Small caps at a turning point

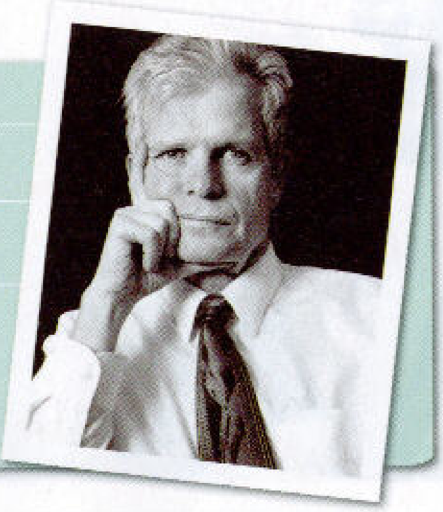
After a two-year bull market, the small-cap sector has been on the ropes recently. Opinion is divided as to whether this will turn out to be merely a blip. James Hall talks to the experts.

ROB HOPKINS
MANAGING DIRECTOR, SMALLCO

FLAGSHIP FUND
Smallco Investment Fund

ONE-YEAR GROSS RETURN
36.6 per cent

Rob Hopkins has been in the investment industry as a fund manager and analyst for more than 20 years. Before launching Smallco in 2000, he specialised in small-cap research at Macintosh, ANZ Securities, BT Alex Brown and Macquarie Equities.



BEN GRIFFITHS
DIRECTOR AND PORTFOLIO MANAGER, ELEY GRIFFITHS GROUP

FLAGSHIP FUND
The Eley Griffiths Group Small Companies Fund

ONE-YEAR GROSS RETURN
34.3 per cent

Ben Griffiths started Eley Griffiths Group with Brian Eley in January 2003. The duo formerly managed small-company portfolios at BT Financial Group and ING Investment Management. He has 18 years of markets experience.

JOHN LAKE
PORTFOLIO MANAGER, SMALLER COMPANIES, BT FINANCIAL GROUP

FLAGSHIP FUND
BT Institutional Smaller Companies Sector Trust

ONE-YEAR GROSS RETURN
41 per cent

John Lake is in his third year with BT Financial Group and his 10th year in the equities market. He runs the BT small-cap fund with colleagues Noel Webster and Paul Hannan.

LOUIE DOUVIS

Small companies have been good to investors over the past two and a half years as the booming Australian economy and soaring demand for resources has helped companies deliver record profits and increase dividend payments.

The Small Ordinaries Index almost doubled in value between March 2003 and late September. However, following two major retracements, some cracks have started to appear.

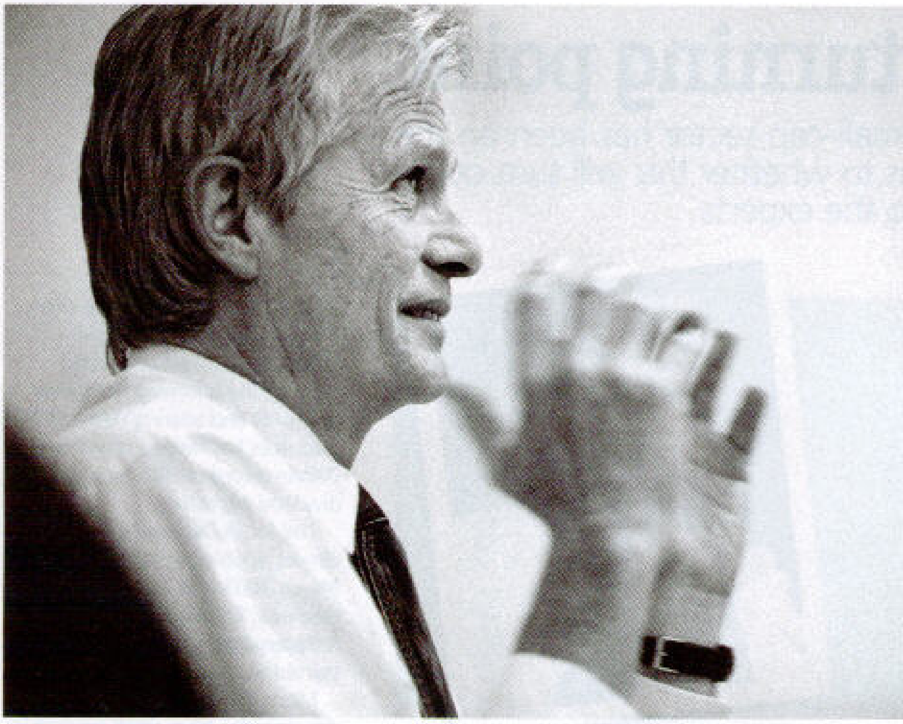
More than 150 earnings downgrades from small companies led to a 13 per cent slump that reached a low point in early May. Ongoing fears about global inflation caused by high oil prices led to another slump in October.

