFID II: ONE YEAR ON, Assessing the Market for Investment Research'
3 Lang, M. Pinto, J. and Sul, E. (2019), 'MIFID II unbundling and sell side analyst research'

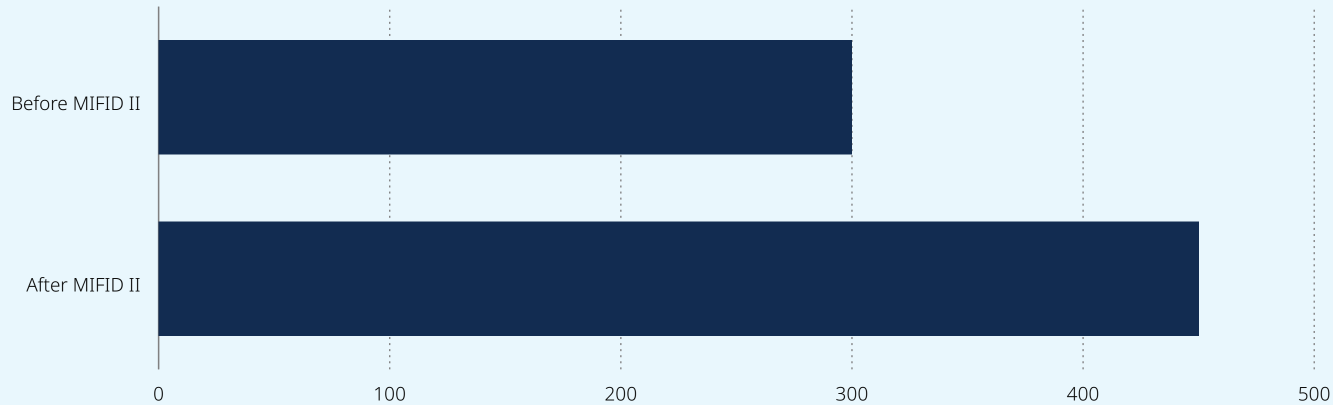
Such concerns about declining research quality and independence are not surprising, given the rise of issuer-paid research and the tactics of bulge bracket investment banks. The CFA Institute noted in its review of MIFID II in 2019, that despite the regulation's intention to level the playing field among research providers, independent brokerage houses have been unable to grow their market share because, "Bulge-bracket investment banks have cut prices to maintain client business and squeeze competitors".[2]

Furthermore, there appears to be a greater reliance on company-paid research after the introduction of MIFID II by European corporations. This is evidenced by a survey undertaken by Nasdaq Nordic of 1,000 companies listed on its main market and its alternative First North market in Sweden, Denmark and Finland. It found that close to 45% of its constituents were now covered by issuer-paid research, largely driven by a 50% increase in the growth of coverage over the prior two years.

While such pay-for-play analysis gives smaller companies visibility in the marketplace, it is arguably littered with conflicts of interest. Investors surveyed by the CFA (2019) expressed significant skepticism about company-sponsored research, "in respect of objectivity, and that it may effectively morph into corporate marketing"[4]. These observations highlight that not only has the quantity of research on European SMID cap companies declined, but so has the quality and independence of a large proportion of research that remains.

Close to 45% of constituents are covered by issuer-paid research, largely driven by a 50% increase in the growth of coverage over the prior two years.

Figure 7 | The amount of paid Nordic research has surged since MIFID II rules introduced



Source: Nasdaq Nordic September 2019

[2] CFA Institute (2019), 'MIFID II: ONE YEAR ON, Assessing the Market for Investment Research'
[4] CFA (2019), 'MIFID II: One year on – An assessment'

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Going forward, for what has historically been a very attractive asset class, we expect the depth and breadth of research coverage to remain low, if not decline further. While there may be some modest relaxation of MIFID II, it is unlikely to change the direction of an overall growing regulatory burden. This, combined with the growth of passive investing, is likely to continue to squeeze the aggregate commission pool for equity research firms.

The growing informational inefficiency within the European SMID cap market is likely to present both challenges and opportunities in an asset class, which, as shown in Figure 8, has added significantly to portfolio performance while also reduced portfolio risk.

