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GETTING A BIGGER BANG FOR YOUR BUCK

Small-cap equities have a reputation for being volatile, but the additional potential returns can make the extra risk worthwhile. Simon Hoyle reports.

The boutique fund manager NovaPort Capital declared at the end of March that more than a third of all Australian Securities Exchange (ASX)-listed small-capitalisation companies will increase their earnings by at least 10 per cent a year over the next three years.

NovaPort, a specialist small-cap fund manager, said that almost two-thirds of the small-cap sector could be classified as having "moderate" or "high" growth potential, with the 10-per-cent-plus "high-growth" cohort representing 34.6 per cent of all small-cap companies.

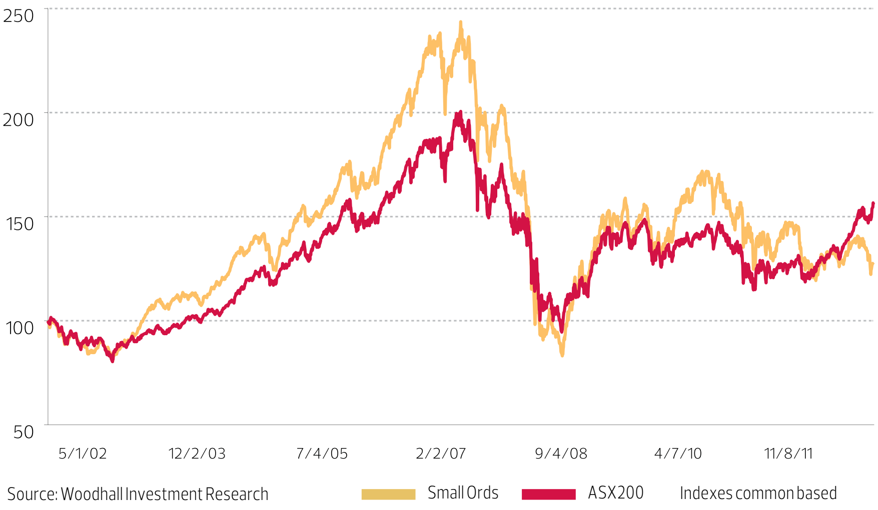
That is welcome news – or, at least, a welcome forecast – for a sector that severely underperformed its large-cap counterpart during 2012. Research firm Lonsec said in a report released in March that the S&P/ASX Small Ordinaries Index returned 6.6 per cent compared to 20.3 per cent for the S&P/ASX 200.

However, it added that "the majority of managers in the Lonsec small cap peer group considerably outperformed the benchmark in 2012", underlining the commonly held belief that small-cap managers generally deliver greater alpha – or return in excess of the benchmark – than large-cap managers.

The accompanying graph, prepared by Woodhall Investment Research, shows that in the 10 years to the end of April 2013, the performance of the S&P/ASX Small Ords was largely in-line with the S&P/ASX 200. But it also clearly shows there were periods when small-cap stocks outperformed large-cap stocks – and it's the companies that drive this outperformance that small-cap managers aim to invest in.

As Ron Bewley, executive director of Woodhall, says, successful small-cap fund management is largely about "avoiding the dogs".

LITTLE AND LARGE



Source: Woodhall Investment Research

Small-capitalisation companies are those listed on the ASX that are ranked outside the Top 100 but within the Top 300, by market capitalisation.

And they include some household names, such as Webjet, JB Hi Fi, Cabcharge and Domino's Pizza. (See table: The big end of the small end of town.)

Michael Courtney, portfolio manager for Ellerston Capital, which manages the Zurich Investments Small Companies Fund, says there are two ways to gauge the performance of small-cap fund stocks and managers.

"You can look at it in absolute terms, or in risk-adjusted terms," he says.

"The volatility of returns – the standard deviation of returns – does show that the small-cap index has been more volatile than, say, the ASX 100 Index.

"But then the other way to look at it is on a risk-adjusted basis, which is where you say, what's the return versus the risk?

"If you look at the median small-cap manager versus the median large-cap manager, the median small-cap manager [has produced] a much higher level of return for the level of risk."

Courtney says that the level of excess returns generated by small-cap managers "over the past couple of years has been a lot higher than it has been historically", and there are two reasons for that.

"One is the large underperformance of the resources sector," he says.

"You could say that on average most small-cap managers have been underweight resources, or have been over the past couple of years, and so they generated large excess returns relative to the index because of that.

"And second, probably, has been if you avoided a large amount of companies that have been driven by a slowing domestic economy, they would have made up a large part of the index as well.

"If you'd avoided those two things, you'd have generated a large amount of excess return over the past couple of years."

Courtney says the "large excess returns are probably unlikely to continue over the next three to five years" because the two underperforming sectors represent a smaller part of the index "and if they continue to go down, the proportional effect is not as large as it was over the past couple of years".

There are a couple of hundred stocks in the Small Ords Index, and it's a close to impossible task for the average manager of a small-cap fund to be fully across every single one of them.

