

# Good times under threat

Investors who have been in small company funds during the past three years are probably feeling decidedly smug. Most have enjoyed a dream run, gaining 25 per cent, on average, for each year.

The past 12 months, in particular, have been exceptional. At least 10 small company funds have gained about 5 percentage points more than the large company funds that form the mainstay of most investors' portfolios.

The top performers have done even better. The Ganes Focused Value Fund, which owns shares in companies such as Treasury Group, Mortgage Choice and Flight Centre, is expected to return an impressive 46 per cent for the 12 months to the end of October, according to its portfolio manager Clive Gaunt.

But these lovely returns don't come without a catch. Small company funds are synonymous with risk because they tend to feel every bump in the economy – which is why most experts don't believe these good times will last.

Driving the small-cap boom in recent years has been the injection of cash into the sector as a consequence of low interest rates, a buoyant economy and strong consumer confidence.

But the rise of cash rates globally and inflationary pressures is likely to affect small company profits, leading to more subdued returns in the next 12 months.

Eley Griffiths' small companies fund manager Ben Griffiths says: "A succession of high rates and a slowdown in economic activity will crimp the ability of small companies to post growing profit."

The booming sector has also been trading at similar price-earnings ratios as the big companies, which most say is unsustainable. MMC Asset Management chief investment officer Peter Constable says small companies are trading at historic highs, making it harder to find a bargain.

"But from what we're

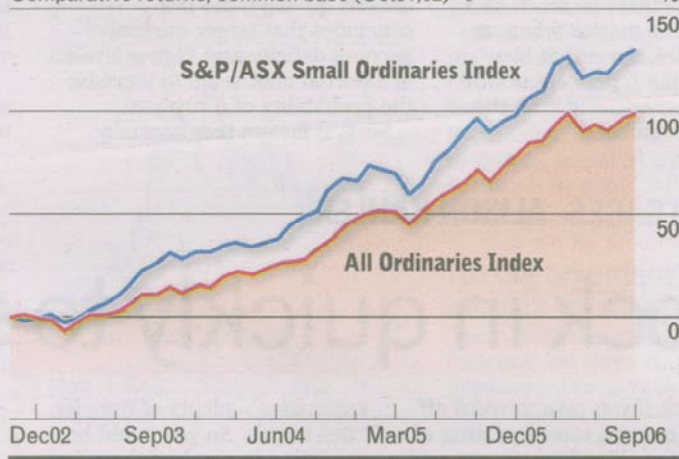
## LITTLE BEAUTIES

### Best small company funds

Name	1 yr (%)	3 yr (% pa)	5 yr (% pa)
Ganes Focused Value	37.37	26.47	—
Smallco Investment	34.56	38.77	22.05
Macquarie Master Small Companies	33.96	33.69	22.19
Pengana Emerging Companies	33.86	—	—
Macquarie Small Companies Growth	31.36	31.01	20.30

### Small Ordinaries Index v All Ordinaries Index

Comparative returns, common base (Oct31,02)=0



Source: Morningstar, Bloomberg

hearing, small companies aren't finding it very easy to make money at the moment," Constable says. MMC's small companies fund is taking a defensive stance, holding about 25 per cent cash in the fund.

But Macquarie's small company funds portfolio manager Neil Carter takes a contrarian view. He expects small company funds to continue to produce strong returns, adding that average returns have been higher in the small-cap sector than any other asset class in more than 15 years.

Carter explains that if an investor put \$1000 into Australian small-cap stocks in January 1990 they would have made more than \$20,000 by January 2006, while other stocks such as domestic large capitalisation shares would have delivered about \$6000.

Most small company funds invest in industrial stocks and

steer clear of cyclical stocks like resources. This is because many small-cap resource stocks are non-producing mining exploration companies which have yet to generate sustainable revenue. Others don't invest in capital intensive sectors like manufacturing.

## The past 12 months, in particular, have been exceptional.

Smaller companies can grow much quicker than bigger companies that also means the potential for downside risk is greater. Because of the volatility of these funds, investors are usually advised to limit the amount they invest to between 5 per cent to 10 per cent of

their total portfolio, with minimum investments ranging from as little as \$1000 up to \$50,000 for new investors.

Most small company fund managers look for three things in stocks: a strong dividend yield (upwards of 4 per cent), good earnings growth (10 per cent) and a company that is not yet recognised widely by the market (trading at 9 or 10 times earnings).

These funds tend to invest heavily in stocks with less than \$130 million in market cap, but others have a mandate broad enough to include everything from so-called micro caps to large companies, giving managers a choice of up to 800 stocks.

Some funds hold as much as 70 stocks or as few as 15 in a portfolio. The more concentrated the holdings the more impact individual stocks will have on the portfolio, affecting a small-cap fund manager's ability to manage a fund's size effectively.

Keeping funds small in terms of assets is another important way to enhance the performance, so most managers close to new investors by the time they reach \$500 million. The bigger a fund, the harder it is to buy and sell stocks without flagging it to other investors who might demand a better price. Small companies are not traded as often as big ones so any big trade is immediately noticed.

"Some fund managers are trying to manage \$1 billion of small company money. We think in this market that is far too high to try and get good performance," says Smallco Investment Manager managing director Rob Hopkins.

Smallco owns shares in companies including data provider IRESS and held the Sydney Futures Exchange when it was merged with the Australian Stock Exchange.

Fees for these funds usually include an ongoing annual fee from 1 per cent to 3 per cent, plus a performance fee of 20 per cent when gains reach a certain level.