If AIM is a casino, can you beat the house?

MHM's practical guide to the 'secrets' of the UK's junior equity market

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While monitoring the markets every day we hear a number of consistent themes and commentary among retail investors. MHM's guide lays bare some of the 'secrets' and myths of the equity market, specifically AIM, where there's no lack of hyperbole labelling it a casino. What are the truths and myths?

The house rules on AIM are certainly different and it will undoubtedly take your money if you don't understand the rules of the games being played. However, it is possible to beat the house and there's never a good guide without a 10-point summary is there? Here's ours, followed by our more detailed thoughts and MHM approaches for navigating equity markets and investing on AIM, based on hard-earned experience from making every mistake in the book and filtering the noise for MH Members.

1. Your costs are likely much higher than you think
2. You can't beat the house if you don't understand the rules and tactics of the game
3. Every market participant has their own agenda and motivation
4. Know what you own, why you own it and what game you're playing
5. Placing your bets well is as important as choosing the bets
6. You are betting as much on the people as the business
7. Ups and downs are inevitable - you can't win every hand so play to be up when you leave the table
8. Unlike a casino you can monitor and alter bets in place, and you should
9. You only really learn by doing - practice is always different to theory
10. There are a lot of 'helpers' out there - not all help is equal

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Your costs are likely much higher than you think

The founder of MHM invests all of his own funds himself and pays no third-party advisory or management fees. This full-time approach is obviously not for everyone, and low-cost tracker funds are probably good bets for those wanting to 'invest and forget' as actively managed funds rarely, in our view, generate additional value after several layers of fees are deducted. For those interested in nurturing their own portfolio of off-the-radar ideas, MHM provides investment ideas for an annual membership fee

Fees and costs in the financial services industry are deliberately opaque so that you can't easily understand and compare what your investments and advice are actually costing you. We continually hear "I only pay x% to my advisor", and while that may be true, what that doesn't include are the fees the underlying managers of funds charge (management and performance) as well as transaction and back-office fees.

Asset management firms are designed to generate fees, not optimise your returns. Whether your funds go up or down, they collect management fees, so their business model is to gather as many assets as possible. The more money they manage, the less likely they are to be able to outperform and the more they are incentivised to keep their job by not straying too far from their (possibly self-chosen) benchmark indices.

Having previously worked in the asset management industry, our founder understands just how high all-in fees are, but knows equally well that no-one likes to be told and people rarely believe just how high fees can be. Therefore, we simply suggest that you ask you financial advisor for a full and detailed breakdown of all fees and costs charged to you. You will get a sense for how much they don't want to disclose by how long and how difficult they make it to show you, before you get what we believe will be a genuine shock at just how high they are when written in black and white.

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You can't beat the house if you don't understand the rules and tactics of the game

Knowing the rules and tactics allows you to play on a level playing field where you can ignore a huge amount of noise from people trying to bet against or make money from you. If you're investing rather than trading, focus on fundamental performance and valuation while using time to your advantage.

Unlike the major exchanges where buy and sell orders are matched and executed on the exchange, AIM generally operates with Market Makers ("MMs") who provide bid / ask quotes for a specified quantity of shares. This mechanism is theoretically designed to ensure that there is liquidity for the smaller, less liquid shares of companies trading on AIM. While this is the case, never forget that the MMs are there to make as much money as they can from transaction fees and spreads.

The MMs can set incredibly wide bid-ask spreads (the prices at which they offer to buy and sell shares from / to you) to make money on the difference, on the basis that they are taking risk by holding shares on their books to make a market and need adequate compensation. They are effectively trading against you and use psychological tactics to do so. For example, on the release of moderately good but not amazing news they can 'spike' the price (move it up quickly) to induce FOMO and sell you shares they don't yet own at high prices, representing that there is huge demand following the good news. They then quickly drop the price to scare those same buyers into selling out again, as if the news wasn't as good as implied, and buy the shares back cheaply to balance their books and make a profit. The opposite occurs with bad news with 'scare drops' (more commonly known by another term not suitable for disclosure here) to get people to sell them shares at low prices before they then raise the price and sell at higher prices, pocketing the profit.

You can read lots of outcry from retail investors about MM 'tricks' and how they are robbing investors and manipulating the market, but these all miss the key point – you don't have to sell (or buy). The MMs aren't forcing you to and if they are able to profit through mostly obvious tactics, it is down to the investor understanding what they own and having conviction in their analysis. The MM's job is the same as yours – to make money in the market. It's up to you if you want to allow them to make it from you.