We asked three leading investors in small capitalisation stocks how they're coping – and what they're buying.

Can the bull run in small-cap stocks continue for much longer?

Rob: "It's possible, but it's not likely. Prior to the start of the Gulf war in March 2003, everyone was very pessimistic and risk averse and they didn't like small caps. Since then, the market's had this sense of euphoria because companies have more than delivered on earnings expectations. How long can it continue? On most brokers' numbers, small caps are now trading at a small price/earnings [P/E] ratio premium to large caps rather than the traditional 10 per cent or 20 per cent discount. I'd say that's unsustainable, and at some stage there has to a correction."

Ben: "The breaking of that 2000 to 2003 bear market in small-cap stocks was a very significant event. A surge in merger and acquisition



activity, combined with mounting evidence of an improving Australian economy, was the catalyst. But now the rally is two years old, investors need to be vigilant, especially as small companies often have a strong domestic focus, so strength in domestic demand is critical. Lately, evidence has been building that a slowdown in consumer activity, record raw material prices, accelerating wage levels and a lack of spare capacity to cope with these things in the economy might be beginning to hurt profit margins."

John: "The outlook is certainly more uncertain than it's been for some time, and some segments of the market are frothy, but we believe there are still opportunities over the next year. However, the small-cap market is unlikely to perform at the same rate as we have seen over the past few years. As long as the underlying economy remains solid, a modest positive trend can be sustained, but performance is likely to be more sector and stock specific over the coming year."

Rob: "The major influences over the next few months from a macro view on the whole market will be the effect a high oil price has on already relatively weak consumer confidence and hence retail spending, but also on inflation. If the Reserve Bank of Australia started a round of interest rate increases, this could well be a trigger for a major market sell-off. If there was a major market sell-off, we would anticipate that small caps would underperform as investors become more risk averse and move into big caps."

What methods do you use to value stocks, and what are these methods telling you right now?

Ben: "We've what we call a process-driven style of investment, which allows you to be disciplined about buy and sell levels, while enabling you to exploit share price momentum. In simple terms, that means we aim to buy companies with above average earnings per share growth for a below average P/E ratio. We also incorporate a critical appraisal of management and an industry rating on every stock. And we observe things like the prevailing yield curve, the bond-yield-to-earnings-yield ratio, small-cap P/E versus large-cap P/E, and the amount of new equity being issued. By these measures, despite the recent pullback, the market still appears a little overextended to us."

Rob: "The major valuation measures we use are P/E ratios, earnings before interest, tax, depreciation and amortisation ratios and dividend yields. Currently, we're finding it fairly difficult to find stocks to buy. However, as we're an absolute return manager we can short stocks to take advantage of falling share prices. And we've been finding a number of opportunities to short stocks recently."

John: "We also use P/Es and other earnings ratios as well as asset-based valuations such as net tangible asset backing and discounted cash-flow analysis. We're finding the current market still presents some opportunities, relative to our assessment of fair value. The greater uncertainty is over macroeconomic issues regarding the economy and the impact this will have on market sentiment."

