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The Trends and Effects of Social Media in Micro-Cap Investing

"We have presented this white paper to provide the framework of how individuals and organizations can utilize the media to influence the market, and to provide guidance to micro-cap companies and how to best operate in this new and incredibly fast-paced environment."

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INTRODUCTION

Throughout the history of capitalism, advances in technology have had a profound impact on the marketplace. Since the dawn of the Digital Age, major scientific breakthroughs have become commonplace, with new devices, modes of communication and ways of conducting business dramatically altering the way we live.

The past decade has been marked by innovations and advancements too numerous to quantify. Relative to the investment world, the growth of online communities may prove to be the most significant. Social media websites, such as Wikipedia, YouTube, Facebook and Twitter, have transformed the Internet from a platform where individuals communicate and find information, into a single, interconnected community. Just ten years ago, few could have predicted the impact that social media would ultimately have on the business environment.

For companies, social media offers numerous benefits, as well as perilous threats. Companies use social media websites to reach new audiences, enhance their profile and connect with their customers, but they are also used by “market manipulators,” who leverage the immense power of these virtual communities to their own gain.

We have presented this white paper to provide the framework of how individuals and organizations can utilize the media to influence the market, and to provide guidance to micro-cap companies about how to best operate in this new and incredibly fast-paced environment.

SOCIAL MEDIA IN BUSINESS

Social media websites such as Facebook and Twitter have created an online, de facto marketplace of their own. While Facebook has proven a useful platform for companies to share information and interact with customers, Twitter's effect on business and capital investing has been explosive.

In simplest terms, a Twitter user can send their 140-character message across the globe in an instant. With a large amount of followers, or if promoted (re-tweeted) by a user with a significant following, these messages can "go viral" and generate tremendous momentum. Importantly, links to other websites or online articles can be sent as "tweets," often with short introductory messages, and this has become a fundamental form of mass communication within the financial community.

The inherent difficulty with a site that grants each individual the power to disseminate an idea or story is that there is no real way for the reader to verify the validity of the information. The sheer size of Twitter's user base, which now sits at more than 500 million, has made it an ideal tool for those with the best, and worst intentions. Those same reasons have made stopping the spread of misinformation difficult.

SOCIAL MEDIA IN THE INVESTMENT COMMUNITY

A company's success or failure depends largely on its reputation. In the past, stories that impact how a company is perceived would be found in newspapers or on television; both media that thoroughly vet their sources and the validity of their content. Via social media websites, individuals or organizations can broadcast information to a much wider audience, without the extra step of having that information verified. Additionally, social media has become a platform for the distribution of market strategies. As opposed to a company promoting their product or service online, actual stock promotion via social media is on the rise. While social networking sites allow companies to reach wide audiences, analysts and investors are also increasing their use of social media.

Seeking Alpha is the world's largest crowd-sourced, online investment community, and represents the dangers of social media's role in capital investing. Unlike other equity research platforms, Seeking Alpha's content is generated by investors and industry experts, rather than sell-side analysts. In addition, their contributor network is comprised of individuals that are financially compensated for the articles they submit, based on how many page views they receive. The intrinsic problem with the organization's philosophy, which espouses the value of crowd-sourced, investor-side information, is that

the authors may have their own personal agendas, may present only part of the story, or may simply have the facts wrong. To this point, Seeking Alpha's website includes a link to "Dispute an Article."

Seeking Alpha has built a massive community; the site currently has 3.5 million registered users, reaches over 8 million unique viewers each month, and generates over 83 million page views per month (Seeking Alpha Media Kit 2014). Seeking Alpha's website touts their influence, stating that "Seeking Alpha articles frequently move stocks, due to a large and influential readership which includes money managers, business leaders, journalists and bloggers." To be sure, the site has proven its ability to "move stocks," however, these stocks may be moving in the wrong direction for the wrong reasons.

The Motley Fool is a multimedia financial services company that strives to be the best and largest investment community in the world. The Motley Fool reaches millions of readers each month; it has published numerous books, sends subscription-based newsletters and offers online tools with the specific aim of helping individual investors.

Much of the information on The Motley Fool's main site is sourced from their staff, as well as content from their partners including Yahoo!, MSN, AOL and others. However, The Motley Fool's blogs and community message boards contain articles, comments and information generated by individual users of the site who are financially compensated for their contributions.

INVESTMENT BLOGS

In addition to large investment communities, the web is also home to seemingly countless investment blogs, each with its own specific area of focus. The Daily Reckoning is a site that has ranked the top 50 investment blogs, which are written by financial analysts, university professors, best-selling authors, startup entrepreneurs and investment advisors. Despite the fact that many of these bloggers are known to be reputable sources of information with unique insights, they can be biased as well. The Internet also hosts numerous investment blogs that are not written by finance professionals, and are therefore not viable resources for investors.