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There are auctions (where buyers and sellers of a share are matched during a 5-10 minute period and executed through an uncrossing trade) at set times every day for AIM stocks: the opening auction at 07:50-08:00, then 08:50-09:00, 10;50-11:00 and 13:50-14:00 before the closing auction 16:30-16:35. These aren't identifiers of excessive demand as certain commentators try to claim, they are simply a consistent trading mechanism happening at the same time every day.

NT – negotiated trade. When you submit an order for a quote through your broking platform, you sometimes don't get a quote for the size you request, and your broking platform will need a trader to execute the order 'manually' through offline negotiation with the market makers. This is generally due to liquidity but does not necessarily signify ongoing explosive demand that some commentators suggest.

There are disclosure thresholds where shareholders must notify companies (who in turn must notify the market) when they acquire >3% of outstanding shares and every time they pass above or below 1% beyond that. This is done through a disclosure form called a TR-1 and allows the market to follow the shareholdings of larger shareholders. While these are indicators of buy / sell decisions of large holders, it is important to understand that people / institutions buy and sell for any number of reasons (portfolio risk management, leverage, liquidity, boredom etc) which aren't always indicative of the underlying performance or value of the companies.

Occasionally trades go through of a very small number of shares (less than 10) or a 'recognisable' number (e.g. 666) and over the years there are widely held rumours that MMs are using these as secret codes to communicate with each other. Many believe that 1 share trading is the code for the company about to release an RNS (a Regulatory News Service announcement). I have never seen the evidence of this. Coincidence occasionally, but never evidence. Trade codes are mythical creatures.

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Every market participant has their own agenda and motivation

If you're investing rather than trading, trade as infrequently as possible, understand the motivation and incentives of information sources and don't be tempted to invest in anyone's 'hot tip' of the day.

Market makers, as discussed previously, are designed to make money the more you trade.

Brokers / broking platforms are the retail investors' route to market – you submit your order to them, and they provide quotes and execution through the MMs or on exchange. Their incentive is for you to execute as many trades as possible, taking a risk-free commission each time, with no responsibility for making you a return. They make their commissions whether you make money or not. They are, therefore, excellent at providing 'useful' market commentary and share tips to encourage trading in and out of stocks.

Many corporate brokers also have research arms and provide seemingly useful commentary and forecasts to aid your investment decisions. However, never forget that their clients are the companies they cover (who can be paying for coverage) and institutional investors who are trading large volumes and generating significant fees. This is not independent research designed to generate returns for retail investors.

There are seemingly endless bulletin board / social media 'rampers' (people talking up a stock) and 'de-rampers' (people talking down a stock). Many have an agenda trying to move the price in the direction that benefits their own trades. They will breathlessly exclaim favoured lingo such as "its gone NT", "its gone into auction", "there will be a TR-1 shortly", "seller on fumes", "code 1" in attempts to induce FOMO from people who don't fully understand the rules. Then there's the other side that seems to more recently have been termed 'FUDsters', spreading fear, uncertainty and doubt in order to drive prices lower for cheaper entry prices or to close short positions. While it is difficult to imagine that so many people don't have better things to do with their time than to try to take advantage of people with lies, there they are. Be under no illusion these people aren't out there and active every day, moving from share to share. Others have simply lost money on a stock and bitterly 'bash' the company and management for years afterwards rather than admitting their own investment mistake. With few exceptions from genuinely knowledgeable investors, none of the ramping or FUD should be taken as informed or actionable advice. Unless anyone can back up their opinions with hard facts and analysis, rather than rumour and non-sensical numbers, they can simply be ignored.

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Know what you own, why you own it and what game you're playing

Play your own game focusing on value and use the 2 advantages individual investors have - time and behaviour. MHM investment memos explicitly incorporate probability weighted, risk-adjusted valuations.

As a retail investor, it is likely that almost everyone else in the market has access to more and better trading data i.e. MMs see the whole trading book and set the prices while funds have high speed exchange access and utilise algorithms that can beat you to every opportunity. How do you consistently compete and have an edge over the market with trading day-in, day-out?

While that isn't a game we choose to play, not everyone comes to the same conclusion, and some are very successful traders with a system that works for them. The key is to know what game you're playing.

If you're trading every day and looking for momentum, catalysts or patterns, you don't really care about the long-term fundamental performance or value of businesses. You just want volatility and people to trade against so you can make money on price movements. Much of the market is doing that, so if you're a long-term investor that likes to look at their portfolio regularly, you will likely see stomach churning movements in the value of your stocks. If you don't know what you own and why you own it, it can be difficult to hold when prices swing down, unless you remember you're playing a different game.