So you all seem to see the October slowdown as the start of something bigger rather than just a bull-run correction? Why is that?

Rob: "We really don't have a view on where the market will go over the short term. We're bottom-up stock pickers and do not try to pick where the market is going. However, I'd say that with a prospective market P/E of approximately 16 times, the overall market does not look particularly expensive."

John: "After such a strong run, we were expecting some pullback in the period heading up to Christmas – the market was just looking for a reason. The volatility we've seen is largely linked to what has been happening in the US markets, where the key concern is the threat of rising inflation and the impact this will have on interest rates. Domestically, we're experiencing the follow-on impact of the fuel price hikes. We do expect this to remain an issue going forward, but the fundamentals of the Australian market remain largely intact, so we would expect to see, on aggregate, ongoing earnings growth across the small-cap sector in the short to medium term."

LOUIE DOUVIS

Ben: "In recent months, the Small Ords has benefited from strong liquidity flowing into the market. There's been speculative fervour, especially among some of the uranium mining hopefuls and a coterie of biotechs. After a long absence, the retail investor has returned to the market and is drawing down on his burgeoning cash balances. These are early indicators of a maturing market."

Is there a risk that these investors – some of whom have never really seen a recession – are too optimistic?

Ben: "There's no doubt the momentum of a strongly trending market can transfix investors, allowing their investment decisions to become emotional rather than rational. Profits, like markets, move in cycles so investors should be careful how they extrapolate earnings growth into the future."

Rob: "Until recently, the market was euphoric and investors seemed to be ignoring the potential effects of rising oil prices on an already slowing domestic economy. Now we've had a healthy little correction. We'll have to wait and see how the market performs and how earnings growth numbers come through to know whether investors are still too optimistic or not."

John: "There's always the risk that a bull market will drive a sense of overoptimism. It's an old industry adage that retail investors typically swarm to the market just as the party is finishing. Taking a disciplined long-term view on companies based around fundamental valuations provides a natural kerb to overoptimism. We certainly believe now isn't a time to be overoptimistic about the market's prospects."

What have been your best calls during the recent bull run – and is there anything you've missed?

Rob: "SFE Corporation, Record Investments, Transpacific Industries Group and Oakton have been recent successes. Stocks we've missed? There'll always be lots of opportunities you miss, but the key to good investing is avoiding the disasters."

Ben: "We've deliberately set our resource weightings higher than some of our competitors to capture strongly performing commodity markets. Aquarius Platinum, Excel Coal, Portman and Australian Worldwide Exploration have been winners. We've missed the boom in uranium mining hopefuls though – but we remain incredulous as to how many will fare over time."

John: "We've benefited from maintaining long-term positions in companies such as Transfield Services, United Group, Primary Healthcare, Timbercorp and Count Financial. There'll always be things you miss, but maintaining a balanced portfolio usually precludes you from buying every stock in a particular winning segment anyway. In a bull market, investors have to be careful about not being disappointed in missing every high-performing stock – a lot of so-called winners carry very high risk."

So what are you buying now and why?

Rob: "Not very much. One company we like is the New Zealand-based travel company Gullivers Travel Group. On current numbers it's trading on a prospective dividend yield of 7 per cent, which gives it strong defensive qualities in a difficult market, and we'd expect its very experienced management team to continue to grow its already strong position in New Zealand and the Pacific travel industry. We don't buy resources stocks because we've noted from previous commodity price cycles that they're notoriously difficult to predict, which makes earnings certainty very poor."

Ben: "We've been progressively increasing our cash weighting to better position the fund ahead of further softening in the market. We've identified a group of stocks that are currently just out of our buying range. If their prices come off a bit, we can buy them. The resources and business investment segments still interest us."

John: "We're still selectively buying stocks as we see both relative and absolute opportunities emerge. Given the current market volatility, we're finding good opportunities to add selectively to existing portfolio positions, as stocks get oversold among all the noise within the areas we're confident will continue to offer opportunities for growth." **Si**