Issues of credibility and validity of information are compounded should a blog article get picked up by a significant online news source, such as Yahoo! or MSN, thus reaching a far greater audience. Promotion of blog pieces via Twitter also has the potential to get a particular article seen by many more readers than the blog itself, which can influence the trading volume, as well as the price of a given stock.

INVESTMENT NEWSLETTERS

Investment newsletters are another popular source of market information for retail investors. Most newsletters are tailored to a particular area of investment, including individual stock recommendations, market trading strategies and overall market/economic insights. Industry-specific newsletters offer a greater degree of focus, and cover a range of business sectors including real estate, energy, and biotechnology.

Newsletters that recommend individual stocks often analyze small-cap stocks (stocks with a relatively small market capitalization) as well as penny stocks, based on the idea that these securities are those most overlooked by Wall Street, and therefore have the most dynamic growth potential. These newsletters may laud the incredible gains their readers have made based on their recommendations, but tend to be less forthright about the misses they have had.

Industry-specific newsletters may provide useful and actionable information, but retail investors must exercise caution to ensure that they are not buying into a given company simply because it is in a hot field. In addition, retail investors may take action based on information or a recommendation from a single source, which is a risky investment practice. It is important to consider that the author or publisher of an article or newsletter may have their own motivation behind the recommendations they promote.

HEDGE FUNDS

In addition to the various sources of market information, hedge funds also have the ability to influence the price of a given security, and present a unique challenge with regard to regulation. Hedge funds are not subject to the same SEC rules as mutual funds or exchange-traded funds, and therefore have fewer requirements to report and disclose information. Although regulation of hedge funds has been on the rise in recent years, they are still able to operate in a more clandestine manner than traditional investment service entities.

In 2012, The New York Times' Gretchen Morgenson reported that hedge funds were submitting electronic questionnaires to stock analysts. According to her article, the fund managers were able to gain subjective information that was not available to the public, which may have included recommendations that could have theoretically resulted in actionable movements in the market. The lack of transparency required of hedge funds allowed this practice to go unnoticed for a considerable

period of time, and represents the scope of their market influence. (http://www.nytimes.com/2012/07/16/business/in-surveys-hedge-funds-see-early-views-of-stock-analysts.html?_r=0)

RESEARCH

Websites, blogs and newsletters play an ever-increasing role within the retail investment community. Individual investors save time by utilizing these information sources rather than attempting to analyze stocks themselves. The danger with these types of sources is that they are not thoroughly vetted, and are therefore considered "non-traditional" sources of information. "Traditional research" is conducted by Chartered CFAs (Certified Financial Analysts), and tends to be more objective.

Traditional research is comprised of two distinct categories: sell-side and buy-side research. Reports that advise retail investors to buy, sell or hold a stock originate from the sell-side of the investment industry. Sell-side analysts distribute information for public consumption, with the goal of influencing investors' approach to a given security.

Buy-side research is used by money managers at non-brokerage institutions – hedge funds, mutual funds and insurance firms – that purchase securities for their own organizations' investments. Unlike sell-side research, buy-side research is not published, and is used by the firm that generated the information.

On the sell-side, public companies often purchase financial research from independent firms to present their clients with accurate and reliable investment information. These firms provide investors with financial data needed to make informed decisions, and offer stock screening, price charts, historical financials, and track earnings estimates.

IMPACT ON THE RETAIL INVESTOR

The number of individual, or retail investors, active in the market decreased significantly following the financial crisis of 2008. As the economy – specifically the securities market – has rebounded, retail investors have steadily increased their market position.

Retail investors typically do a lot of research on their own, and the proliferation of financial advice available has empowered these investors to take more of an active role in the trades they make. Too often, however, individuals do not make enough of a distinction between web-based or social media-

driven information and traditional, research analyst reporting. Those that fail to make this distinction are vulnerable to a number of financial threats.

In general, retail investors are prone to “momentum trading” – buying stocks as they go up and selling them as they go down in value. Television financial pundits, newsletters, as well as web-based, social media-driven “research” can also heavily influence the stocks individuals buy or sell. To be sure, many investors will conclude that they can not be the only one acting on this information, but it would be difficult for anyone to ignore an opportunity that a website or analyst has called “the next big thing.”

SHORT SELLING

Short selling, also known as “shorting” or “going short,” is the practice of selling securities that are borrowed by the seller, and subsequently repurchasing them, or “covering.” Short sellers profit when the price of a security decreases, as they are able to repurchase it for less than the amount received at the initial sale. Short sellers predict that the price will drop, enabling the stock to be sold at a lower price, and in some cases influence the dip in value themselves via social media. The percentage of “short players” in micro-cap stocks has increased significantly over the last five years. They assume high risk, but the potential for loss is much greater than the potential for profit on the part of the retail investor. In some instances, companies have had their reputations damaged by manipulators aiming to cause a drop in price.

In the event that a heavily shorted security should rise in value quickly, short sellers are often forced to close out their positions, increasing the upward momentum of a stock or commodity. A “short-squeeze” occurs when sellers are pushed out of their short positions, typically experiencing a loss. If a stock starts to rise rapidly, those with short positions will often cover their position by purchasing the stock, which can cause the price to rise even higher.