Figure 8 | Adding smaller companies has significantly improved risk-adjusted returns.

Allocation		3 Years				5 Years				7 Years				10 Years			
MSCI Europe Large Cap	MSCI Europe SMID Cap	Returns	Change (bps)	Std. Dev.	Sharpe Ratio[1]	Returns	Change (bps)	Std. Dev.	Sharpe Ratio[1]	Returns	Change (bps)	Std. Dev.	Sharpe Ratio[1]	Returns	Change (bps)	Std. Dev.	Sharpe Ratio[1]
100%	0%	9.42%		11.98%	0.65	4.66%		12.92%	0.28	5.55%		13.00%	0.37	4.76%		16.29%	0.26
95%	5%	9.53%	10.9	12.02%	0.66	4.81%	15.3	12.94%	0.29	5.72%	17.6	13.00%	0.38	4.93%	16.9	16.31%	0.27
90%	10%	9.64%	10.8	12.06%	0.66	4.96%	15.3	12.96%	0.30	5.90%	17.6	13.01%	0.40	5.10%	16.9	16.34%	0.28
80%	20%	9.85%	21.5	12.17%	0.67	5.27%	30.4	13.03%	0.32	6.25%	35.1	13.04%	0.42	5.44%	33.6	16.41%	0.30
70%	30%	10.07%	21.3	12.28%	0.69	5.57%	30.2	13.11%	0.34	6.60%	35.0	13.09%	0.45	5.77%	33.5	16.49%	0.32
60%	40%	10.28%	21.1	12.42%	0.69	5.87%	30.0	13.22%	0.36	6.95%	34.8	13.15%	0.47	6.10%	33.3	16.59%	0.33
50%	50%	10.49%	20.9	12.57%	0.70	6.17%	29.8	13.34%	0.38	7.29%	34.6	13.23%	0.49	6.44%	33.1	16.71%	0.35
40%	60%	10.69%	20.7	12.74%	0.71	6.46%	29.6	13.47%	0.40	7.64%	34.5	13.33%	0.52	6.76%	32.9	16.84%	0.37
30%	70%	10.90%	20.5	12.92%	0.72	6.76%	29.4	13.63%	0.42	7.98%	34.3	13.45%	0.54	7.09%	32.7	16.98%	0.38
20%	80%	11.10%	20.3	13.11%	0.72	7.05%	29.2	13.80%	0.43	8.32%	34.2	13.58%	0.56	7.42%	32.5	17.14%	0.40
10%	90%	11.30%	20.1	13.32%	0.72	7.34%	29.1	13.99%	0.45	8.66%	34.0	13.73%	0.58	7.74%	32.4	17.31%	0.41
0%	100%	11.50%	19.9	13.54%	0.73	7.63%	28.9	14.19%	0.46	9.00%	33.8	13.90%	0.59	8.06%	32.2	17.50%	0.43

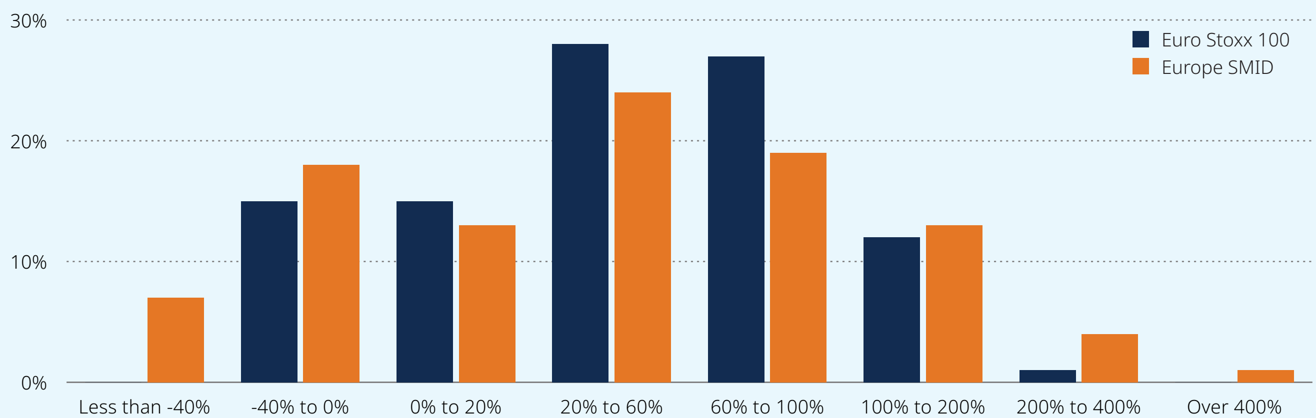
Source: eVestment, Portfolios rebalanced Monthly, Results in USD, 1Risk Free Rate: FTSE 3-Month T-Bill, Mackenzie Investments Europe December 2019