Volatility isn't risk and price isn't value. If you own something, you should have already factored risk explicitly into your assumptions and valuation. Traders swing prices about without much reference to underlying valuation, so why should you be concerned with what price they are buying and selling shares on any given day? Once you have that conviction, focus on your game, which is long term outperformance from successful businesses. Sell if the investment thesis changes for the worse or the company isn't delivering, but traders and other market participants are playing a different game. Take advantage of price movements that aren't justified by fundamental performance and business progress, but on a daily basis, leave the traders to it.

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Placing your bets well is as important as choosing the bets

MHM's watchlist is divided into 3 sections of companies so it's easy to identify established, cash generative business from high growth businesses and early-stage companies so positions can be sized accordingly.

It's easy to get excited about a compelling new investment, particularly when due diligence continues to confirm your thesis and increase your conviction. It is so tempting to go all in and take a full position before the market figures it out and the price moves away from you. We've been there and done it. And then the price moves down and you want to buy more because it's cheaper and you believe nothing has changed. Then you're annoyed you bought higher and don't have the funds to buy more.

The price always goes down at some point after you've bought. Our founder believes he's bought perhaps 2 shares over the years that caught the bottom and only ever went up – these were luck. The thing is, every time you buy a share you're immediately down – the bid-ask spread and trading fees ensure that is simply a fact. Sometimes, would you believe, you can also be wrong about the business, management or timing of events. That's a shock you learn the hard way...

The answers are well documented. Buy in tranches so you build your position over time, allowing you to take advantage of temporary price declines and help your mental wellbeing. It is also easier to cut losses if your thesis starts to go wobbly fairly quickly.

Which leads us to position sizing – the most exciting investment prospects are those with high growth, blue sky valuations that the market hasn't yet discovered. These also tend to be the riskiest investments. There's a place for them in portfolios, but size them accordingly – if you're right and the price goes stratospheric, even a small investment will have a big impact on overall returns. If you're wrong, you're not totally out of the game when prices drop suddenly, and the mental scarring will be greatly reduced.

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You are betting as much on the people as the business

MHM investment memos all have a section of who we're partnering with and what their incentives are.

On AIM, this point is particularly crucial. While there is recognition that AIM companies are likely earlier stage businesses, it is easier to forget that management teams perhaps don't all have the requisite operational of financial experience and, in our view, many boards certainly don't.

We have written in depth about our view of the effectiveness (lack thereof) of many non-executive directors, so we won't re-hash that all again. Suffice to say that those running and governing the business are as crucial to your investment thesis as the business itself, particularly when incentives are mis-aligned which they sadly so often are.

The motivations of other shareholders can also impact short term share prices if they become forced sellers or are looking to increase to their holdings significantly.

Understand how the people you're 'partnering' with behave. There are some fabulous management teams out there who understand intrinsic per share value, but they are far from universal. Always look at everyone's incentives. Incentives drive behaviour.

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Ups and downs are inevitable – you can't win every hand so play to be up when you leave the table

Identify investment opportunities that are misunderstood and fundamentally undervalued by the market that can be held to minimise frictional costs and meet long term return targets. Getting rich quick is hard and requires luck. Getting wealthy slowly is a proven path.

What have we learned as indisputable facts about investing?

- The only guarantee is that you will make mistakes.
- If you hold more that 2-3 shares it is really, really hard to have them all be up at the same time.
- You can't time markets and when shares will be at their lowest point.
- The market is not efficient and rarely do prices match value.
- Market participants are emotional and irrational for much of the time.

You need to keep these 'facts' constantly in mind. There will likely be more down days in your portfolio than up days, or you will at least feel the down days much more. So don't worry about trying to win every day (unless you're trading). Let your investments do their work over time and build value.

The market is hugely inefficient and wild swings in share prices don't correlate to changes in value on a daily basis. In the long run though, the market does get it right at some point. You just don't know when that will be, so you need to leave enough time in your investment horizon to reach your target returns.

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Unlike a casino you can monitor and alter bets in place, and you should

Watchlist companies are monitored and analysed to ensure they are tracking their investment theses. Discussion boards allow for members to bring their individual expertise to bear on every investment.

This is perhaps one of the greatest yet most underutilised gifts of the market. Where else do you get to update and alter your bets as more information is provided? Investments, particularly on AIM, aren't invest and forget. A portfolio needs monitoring and tending, and you must not water weeds. Weeds need killing off quickly before they ruin the portfolio while seeds need planting and flowers watering to ensure a full bloom.

