

Strong performance comes in small package

Christine St Anne



RESEARCHFOCUS

When former brokers Rob Hopkins and Bill Ryan established boutique fund manager Smallco five years ago, they were provided with an early learning experience by managing assets in a negative investment environment.

Smallco's flagship Australian equity small cap fund initially began with poor performance. Instead of simply closing shop, the managers made some changes to their process and the rest, as they say, is history. This year the fund has delivered an impressive 29.2 per cent return and 18.9 per cent return since its inception in 2000. "We made four big changes, which included tightening our risk profile and improving our portfolio construction," Smallco managing director Rob Hopkins says.

The fund runs a concentrated portfolio, however, the money invested in each stock is now limited to a maximum of 10 per cent of the total value of the fund. The amount that can be invested in a company that is in a turnaround phase is limited to 3 per cent of the fund. Hopkins says: "We want to invest in turnarounds because when they work, they provide spectacular returns. However, a turnaround can take a long time and often they don't happen."

The average monthly market volume of each stock held is calculated to determine stock liquidity.

The manager also monitors the percentage of the fund held in stocks with a market capitalisation of less than \$100 million, limiting the cumulative holding of these stocks to 10 per cent of the fund.

In addition to these four portfolio construction limits, to ensure sector diversification the fund also maintains a holding across at least four global industry classifications out of a possible 10.

Skandia head of research William Burkitt says it does not matter if a portfolio manager "stuffed up", as long as they learned from that experience.

"It is often during difficult times that you uncover a gem," Burkitt says.

Burkitt discovered (what he termed) a gem following a casual conversation with a Smallco director where he found himself attracted to the manager's growth style. After researching Smallco, Burkitt and his team decided to list the manager

on its Blended Australian Smaller Company Fund platform. Burkitt not only liked the manager's growth investment style and concentrated portfolio but its ability to short sell up to 30 per cent (and also borrow up to 30 per cent) of the fund. He says this approach is unique in the small cap space and while there may be risks, such as the risk of stock recalls, he says such an approach increases the scope to add value and protect the market from a downturn.

Hopkins says the fund's ability to short sell its stocks provides the fund with an advantage during falling markets, giving the manager the competitive advantage that it can still make money during negative markets – a lesson certainly learnt from their early days.

Because of their background in stockbroking, Hopkins says the team is very strong in fundamental research.

The fund invests in companies that have an attractive outlook and high return on funds employed, which means such a company has the ability to generate strong cash flows that can pay good dividends to shareholders. Based on these factors, the fund tends to focus on sectors that have low asset values, such as financial services and software companies. The manager also favours companies in a monopoly or duopoly situation.

Hopkins also says it is important the companies have good management with a strong and ethical board. "If we think there are any unethical considerations there, we stay away. It is hard enough for honest good people to make money," he says.

In fact, the manager adopts a light ethical screen to the companies it researches, staying away from businesses that have interests in alcohol, tobacco products, gambling or armaments.

The fund will be capped at \$200 million and Burkitt notes this should enable the manager to continue to manage its 30 stock portfolio without compromising its ability to enter and exit positions or adversely impact transaction costs. Smallco currently holds \$30 million in funds under management and Hopkins says the next step is to open the fund to retail participation. □

The fund is unique in nature, being an Australian small cap-focussed, concentrated, long/short fund with a mild ethical overlay and the ability to gear.

Lonsec considers Smallco's investment team to be suitably experienced and adequately resourced. Importantly the investment team is experienced in both small cap analysis and in the ownership/management of small companies. Portfolio management experience is, however, lower than many peers.

Lonsec considers the manager's investment process to be well developed and thorough. Pleasing to Lonsec is that the process adopted by Smallco is more structured than that adopted by many boutiques reviewed particularly in terms of the recording of research notes and the use of a standardised valuation template. Performance to date has been very strong, with the fund achieving its performance objective over the three year period assessed. Encouragingly, post the introduction of more stringent investment controls – following significant underperformance – the fund's relative and absolute performance has been very solid.

Lonsec