PRIME TARGETS FOR SHORT PLAYERS

“Short players” have been around nearly as long as the stock market itself. Short players are individuals who, based on their market predictions, buy or sell a given security that they feel is primed to move. Short players can benefit from that security’s decrease in share price, and social media websites have significantly aided their ability to effect the change they seek.

Companies that bring disruptive innovations into the marketplace are particularly vulnerable to short players. Disruptive innovations, also known as disruptive technologies, are those breakthroughs that open entirely new markets while simultaneously threatening existing ones. For example, in the early 20th Century, General Motors and Ford Motor Company – purveyors of a new mode of transportation – could be classified as disruptive, while Tesla Motors is in a similar position today.

Disruptive technology stocks could be overpriced because they hold the promise of explosive growth. A disruptive innovation stock has the potential to increase in value exponentially, while established stocks in traditional industries almost never experience that level of upward movement. Retail investors tend to participate in momentum buying of these types of stocks. In cases where short players determine that a stock has been overvalued, they will seize the opportunity to profit from their prediction that a correction will take place.

In recent years, life sciences and biotechnology companies have been increasingly targeted by short players. These businesses are particularly attractive to market manipulators because they are disruptive technology companies with high expectations for major growth, and are often listed on the OTCQB or OTCQX. These companies also have the liquidity sought by short players, as their shares can be borrowed for shorting purposes.

As an example, a technology company was heavily being targeted by short sellers. The company stated that misleading, inaccurate and negative articles and “reports” had been issued by market manipulators seeking to profit from a decrease in the company’s stock price.

Companies whose stock has experienced a big run up in price are also frequently targeted by short players. Short players predict that the stock price will slide back some, creating the opportunity for a short sale. Emerging Growth Companies (EGC) that are pre-revenue are also vulnerable, as their stock prices are typically based more on market expectation than their P/E ratio or other traditional means of valuation.

Stocks that trade at a very high multiple are also susceptible to short players. For example, a short player may foresee a stock experiencing at least a minor regression; if that stock was trading at 8x and moves back down to 6x, the short player stands to benefit.

MARKET MANIPULATION

All of these sources of traditional and non-traditional research have the potential to influence retail investors' decisions on how and where they invest their funds. As many individuals do not possess a full understanding of the key differences between the types of research they are reading, they are susceptible to a number of investment pitfalls.

COMPANIES ARE UNDER ATTACK

In addition to the numerous forms of market manipulation that prey on retail investors, short players leverage the power of social media to alter the public perception of a company, thus driving the stock price down. Companies have begun utilizing financial public relations firms to enhance their online presence. To be sure, these firms laud their own ability to move stocks; according to a client testimonial from an agency's website:

> *"(The firm's) ability to influence their clients' online reputation is unrivaled. As online engagement increases in importance in the equity markets, (the firm) has developed a unique and credible platform that builds long-term engagement amongst key stakeholders."*

This sentiment, from a CEO in biotechnology, illuminates the power that financial public relations firms can exert on the marketplace through their promotional campaigns. In some cases, however, these agencies employ various methods of company and stock promotion. Their techniques are often rooted in the dissemination of bearish articles on a stock, which are typically issued by short players seeking to profit from the movement of that stock. In other instances, articles have been found to be inaccurate and misleading, and are often attributed to experts in the field or fund managers. In reality, some of these articles are produced by paid writers using fake identities and fabricated credentials.

BEST PRACTICES FOR COMBATTING SOCIAL MEDIA-DRIVEN VOLATILITY

All of these threats to the normal, natural lifecycle of a security's price can have disastrous effects on the companies targeted. Short players, armed with their use of social media to influence the investor marketplace, have shown the ability to create uncertainty for investors and companies alike.

There are a number of steps that companies can take to combat the volatility caused by short players and the often misleading information dispersed via social media:

- Initiate a strategic Investor Relations program with regard to capital markets
- Conduct “Non-Deal Road Show” to retail and institutional investors
- Get the real story out to buy- and sell-side analysts
- Have management present at appropriate conferences
- Manage the expectations of the investment community

As micro-cap (QTC, QB-QX) companies mature, they can be uplisted into a senior exchange. At that point, their investor mix begins to shift from retail to institutional investors, which results in less volatility.

CONCLUSION

New and innovative technologies have the power to change the world, both for the better and worse. Social media is no exception, as companies are able to utilize online communities to raise brand awareness and enhance their web presence and overall profile. Conversely, individuals within the investment world are continuously devising ways to leverage the power of social media to their advantage.

Companies can help protect themselves by enlisting the services of an Investor Relations firm. Investor Relations firms with a wealth of experience, deep understanding of the ever-evolving marketplace, a keen ability to focus on accurate information and a foundation of solid, proven approaches, offer a distinct advantage to their clients, who are well equipped to navigate the often nebulous world of capital investment.