This is particularly true when share prices are as news driven as they are on AIM. There are so many investors focused on seemingly trying to double their money in a week and getting bored quickly when they don't. Rather than fundamental analysis and understanding of long-term business value, this leads to a huge focus on the next significant piece of news, or in many cases, rumours of significant news.

The news is 'pumped' to attract buyers ahead of the expected good news and when that news is released, even if it is better than expected and considerably increases business value, the share price falls on the 'sell the news crew' exiting as their current game is finished.

Linked to the importance of people, there is a dearth of investor communications expertise at board level in AIM companies, with companies too small to have dedicated investor relations. Consequently, they hold their share prices hostage to one-off updates (or rumours of updates) in lieu of consistently good and transparent communications. This phenomenon again requires careful monitoring to distinguish actual news from noise and the conviction to act logically in the face of the market seemingly telling you that you are wrong.

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You only really learn by doing - practice is always different to theory

MHM strives to provide honest appraisals of investments with case studies on the times it went wrong to learn the lessons and constantly improve.

Are you really comfortable leaving your financial future entirely in the hands of fund managers who you most likely don't know by name and have no idea what their track record is? You don't employ anyone to do anything for you without checking them out and understanding their costs in any other industry, but when we're handing over our hard-earned money to financial advisors to invest with other people, what due diligence do you really do? The answer, I fear, is little. Finance and investing seems so complicated we are willing to trust some credentials and qualifications along with a brand name firm.

By investing at least some of your portfolio yourself you will certainly feel a spectrum of emotions with share prices going up and down, but it's like everything – you start small and as you get better with practice you build pattern recognition and 'muscle memory'. You will know what you own and why, leaving you better prepared to not be shaken out of good investments or drawn into bad ones by market participants working against you.

Imagine you're down 50% on an investment but nothing has changed for the business or your investment thesis. When you bought in you thought it was worth double what you paid, so now it's worth 4x the current price. At this point, at 50% down, many people sell out of boredom, are scared out the position by negative but unsubstantiated market commentary ("it's down, it must be rubbish") or just sell to chase the next new idea as this one didn't work out fast enough. But you've done the work, you have owned and followed the company so you know it well. If nothing has changed, you really have to find something special that you are as convinced will do 4x.

Having patience, sitting on your hands and trusting your own research are the hardest things to do in investing. You can only learn by doing and understanding how it feels, both on the way down and the way back up.

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There are a lot of 'helpers' out there - not all help is equal

Every MHM idea, current and previous, is on a watchlist with prices updated daily, companies are monitored with relevant news analysed and investment memos updated upon material news with all forecasts and theses compared to the original memo. There is no hiding, and the results will always speak for themselves.

There are plenty of investment idea sources out there, ranging from the excellent but infrequent, to torrents of daily tips with no analysis. The providers all have their own incentives, which rarely include making you the highest return for the lowest cost. Instead, they are focused on generating advertising revenues from traffic and encouraging trading for transaction fees or price movements in their favour.

Many of the information sources used to generate investment ideas just give an idea and move on without tracking performance – the point of the idea was generally to generate advertising and trading fees and that was achieved without concern for what your investment return might be. Tracking would also lead to its namesake – a track record. There are very few investment track records that people are happy to share because it's so hard to beat the market. Have you ever had a pro-active update on any share tips you've received if the share price wasn't up and someone wasn't trying to sell you the next idea? That's just selective marketing.

Broker research is updated as it's either paid for or used to generate business for the broker, but any recommendation and price targets tend to be range bound around the current share price so there's little fear of standing out from the consensus and putting job security at risk.

In our opinion, there simply aren't enough good investment ideas out there to generate even 2/3 good tips per week/month, let alone genuinely compelling investment ideas. Again, we differentiate investment ideas from trading ideas where trading is a different games of seconds / minutes / days rather than months / years.

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Conclusions for our founder

The MHM platform is uniquely designed to help identify compelling, off-the-radar investment ideas to build a non-consensus portfolio to outperform markets and achieve long-term investing goals.

“I have made every mistake, suffered from every shortcut, and fallen for every trick in the book. All of that after 20+ years in corporate finance and private equity where, with all that finance experience, I had the hubris to believe I knew what I was doing from day one.

Everything is different when it’s your own money and like poker, you’re not just playing the game, you’re playing against the psychology of all your opponents in the market. I have learned (again) that as with all things, you need to do the work to succeed. At MHM we try to present a lot of the work in compelling, actionable investment ideas, but experience tells us that you have to convince yourself and be interested in the companies you invest in or it’s too easy to buy badly or sell at the wrong time”.

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