

The strategy To invest in small companies.

Why would I do that when they've been absolutely hammered for the past 18 months or so? If you're a bargain hunter, the best time to buy is when prices have been slashed. The rush to safe investments over the past year or two has created an environment where investors have lumped all small companies together and decided they don't want a bar of them. But good companies have been trashed along with the bad. One group that reckons this is the most attractive investment climate we've seen in years is Fairview Equity Partners, which manages the Fairview Emerging Companies Fund. Principal Chris Adams says the Small Ordinaries Index has traditionally traded at 12 to 14 times earnings. But it is now at about 10 times and some "very good" companies are trading at about half that. While the Small Ords has risen about 30 per cent since the end of February, it is still down about 50 per cent from its peak in early November 2007. Over the 2008/9 financial year, the Small Ords fell by 31.76 per cent.

Sounds like a wild ride. How risky is investing in the small end of the market?

Adams says small companies have greater leverage to both rises and falls in the overall market. That means you can do better than in large companies when the market is running hot but you can lose much more when prices are falling.

Good management is more important with small companies as managers generally play a hands-on role.

Smaller companies tend to be less diversified and more vulnerable to economic downturns and they also get knocked around when investors desert the riskier end of the market for safer investments. Adams says they also tend to be a lot less liquid than big companies. So when investors are bailing out, prices are pushed down further – though that lack of liquidity can also boost your returns when people are buying in.

For this reason small companies should only make up part of your share portfolio. The actual proportion will depend on your appetite for risk but Adams says 10 per cent to 30 per cent is probably in line with their weighting in the overall sharemarket.

He says the small companies sector is also weighted heavily to resources, which increases its volatility.

What sort of companies should I invest in? Adams says stock picking is an essential skill in small companies – especially in the current market, where there is still a risk of further economic bad news. The quality of the underlying business is critical. It needs to have a



I can do that

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solid and growing income stream, a secure market position, good pricing power – basically the sort of business you'd be happy to own yourself. But even more critical is the quality of management. Adams says good management is more important with small companies as the managers generally play a hands-on operational role in running the company. With large companies, this is rarely the case. He says the reliability of management's reporting is also important. "[Investors] have to be able to rely on what management is saying and with quite a few [companies] you can't."

Adams says companies such as McPhersons, ThinkSmart, APN News and Media, Retail Food Group, Australian Infrastructure Fund and CSG all have the potential to double in value. All have been trading at four to six times earnings and have maintained strong fundamentals despite the downturn. Adams says the group also includes a couple of cyclical stocks, which Fairview believes have been oversold and will bounce back strongly when the economy recovers.

But you have to do your research.

"There are quite a few companies that appear cheap but their earnings profile could still be weak or they could be subject to further downgrades because they're not good businesses," he says.

Is it easy to identify the winners? If it was, everyone would be doing it. Unlike big companies, smaller companies are rarely researched by brokers, which means investors have to make their own judgments and seek out their own information. Small company fund managers rely heavily on visiting companies and talking to management to get information but unfortunately this is harder for retail investors.

An alternative is a small companies fund. Adams says well run small companies funds have historically tended to outperform the index more often than funds that invest in large companies, though they are still highly volatile. Morningstar's figures show small company fund returns ranged from 12.89 per cent last year (the Hyperion Small Growth Companies Fund) to minus 35.67 per cent (Macquarie's Small Companies Growth Fund).