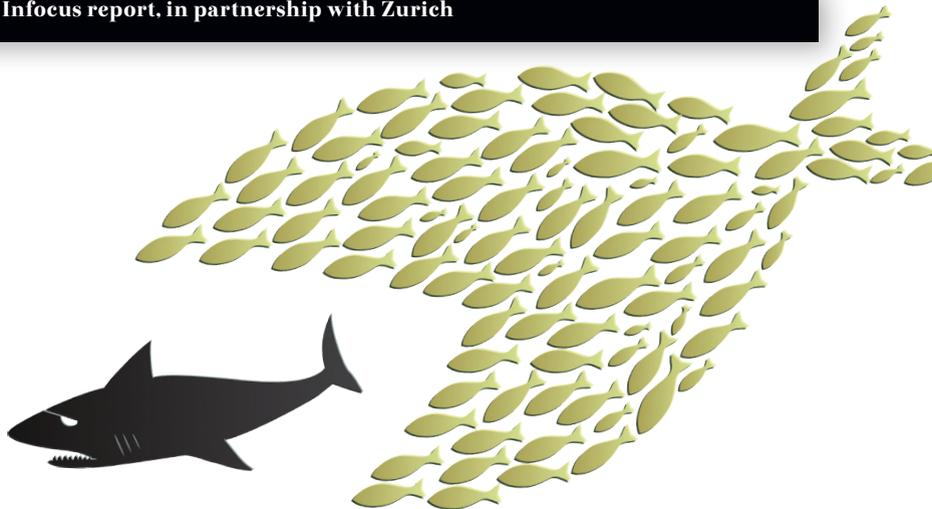


WORDS TAHN SHARPE



# The BIGedge IN SMALL CAPS

MANAGED FUNDS HAVE FOUND A WAY TO PUSH BACK AGAINST THE TREND TOWARDS PASSIVE BY **SWIMMING IN THE DIMINUTIVE END OF THE ASX**, WHERE EXPERTISE AND CAPACITY FOR RESEARCH CAN REALLY PAY OFF.

**A**s the rise of exchange-traded funds turned the screws on managed fund providers, the active management side of the industry was forced to take an honest and critical look in the mirror.

While index advocates have been beating the drum, active funds have quietly evolved. Not only are they leaner and cheaper, they have also rediscovered their mojo, via a small-cap sector that is value rich and tailor-made for their strengths, analysts and advisers say.

Index funds have revolutionised the investment landscape, bringing low-cost options to consumers. Yet when it comes to small caps, quality fund managers have a fundamental advantage, in that they can sift through the bigger pool of companies that sit down the lower end of the ASX, and cherry pick the ones that are undervalued.

“Each one of these companies,” Morningstar senior analyst Ross MacMillan says, “is far less researched than a CBA or Woolworths.”

This absence of quality research provides fertile ground for fund managers who can provide it, MacMillan explains.

Zurich Investments investment specialist Charles Stodart makes the point that “the universe is larger and more diversified” in the small-cap arena, which provides “a broader opportunity set”. Small-cap companies are big enough to offer scale, but small enough to offer real value.

“The small-cap space does tend to be under-researched,” Stodart says. “Less analyst coverage means you have much more potential to discover undervalued stocks.”

#### A FLUSH MARKET

Grant Patterson, managing director at Providence Independent Investment Advisory, says having the resources and the wherewithal to analyse small caps is even more valuable in the current economic environment, when the domestic market is fully priced.

“Active managers make a big difference, particularly with small caps, because they weather the cycles





much better,” Patterson explains. “When markets are fully valued – as they are now – we’d be cautious about following the momentum through passive indices because we don’t believe that’s going to provide protection in the downturn.”

Zurich’s Stodart shares the view that we’re entering a late-cycle environment. He says small-cap gains will be harder to come by in the near future. Having just relaunched the Zurich Small Companies Fund in December, in partnership with Sigma Funds Management, Stodart has a close eye on current market expectations.

“Most asset classes are fully valued at this time, and upside opportunity in small caps is limited,” he says. “When your starting point is one of high valuation, that limits the return opportunity over the following period. It’s hard to see how the environment can get a lot better, given that interest rates are already low and may go higher.”

This is where expertise delivers. Despite the relative lack of value in the market, Stodart is confident Zurich’s Small Companies Fund can outperform the index by as much as 5 per cent. Achieving this would mean leveraging deep research capabilities and drilling down past sectors and markets, to the level of individual businesses and people.

“At this stage, the upside in small caps won’t be found at a broad index level, it’s there at a company level,” Stodart says. “For us, that means anchoring the process in a reasonable valuation, and then doing a comprehensive business risk assessment that looks at the industry, the franchise itself, management and how they use their capital.”

#### CLIENTS NEED A STORY

For advisers, it’s important that clients co-sign on their investment choices and have a degree of understanding about their portfolio. However, it isn’t feasible to go into detail about a plethora of individual small-cap companies, and clients rarely have the patience for it.

Instead, advisers increasingly present the fund managers themselves as the story. But in an environment where active management is often pitched against lower-cost index funds, the narrative needs to be compelling.

Liam Shorte, director at Verante Financial Planning, says advisers need to focus on who

the manager is, not what they’re invested in – philosophies, not firms.

“You want to sell a manager’s performance and level of knowledge, rather than individual small-cap companies,” he explains. “It makes a lot more sense to paint a picture using their experience, their results and their philosophies, because the client doesn’t always know those smaller companies.

“If it’s too complex,” Shorte says, “clients won’t understand it. People want confidence in what they’re investing in.”

Stodart says having a strong and consolidated story was part of the reason Zurich reverted back to purely domestic equities when the Small Companies Fund relaunched.

“Our previous manager had an allocation to Asian companies in the small-caps fund, but now it’s purely an Australian small-caps fund,” he explains. “What we’ve done with Sigma is make the fund somewhat cleaner for advisers, which we think is a real value add.”

The other advantage for Zurich is that a consolidated allocation ticks a well-defined box in the kind of managed accounts that the advice industry is trending towards.

“A balanced client portfolio might have around a 30 per cent allocation to domestic equities, of which, 5 per cent to 10 per cent will be put towards small caps. The Small Companies Fund is tailor-made for that slot.”

#### FOOL’S GOLD

It’s tempting for investors to gamble on individual small caps themselves – and it’s a big risk.

Morningstar’s MacMillan says that for clients and advisers, “It’s really worthwhile finding a small-cap fund manager with an established history of getting good returns.” Concerns about the external factors that might affect small caps are largely better off left to the experts, he says. At any rate, they are probably already priced in.

“It’s not a matter of worrying about the economic environment, and this sanguine view also applies to legislation and technology,” MacMillan explains. “Look at rates; the next move will probably be upward, but should that stop you from investing in a small-cap manager? Not particularly. The right manager should know that anyway.”

Zurich’s Stodart agrees that advisers shouldn’t pay undue attention to ups and downs in the economic environment. He points to the perception that technology poses a threat to small caps as an example.

“The broad perception is that tech is a threat, but there are always individual companies that can harness that threat and turn it to their advantage,” he argues. “Good quality companies will always be able to find their place in the market.” ■



We've partnered with Sigma Funds Management to provide your clients with the best investment opportunities – from the untapped potential of Australian small caps.

Zurich's Small Companies Fund handpicks a portfolio of small cap stocks – including brands your clients know and love. Companies with passion, performance and growth potential, proactively selected through Sigma's value-driven process.

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