We believe the benefits of this increased informational inefficiency in the European SMID cap space will accrue to those managers that pursue an active approach. When dispersion of stock returns is high, active managers have greater opportunities to add value through fundamental stock selection. This is particularly true given that, "firm-specific news is a larger driver of differences in small cap stock returns than it is for large cap stocks"[5] (MSCI 2018).

This should be even more relevant going forward, should the quantity and quality of research continue to decline. This will lead to more companies with a sustainable competitive advantage, robust financials and strong corporate culture being neglected, underappreciated and underfollowed by the market.

European stock return dispersion is much higher for smaller companies, relative to large companies

Figure 9 | European company return dispersion over three years is much wider for smaller companies than large



Source: Bloomberg, Mackenzie Investments Europe

[5] MSCI 2018, International small caps are alive and kicking, viewed 14 May 2020, https://www.msci.com/www/blog-posts/international-small-caps-are/01020528068

We believe the patience and skill of active managers is required to exploit the benefits of lower liquidity. Liquidity in the European SMID cap equity space has clearly improved in recent years as a greater proportion of large cap money has moved into SMID. This can be seen in Figure 10, which highlights that the year-over-year percentage change in shares traded below the $5B market cap has increased.

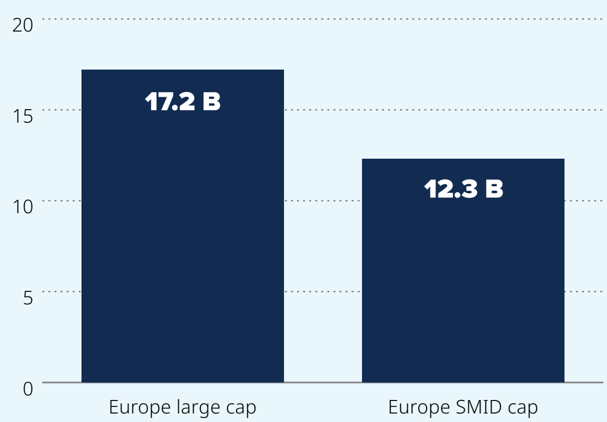
While this serves to highlight that MIFID II hasn't had a negative impact on SMID cap liquidity, it is also clear to see that European SMID cap companies have lower average daily trading values relative to their large cap peers (Figure 11). The lower levels of liquidity present an opportunity, as noted by Gupta, Oberoi and Subramanian (2019): "Markets with low accessibility and low liquidity are generally mispriced, providing greater opportunity for stock selection to active managers"[6].

Figure 10 | Change in European equity liquidity year-over-year

YoY % change in volumes	'18 vs '17	'19 vs '18	'20 vs '19
Small ($100M-$1B)	28%	23%	59%
Mid ($1B-$5B)	27%	7%	55%
Large (>$5B)	19%	1%	51%

Source: JP Morgan, Mackenzie Investments Europe

Figure 11 | Average daily traded value during the last 6 months



Source: MSCI April 2020

[6] Gupta, A. Oberoi, R. and Subramanian, R. (2019), "Evaluating opportunities in active management". The Journal of Investing

