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Good things in small packages
hit hard when times get tough



Small cap funds have topped the charts, but now is not the time to jump in, writes George Liondis.

WHEN they are good, they can be very, very good. When they are bad, they can be rotten.

Luckily for small company, or small cap, fund managers, it has been a good year, although you would get very long odds on a repeat dose over the next 12 months.

Small cap managers stick to stocks outside the top 100 companies in Australia. Stocks most of us haven't heard of.

You won't find these fund managers investing in BHP, Rio Tinto, Telstra or any of the big banks.

Small and often lesser-known companies have more potential to deliver the surprise-packet returns investors dream of.

But it's a two-way street. When markets fall, small cap stocks are likely to fall longer and harder than larger, more established companies, which is why most experts are urging extreme caution with the sector.

But first, the good news.

GOOD DAYS

The figures don't lie. It has been a pretty good year for small cap fund managers, especially when compared with those that concentrate exclusively on the larger end of the market.

Of the 10 best-performing retail-managed funds in Australia over the past financial year, all but two were small companies funds.

This includes funds offered by well-known managers such as Macquarie and Colonial First State, as well as small cap specialists such as Opus Capital and Smallco.

Smallco's managing director, Rob Hopkins, says the success of small companies comes down to a simple formula. "Small companies offer more

opportunity," he says. "They are more likely to double or triple in size. Whereas for a company like NAB, this would be very difficult."

The performance of small cap funds over the past year is even more remarkable given they haven't been able to invest in mining giants such as BHP and Rio, which have consistently been among the top performers.

But that doesn't mean small cap funds haven't grabbed a piece of the mining boom.

John Bugg, head of small companies at Macquarie Funds Management, says his fund found a backdoor way to get in on the act.

It invested in small engineering and construction companies that service the mining sector, including WorleyParsons, United Group and Bradken.

The fund was the top-performing retail

After three years of record returns, the consensus is the local stockmarket is running out of puff.

And a falling market is not a happy hunting ground for small cap funds.

"Small companies are typically more risky and they are typically more exposed to economic downturns," says Jerome Lander, acting head of fund manager research at van Eyk. "They tend to underperform when things get worse on the markets and largely outperform at the start of a bull run."

Small cap managers admit a market correction will hurt.

"If markets go down, I think you will see small companies go down," Smallco's Hopkins says.

"At the moment, we have small companies trading at a premium to larger companies and I don't think that is sustainable.

"In the long-term, small companies should trade at a 10 per cent to 20 per cent discount to larger companies. If we get a downturn, it will hit small companies worse."

CHOOSE WISELY

Even in favourable market conditions, Lander says, investors have to take care when choosing a small cap fund manager.

"Some small cap managers run portfolios with very high stock-specific risk that is not well managed - they are taking big bets on risky stocks," he says.

"You are better off with a more diversified portfolio that will outperform over time."

Another factor to weigh up is fees.

On the face of it, small cap managers don't charge a whole lot more than those who invest in larger stocks. The average annual management charge for small cap funds is 1.96 per cent, compared with 1.74 per cent for large company managers, Morningstar Research data shows.

But Lander says many small cap managers are beginning to charge "performance fees" on top of their basic management charge and these often kick in at too low a threshold, so investors pay more for only moderate amounts of outperformance.

TOP 10 SMALL CAP FUNDS

Name	1 Yr %	3 Yr %pa	5 Yr %pa
Macquarie Small Companies Fund	39.18	37.94	17.84
Pengana Emerging Companies Fund	37.49	--	--
Smallco Investment Fund	35.49	42.68	21.25
Opus Capital Premium Equity Fund	33.47	27.38	22.53
Colonial Developing Companies Fund	33.27	25.88	12.92
Opus Capital Dynamic Equity Fund	32.60	30.98	24.97
Portfolio Partners Emerging Shares Trust	31.91	30.76	14.78
Colonial Future Leaders Fund	31.30	27.83	11.02
AMP Small Companies Fund	28.96	34.11	18.24
Aust Unity Acorn Microcap Trust	28.77	27.40	--

Australian share fund over the past 12 months, returning more than 39 per cent.

MARKET WARNING

Despite the strong performance of small cap managers, many experts are now treading warily.

Managed fund research group van Eyk usually tells its clients to allocate 10 per cent of their Australian share portfolio to small cap funds, but the group is now warning investors to limit their exposure.

Why? Simply because of expectations about where the Australian sharemarket is headed.