

# Towards a more efficient market

**A sector worth 16% to 20% of the UK economy is near invisible to external investors.**



Alan Hodgart

**T**he MPF holds no views on the merits of listing. However, we feel strongly that business opportunities should not be inhibited by artificial barriers. We worry about a situation where management proposes a listing, but partners veto the plan on the entirely rational grounds that there is little merit in devoting significant time and resources to end up invisible. So we determined to create an index of listed professional firms to 'lift the veil' and track performance.

Our first challenge was to agree on the definition of a professional firm. After much debate, we settled on the following: "Professional firms are organisations whose products and services are based on professional expertise rather than on discrete products or commodities. To qualify, 80% of an organisation's core business activity must require specialist knowledge of a subject, field or science." Supplementary tests were designed to cover: education/qualifications; regulation; code of ethics; financial independence; how selected by clients; and type of services (see

page 16 for full definition).

We discovered that there are some 70 companies on the UK Stock Exchange Full List and AIM that meet the MPF definition. Had we chosen a 50% specialist knowledge threshold, the number of qualifying firms would have been closer to 200. Our next concern was that the new index would be imbalanced if firms that operate in financial services or with a market capitalisation of below c£20m or above £1bn were included. These adjustments resulted in a final list of 35 constituent firms (see page 10).

We next looked at comparable indices, concluding that the FTSE 350 Support Services Index came closest in terms of overlapping companies in that half the firms in our index are allocated to support services. This low volatility index is traditionally seen as defensive when building a portfolio. We suspected that calculating our index using historic data would result in a more volatile chart as we were including AIM companies as well as those allocated to sectors such as real estate that have experienced huge swings in market capitalisations in recent years.

Noble gathered the necessary financial and stock exchange data for each of the 35 firms and compiled the index, using March 2006 as the base. As anticipated, the Index showed greater historic volatility, outperforming the Support Services Index up to the autumn of 2008 but underperforming there-

after. However, our index consistently outperformed the FTSE AIM UK 100 index.

Volatility is a two edged sword. It's fantastic when you are ahead but agony when the market goes against you. Some professional firms allocated to more volatile sectors have therefore sought to be re-classified as support services. But this too has its disadvantages given that professional firms are in a minority in that category yet have distinct characteristics.

Another consequence of an invisible sector is that no-one is tracking the constituent firms as a composite group and no investment funds have been created specifically to invest in the sector. This has led to a communications gap between professional firms and the City. We came to the view that publishing a Professional Services Index would not be sufficient to overcome this structural gap and that it would be necessary to embark on a media campaign to encourage financial institutions to:

- Allocate specific analysts to cover the new sector
- Treat qualifying firms as primarily professional firms whether they are classified to support services or to other ICB sectors.

Our aim is that when firms have something worth saying, it will not just be existing investors who are listening. And that's a big step towards a more efficient market.

**Alan Hodgart of H4 Partners is chair of the MPF Listed Firms Committee.**