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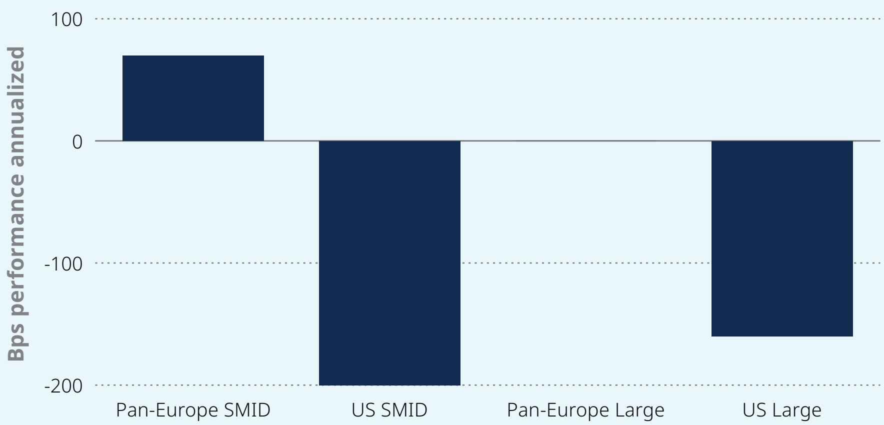
European SMID cap equities

The relationship between returns dispersion, lower liquidity and opportunities for active managers is also consistent with historical performance. In contrast, active managers operating within the Pan-European and U.S. large cap space, which have fewer stocks and greater analyst coverage, have frequently trailed their respective benchmarks.

Figure 12 | Pan-European actively managed SMID cap alpha significantly outperformed other asset classes on a 10-year view



Over the last 10 years, actively managed European SMID cap funds have delivered significant returns above their respective benchmark.

Source: JP Morgan, Morningstar, annualized data to December 2019

Why European small and mid cap companies?

The European small and mid (SMID) cap space has significantly outperformed its large cap equivalent over the longer term. This outperformance was driven by a variety of factors, including the fact that SMID caps typically have greater exposure to growth sectors and are in an earlier stage of development than their larger cap counterparts. This means that they are able to grow faster or can be focused on a single product or service, which makes them attractive takeover candidates. At Mackenzie Europe, we passionately believe the outperformance of the asset class can continue, driven by its greater dynamism and flexibility. This will enable SMID caps to pivot their business models to capitalize on emerging secular growth trends more rapidly than their more heavy-footed large cap counterparts.

Why Mackenzie Europe team?

The Mackenzie Europe team has been investing in the European SMID cap space for over 20 years. In making investment decisions, the company can leverage a wealth of intellectual property in the asset class accumulated by its team members. Each team member has, on average, two decades of experience meeting companies in the SMID cap space, right across Europe. The team is comprised of several European nationalities, which brings extensive on-the-ground experience (both buy-side & sell-side) and cultural insights into the key investment regions across Europe, which we believe is a core competitive advantage.

Why choose our strategy?

The Mackenzie Europe team has a strong track record of investing in European small and medium sized companies. It has achieved this through a disciplined approach to fundamental investing, focused on identifying relatively undervalued and under-appreciated companies with high and/or improving returns on invested capital, and a sustainable competitive advantage. The team's primary skill is in identifying companies that combine credible management, solid business strategy and strong governance in the sparsely covered SMID cap equity universe.

Conclusion

While MIFID II currently only impacts Europe, it has had many unintended consequences that impact SMID cap companies. Most strikingly, it has accelerated the decline in the quantity of research being produced: 67% of stocks in Western Europe now have no coverage or very thin research coverage.

The quality of coverage that remains has also declined with the rise of pay-for-play analysis, which is littered with conflicts of interest. The resulting reduction in informational efficiency has led to mispricing. This presents a significant opportunity to add value through fundamental research in an asset class that can significantly improve portfolio returns, while also reducing portfolio risk.

Active management has a strong track record of outperformance among European SMID caps, something which we believe can continue in an increasingly fertile investment landscape. Those active players that are well-resourced, highly-skilled and have extensive experience in the European SMID cap space are likely to be best-placed to deliver superior risk-adjusted returns.

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