Portfolio Market lessons

Cash is king, but savvy managers rule

Small caps

Richard Hemming

Veteran investors such as Rob Hopkins are well aware how the winds blowing through an economy buffet small companies.

Investors in small companies – those outside the top 100 by market value – agree the recipe for prospering in even the most challenging times is to adhere to the saying "cash is king".

The S&P/ASX Small Ordinaries hit a record high of 3033.2 on May 11 – as did the broader index – and has since fallen about 6 per cent.

In the three months to July 27, the S&P/ASX Small Ordinaries fell 3.5 per cent, marginally less than the 4 per cent decline in the broader S&P/ASX 300 Index.

But it is more difficult to detect sector trends in small caps than in the broader market.

That said, the most resilient stocks are those not reliant on a strong economy for growth. Small cap funds that have performed well over the past few months include: IT services companies such as Oakton and SMS Management & Technology; financial services companies including IRESS Market Technology, WHK, engineering contractor Transfield Services; and resources companies AED Oil and Precious Metals Australia.

Hopkins' fund at Smallco Investment Manager has risen 1.4 per cent in the past three months. He points to two factors that have enabled him to achieve this – earnings and dividends.

"Having stocks which have strong earnings growth is the key," he says. "The companies we own we forecast to increase their earnings by an average of over 30 per cent for the year. On top of this, we do take quite a lot of notice of companies with high distributions, which protects your downside."

Hopkins says his fund has an average dividend yield of 5 per cent, while some companies have dividend yields as high as 8 per cent. This compares to the average yield for the market of under 4 per cent.

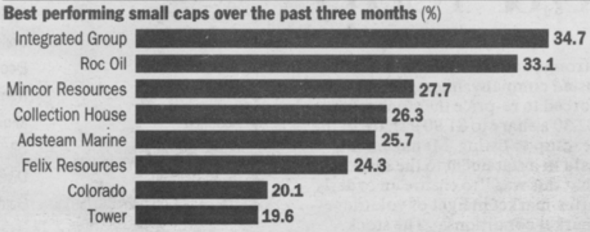
One factor driving the volatility has been rising interest rates in Australia and globally.

Last week's announcement that inflation was rising at rates above market expectations triggered a sell-off of companies whose earnings are based on consumer spending on non-essential items.

Retail stocks including Harvey Norman, JB Hi-Fi and Billabong all fell more than 2 per cent on the day of the announcement.

SMALL WINNERS

Best performing small caps over the past three months (%)



Source: Bloomberg

But some retailers are faring well, and Paradice Investment Management portfolio manager Matt Riordan says their differing fortunes in part reflect their ability to read consumer demand and manage inventory levels.

"For small caps, management capability is what we rate the highest," he says. "There is a higher management ownership in smaller companies in general. When the economic outlook is clouded you need good management to make rational decisions which benefit shareholders."

David Jones was also sold off, falling more than 3 per cent. The stock has subsequently rallied 7 per cent after the company issued a profit upgrade and is now trading at just over $3 a share.

DJs raised its second-half net profit guidance from as low as 5 per cent to as much as 32 per cent or $33 million last Thursday after achieving fourth-quarter sales growth above expectations.

The retailer trades on a fiscal 2007 price/earnings multiple of just over 15 times, a slight premium to the average multiple for small caps of just under 15 times.

Macquarie Bank small cap fund manager John Bugg agrees, adding that the retailers he owns have niches that protect them from poor sales. His fund owns the The Reject Shop which specialises in end-of-line products, items that will be repackaged and inventory that needs clearing by suppliers.

The shares have more than doubled in the past 12 months. At $6.60, the stock is trading on a P/E ratio of just over almost 17 times.

Riordan says his fund has benefited from owning United Group and Transfield Services.

Both companies trade at multiples of over 17 times, but he says the amount of work available in non-residential construction here and overseas ensures high earnings growth in the future.

Stocks that weather well in all economic climates, fund managers say, are those requiring little working capital or have low amounts of money tied up in stock and don't require much capital expenditure.

Companies in the information technology and financial services sector are favourites.

Bugg says mining companies that are low-cost producers in or nearing production are investors' best bet for combating swinging commodities prices.