

The view from some of the market's best small cap stock-pickers



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SMALL CAP VIEW

- Three months ago, small cap valuations were concentrated around the mean. Now valuations, measured by share price to discounted cash flow valuations, are more dispersed. We are finding ideas that look good long-term value, rather than the more marginal ideas earlier this year. In this murky environment, I expect small-caps to keep underperforming large caps. But there are good long-term opportunities for stockpickers.

- The short-term outlook for small caps is challenging. More earnings downgrades are filtering through. The market is looking for earnings-per-share growth of 30% for small industrials in financial year 2011. I am nervous about that number. Companies we talk to say things are OK but hardly boomtime. However, once we get through a difficult second half, small-caps could do much better as GDP growth returns to above 3%.

- The market is pricing in fairly aggressive earnings growth for small caps from financial year 2011. We agree with the earnings trajectory but think the timing is optimistic. Aggregate FY2011 earnings look too strong, with higher growth likely in FY2012. With more market consensus FY2011 earnings downgrades likely, it will be a stock-picker's year. The medium-term outlook for small caps is promising as the Australian economy accelerates next year.

KEY SECTORS/THEMES

- Small financials such as Bank of Queensland, Henderson Group and IOOF Holdings are attractively priced. Certain technology outsourcing companies are well positioned to capitalise on an improving economy and business-spending pick-up. Thermal coal producers are also interesting. Most have much longer mine lives than typical small resource companies and are better positioned on the global cost curve.

- Portal stocks such as Seek and REA Group have terrific growth prospects and higher earnings visibility. The challenge is high valuations. But the market may be overlooking the potential for Seek and REA to beat earnings expectations, which would lower forecast P/E multiples. Small media stocks look interesting as advertising picks up in an election year. Selected healthcare stocks also offer earnings visibility.

- The big theme will be takeover activity in small caps in the second half. We may be at the worst point for small retailers after several interest rate rises, terrible weather and weaker consumer confidence. Certain media stocks look attractive with more advertising likely this year. We like the mining services sector at current valuations but be selective. Look for companies with exposure to producing mines.

THREE TOP IDEAS

- Whitehaven Coal
- Bank of Queensland
- SMS Management and Technology

- Seek
- ResMed
- Southern Cross Media Group

- Bradken
- Ludowici
- ResMed

