

A small circle of good friends

One ambitious fund is beating the benchmark by reducing diversification, writes **Richard Hemming**.

Rob Hopkins of top performing small-cap fund manager Smallco Investment Manager hunts for stocks he believes will double in three years. And he has had some surprising success.

The performance of the fund he manages with fellow portfolio manager Bill Ryan at Smallco indicates the duo have found a number of companies that have made the grade.

"The question we ask ourselves is whether the stock can double in size over the next three years," Hopkins says. "We aren't looking for a 5 to 10 per cent return in the next month. The core of our strategy is to buy and hold a small number of companies."

The Smallco Investment Fund has returned 38 per cent a year for the past three years to October 31, well above its benchmark, the S&P/ASX Small Ordinaries Index, which has returned 23.7 per cent over the same period.

The pair invest in companies with market caps between \$100 million and \$500 million because these companies have sufficient buyers and sellers to guarantee ease of entry and exit but are still under the radars of many investors.

Hopkins attributes the group's success to investing its \$13 million in between 20 to 35 companies. Higher profile fund managers in the small cap space such as BT Financial Services and Paradise Investment Management tend to have more than \$500 million invested at any one time in anywhere from 50 to 80 companies.

"Other places argue that it reduces the risk of a portfolio to own a greater number of stocks, but we think it is better to have a small number of good stocks than so many where you can't remember their names," he says.

Key holdings in the portfolio include companies in the financial services and IT sectors because they meet the fund's criteria of achieving returns of 20 per cent plus on the



Rob Hopkins avoids retailers and property developers.

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company's equity, compared with the average return for small caps of about 10 per cent.

Companies from these sectors in Smallco's portfolio are trading systems provider IRESS Market Technology, website register provider Melbourne IT, IT services provider SMS Management & Technology, online advertising company emitch and online accommodation provider Wotif.com.

Despite the 62 per cent increase in IRESS's stock price in the past 12 months, Hopkins still believes the stock could double over the next three years. Its stock finished up 13¢ to \$7.03 on Friday.

"All the fund managers in Australia and New Zealand are on its system where it has a monopoly position," Hopkins says. "It can push up pricing. It doesn't do it aggressively but it is also good at adding extra services, recently adding electronic trade confirmation."

The company trades on a forecast price-earnings multiple of almost 23 times, a premium to the average one-year forward small cap P/E of about 16.5 times.

Hopkins also believes in emitch's ability to grow its earnings per share above 20 per cent a year in the next few years.

"The online advertising market is

becoming the second-biggest ad market behind newspapers and free-to-air TV," he says. "In the current year, internet advertising volumes have gone past radio and magazines."

Recent purchases include Macquarie Media, the fund which is 20 per cent owned by Macquarie Bank and invests in domestic and offshore media companies. The compelling reason, Hopkins says, is the fund's yield, which is forecast to be 9.4 per cent this financial year and 12 per cent in fiscal 2008.

"There is an old adage in the stockmarket: companies don't trade on double-digit yields, because either they don't pay it, which I don't think will be the case, or the share price goes up."

In mid-November this year, Macquarie Media bought 15 per cent of regional media player Southern Cross Broadcasting.

According to Hopkins, this deal puts Macquarie Media in a box position in regional media because of its ownership of Macquarie Regional Radioworks. He believes the deal cements its monopoly position in regional media because its holding prevents other corporations taking over Southern Cross Broadcasting and clears the way for it to bid for the privately owned Nine affiliate WIN Television.

Smallco doesn't invest in companies that rely on increased spending by consumers on non-discretionary items such as fashion and new homes because Hopkins says that their profits are too dependent on the vagaries of the economic cycle.

"As a general rule we don't invest in retailers, building material providers or property developers. You would have to predict when the [economic] cycle will turn and more importantly, when the market thinks the cycle will turn.

"We prefer financial services companies because they make bigger profits each year no matter what the condition of the economy. We don't look at resources companies because their profits depend upon commodities prices, which are too hard to predict. We don't know enough about this sector."

Knowing your weaknesses as well as your strengths is something Smallco has turned to its advantage.