"We start off looking at all stocks in our universe," Courtney says.

"We focus on all companies outside the ASX 100, so focusing on small-cap stocks, and generally companies greater than $100 million market capitalisation. And then we exclude a whole bunch of companies – we don't do REITs [real estate investment trusts] or listed investment companies, so that narrows the universe down quite a bit once you exclude all of those.

"There's probably about 300 to 400 companies [that] come out of that initial screen; and then we're really looking for companies that we think have a minimum 50 per cent upside return over three years. When we put a portfolio together, we don't run it from a relative perspective. We don't go, these are the top five stocks in the index and do we want to underweight or overweight them?

"We look at our universe of companies and decide which companies we think may have a chance of delivering over 50 per cent return over the next three years. Then we look at, what is the level of downside risk for those companies?

"We don't really want to buy companies that have 50 per cent chance of going up 50 per cent, but a 50 per cent chance of going down 50 per cent. We like to have the ratio skewed more two- to three-to-one in terms of upside over downside effect.

"And that upside or downside [assessment] will come from looking at things like valuation. If a company is on, say, 10 times versus 30 times p/e [price/earnings], there's more downside risk to the company that's on 30 times p/e, generally speaking."

Courtney says the manager also looks at the business model of the company and how sustainable it is, the company's

SMALL-CAP FUNDS, BIG RETURNS

Fund name	APIR Code	Net Assets ($m)	One-year return (%)	Three-year return (%pa)	Five-year return (%pa)
Hyperion Small Growth Companies	BNT0101AU	60.56	39.20	14.20	16.92
BT MicroCap Opportunities WS	RFA0061AU	150.29	13.27	15.96	14.03
Smallco Investment	ASC0001AU	128.04	54.46	23.08	12.93
Schroder Microcap	SCH0033AU	2.71	38.58	20.96	12.61
SGH ICE	ETL0062AU	73.06	28.52	12.68	11.90
Naos Emerging Companies Long Short Eq	NAM0002AU	7.43	-9.98	5.76	11.63
Ironbark Karara Australian Small Comp	PAT0002AU	164.00	8.72	9.81	11.14
CFS Wholesale Developing Companies	FSF0468AU	2.95	14.89	14.16	11.10
NovaPort Premier Smaller Companies	HOW0018AU	3.21	31.59	12.89	10.78
CFS FC Inv-CFS Developing Companies	FSF0088AU	4.02	14.07	13.40	10.29
NovaPort WS Smaller Companies	HOW0016AU	53.09	27.84	11.73	10.08
CFS Developing Companies	FSF0035AU	234.25	13.86	13.15	10.08
SGH ICE Professional Investor	ETL0374AU	0.00	27.77	10.81	9.80
NovaPort Smaller Companies	HOW0017AU	20.67	30.57	11.73	9.62
Investors Mutual Small Cap	IML0006AU	14.67	18.92	12.34	8.79
Pengana Emerging Companies	PER0270AU	562.07	24.38	11.62	8.77
Ganes Value Growth	WPC0004AU	45.55	22.24	13.18	8.41
Intelligent Investor Wholesale Value	WPC0003AU	31.93	25.83	12.44	8.37
Wilson HTM Priority Growth	WHT0008AU	83.02	-3.22	0.09	8.35
Ganes Focused Value	GCM0001AU	8.41	20.49	12.32	7.73

Source: Morningstar Performance data to 30-Apr-13 Funds ranked by five-year performance

> "IF YOU LOOK AT DATA OVER TIME FOR SMALL-CAP MANAGERS, WE'VE BEEN ABLE TO ADD A LOT OF EXCESS RETURN, A LOT OF ALPHA

competitors and industry, "and then we try to model what the earnings will look like over the next three to four years".

"We'll visit the company maybe one time, several times, and their peers, and get an understanding of how that business is operating, and try to give ourselves a level of comfort in terms of what we think that upside potential is and what the downside risk is.

"We don't chase companies that are worth $1 and try to buy them for 90 cents; we're looking for bigger upside over time. That way, if it doesn't work out, we've got a bit more of what we call a margin of safety when we do that."

Courtney's portfolio typically holds 35 to 40 stocks.

The chief investment officer for Avoca Investment Management, Jeremy Bendeich, says that large-cap managers have struggled, net of the fees that they charge, to add a lot of value.

"That's why many people are going into index funds, large-cap index funds," Bendeich says.

"They're paying a large-cap fund manager and they're not getting a lot of bang for their buck. But if you look at data over time for small-cap managers, we've been able to add a lot of excess return, a lot of alpha. And in Avoca's particular case, since inception, it's about 13 per cent over and above the index – that's since we've been going, in August 2011. That's similar to our previous track record, or a little bit better, before we left UBS.

