



Home > What the experts are buying

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What the experts are buying

ASX Investor Update's Tony Featherstone asked three leading fund managers who specialise in small and mid-cap shares:

1. Is now a good time to buy shares?
2. What approach should investors take in buying shares?
3. Key investment mistakes during the global financial crisis, and how to avoid repeating them
4. Favourite sharemarket sectors or investment themes
5. Three shares their fund owns.

(Editor's note: Do not read the shares mentioned in this feature as recommendations. The fund managers may have different investment goals, or have bought at different prices. Treat the comments as ideas for further research if deemed suitable, or a discussion point with your financial adviser).



Ed Prendergast
Portfolio manager
Pengana Emerging Companies Fund

Buy shares now? Yes, for investors with a medium-term horizon. The market is not overly expensive, although not nearly as cheap as 12 months ago. The Australian economy is still strengthening and sectors exposed to corporate spending are yet to benefit. Earnings in these sectors are still depressed because companies are just starting to spend again, having weathered the crisis. There is still value left, although I would not describe it as screaming value, but there are good gains to be made by investing in the right places.

Investment approach: Individual investors should not invest in the market in one go, but in four or five lots over a longer period so your portfolio is less affected by short-term market movements. Buy companies that have interest cover (the number of times earnings can cover interest repayments) of at least four times. Beware sectors or shares that have already taken off. They may still be good investments, but research these shares to ensure they are not overvalued relative to their peers or the market generally.

Lessons from the GFC: Do not invest in any company you do not understand, and do not try to time the market. Those who sold at the bottom of the bear market have suffered huge wealth losses. Invest for the long term to smooth out market rises and falls. Do not follow momentum: don't chase shares simply because they are rising, or sell just because they are falling. Gains or losses may be due to sentiment rather than fundamentals.

Favourite sectors/themes: We like sectors that will do better as companies spend again on things such as recruitment or labour-hire services, information technology, or other business services in the next 12 months. Companies are loosening the purse strings and investing again in these areas. Mining services is another example, as resource companies increase exploration and project spending after conserving cash during the market downturn.

Three shares your fund owns: M2 Telecommunications, REA Group, CSG Group.



Rob Hopkins
Portfolio manager
SmallCo Investment Fund

Buy shares now? We believe so. The market is not as cheap as it was a year ago, but the Australian economy is going from strength to strength, which should translate into earnings growth over the next few years.

Investment approach: Obviously it depends on an investor's situation. Our approach is to hold a concentrated portfolio of good smaller and mid-cap industrial companies that will continue to prosper should the Australian economy grow over the medium term.

Lessons from the GFC: Two key themes were reinforced during the global financial crisis. First, the importance of a holistic approach to investment. At the height of the market, too many people focused upon earnings or dividend yields, and missed over-gearred balance sheets (with too much debt relative to equity), to their own demise. Second, the importance of investing in companies with reliable and consistent earnings.

Favourite sectors/themes: We like internet companies for two broad reasons. First, the strength of their business, namely the self-reinforcing circle of those using the internet going to the site with the greatest inventory, and those with the inventory (such as advertisers) going to the site with the most users. This leads to internet companies with a dominant position being very difficult to dislodge - a natural monopoly that is very attractive. Second, the expected demographic tailwind in Australia as advertisers, sellers and buyers continue to flock to the internet as their main marketplace over the medium term.

Three shares in your fund: The jobs portal, Seek, is a high return-on-equity and cash-generating business with a dominant market position. Growth avenues include the transition of employment classifieds to the internet and the cyclical improvement in employment, which we expect to continue. Talent2 International has experienced management who have been successful over a long period and now sit over a business in the early stages of the recruitment cycle recovery. ResMed Inc is a leading participant in the treatment of sleep apnea globally - a market we expect to continue to grow at double-digit rates for a number of years.



Neil Carter
Portfolio manager
Macquarie Small Companies Fund

Buy shares now? This is a good time to buy, mainly because the alternatives are not that appealing. Cash interest rates are fairly low; property is at all-time highs and affordability will worsen as interest rates rise; and bonds are likely to fall as interest rates go up. In contrast with the economic recovery continuing, this is a good point in the cycle to own equities. Earnings are likely to increase and there is scope for further re-rating of price-earnings (P/E) multiples. Equities also provide a hedge against inflation, should that rear its ugly head again.

Investment approach: Use a broad framework looking at five factors:

1. What is the quality of the franchise you are buying into? Seek out attractive industries and companies with sustainable competitive advantage.
2. What are the key value drivers of the business, and are they improving or worsening over the next few years?
3. Is the valuation attractive? Look for companies trading at a valuation discount to their peer group, on the right metric for that industry (usually a P/E ratio).
4. What risks can you identify?
5. How strong is management and what is their track record like?

If your company ticks all five boxes you should have a strong conviction it is a good investment. But remember, you will always get some things wrong so have a diversified portfolio. The smaller you go down the market-cap spectrum, the more diversification you will need.

Lessons from the GFC: Liquidity, liquidity, liquidity - from a corporate balance sheet point of view (is this company fully funded?) and from a personal portfolio perspective (can I liquidate this investment if it goes wrong or I need the money?) If not, avoid the shares.

Favoured sectors/investment themes: Information technology services, advertising, mining services, commodities - especially the bulks: iron ore, nickel and platinum. We also like renewable energy.

Three shares your fund owns: linet, Amcom Telecommunications, Austin Engineering.

From ASX

- The [ASX video Investing for yield](#) is an ideal place to start for investors who want to learn the basics about this strategy.
- [Dividends](#) on the ASX website also provides useful information for those who want to learn more about income investing.
- Another feature on the ASX website is a [dividend tool](#) that enables you to find dividends for up to 10 companies at time, by company or sector.

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