"We're not unique. There are many of us that have been able to do that in the past and that's primarily a function of the fact that the large-cap market is very well researched; it's much, much more efficient;

and you don't get as big opportunities to buy stocks cheaply, when the market gives up hope about a stock or the market gets it wrong.

"There are some great inefficiencies in the small-cap market, whereby people like ourselves who go out there and do a lot of rigorous analysis, can say, we think a stock is worth $1.50 and it's now trading at 75 cents. You don't normally find a stock that's worth 100 per cent more in the large-cap market, but you can find these stocks [in the small-cap market] if you do your work, and you can construct some interesting portfolios which generate some really nice returns.

"We might be one of 10 people initially working on a stock in the small-cap market, whereas there's 100 or 1000 guys looking at CBA or Westpac, something like that. You don't tend to get those opportunities, because people just move the money so quickly."

Bendeich says some of the best ideas come from watching as companies grow from about $100 million to $250 million in market capitalisation.

"It's when they get to the stage of $250 million to $700 million that things can get pretty interesting," he says.

"It should be more than just a concept at this stage. Or there should be some certain hard asset behind it that you can stick some kind of valuation on."

Bendeich says there are 400 to 500 stocks that fit that category, even though there are only 200 stocks in the Small Ords Index.

"That's why we limit research capability; we try to identify some potential stocks that we want to do work on, and then we hone in. In our team we only look at 90 to 100 stocks of that bigger universe – otherwise you'd just be spinning your wheels all day long trying to keep on top of 600 potential investments.

"We narrow it down and then of those 90 to 100 we typically invest in 35 to 45 of them. You've also got, in the small-cap space, a lot of companies that are much happier to talk to you. They want their story to be known; they provide you with very good information; and some of the stories are a lot simpler as well – there might be just one product, selling in one type of market, whereas how do you know what Rio Tinto is worth? It's like about 100 companies.

"Small companies generally have less diversity in their earnings – a business might be based on a single product – and they often have a concentrated client base or market. Any changes in the environment they operate in – a new competitor might emerge; or they might lose a major customer - can quickly and fundamentally change the valuation of the company. Bendeich says risk is therefore mitigated in a traditional way at the portfolio level: "We don't put all our eggs in one basket. We have a maximum position in any stock of 6 per cent of the fund. And we don't concentrate all our bets in one particular sector." ■

This article has been edited to add the fact that Ellerston Capital is manager of the Zurich Investments Small Companies Fund.

EXPERIENCE PAYS

Ellerston Capital's Michael Courtney says the fund he runs can place up to 20 per cent of its money in Asian small-cap funds - a feature that sets it apart from other funds in the local market.

When he spoke to *Professional Planner*, Courtney was in Manila assessing potential investment opportunities there. The Zurich Investments Small Companies Fund, which Ellerston manages, invests part of its portfolio in Asia ex-Japan small-cap companies.

"We're trying to work out whether our existing investments are good, and whether we should be adding new investments going forward," Courtney says.

The experience the manager has gleaned in Australia guides its decisions in Asia, he says.

"We don't try to know everything about every single stock in Australia or across the whole of Asia, he says. "In Asia we look at more thematics. We do not focus on all sectors of the market. We're not doing tech stocks in Taiwan or Korea, for instance, We're doing areas where we think we have a level of knowledge and expertise that we can apply from our Australian experience into Asia.

"We think we're pretty good at looking at consumer names in the Australian market, and then applying that into the consumer space in Asia. In the past we've owned a supermarket chain in the Philippines. In some parts of Asia you're getting higher levels of GDP growth than in Australia and higher levels of consumer spending, without the large risk that's been imposed by the internet, because of the low penetration of the internet."

Courtney says Ellerston has owned pay-TV company Austar in Australia, and used that experience to invest in a pay-TV operator in Indonesia. There, he says, there is less threat from "the disaggregation of the market because of the internet...which really hurts the pay-TV model".

"But in a place like Indonesia, there's only 10 per cent internet penetration and it's an archipelago, so satellite TV works quite well, so we can see some very strong factors driving that market.

"We look at themes that have worked in Australia over time and apply them into countries in Asia that are a bit behind Australia in terms of economic development."

TABLE: THE BIG END OF THE SMALL END OF TOWN

Top 10 companies in the S&P/ASX Small Ords – by index weight

Company	ASX Symbol	GICS Sector
1. Australian Infrastructure	AIX	Industrials
2. IOOF Holdings	IFL	Financials
3. Perpetual Limited	PPT	Financials
4. Super Retail Group	SUL	Consumer discretionary
5. Henderson Group	HGG	Financials
6. DuluxGroup	DLX	Materials
7. JB Hi-Fi	JBH	Consumer Discretionary
8. REA Group	REA	Consumer Discretionary
9. Fairfax Media	FXJ	Consumer Discretionary
10 Navitas	NVT	Consumer Discretionary

Source: S&P Dow Jones Indices. Data as at March 28, 2013.

Value need not be measured by size.

Zurich Investments Small Companies Fund

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