

Starring role for minnows

Smaller companies produce big results given time, reports John Synnott

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FUND managers want investors to be patient and take a long-term view.

Have an investment time-frame of at least five years, they often say.

Financial experts are also fond of saying that a one-year top performance is no guarantee of future performance.

Instead, they say investors are likely to do best out of a fund that can weather a full market cycle - or close to - and still emerge in the top quartile of performers.

So, what sort of managed funds have done best in the past five years?

The answer is smaller company funds - broadly speaking, these funds invest outside the Top 100 companies, though some do invest in midcaps, the second 50 of the Top 100. Eleven of these smaller company funds made it into the Top 20 performers, according to Morningstar Research.

That's twice as good a show as large Australian - typically managed funds investing in Top 100 companies - company funds with five in the Top 20.

And so it should be, with small companies running particularly hot in the past three years (a 27 per cent rise versus 21 per cent for large companies).

So, how do they do it?

Taking a 40 per cent bet on resources helped to make the EQT Small Companies Fund the top performer.

Yet, it is really about being different and not following the herd to find value, according to top performer Steve Hiscock, the fund's chief investment officer.

"We have a bias to smaller companies, some are so small they are outside the smaller companies index," he says.

The fund manager looks at a company's quality of management, the industry structure and the stock's valuation.

And, if you do target tiny companies around the \$100 million market capitalisation size, they are relatively friendless, perhaps with one or two institutional investors; and they are not properly researched and they are the best place to hunt for value.

In contrast, the bigger small companies, capitalised at \$600-700 million, are researched by stockbrokers and generally have institutional investors.

The top-end companies in the smaller companies sector have had a fantastic year, but EQT believes the outlook is better from the bottom of the market. "For major small company stocks the outlook is not so good

in that they are incredibly expensive, trading at a premium to the large company index," says Hiscock.

Persistence is the key to success for Opus Capital Premium Equity, says director of investments Dean Fergie.

"We go for growth companies doing good things that will get better in 2-3 years time.

"Many investors will sell out when companies have risen 50 or 100 per cent to realise their profits.

"We have held ABC Learning and Timbercorp for four to five years."

And, the manager does not get hung up on short-term volatility of even 30 to 50 per cent falls if the company is on track, as in the case of Toll Holdings.

The twist for the Smallco Investment fund is that it is only the smaller companies fund that takes short positions in up to 20 per cent of its holdings, when the manager believes the share price will drop. This strategy has provided 15 per cent of the return, though it does make it more risky.

"The companies we invest in are forecasting 35 per cent earnings growth in the next 12 months, provided the share market does not get hit badly," according to senior fund manager Rob Hopkins.

Portfolio Partners High Growth Shares Fund, which focuses on large companies, has also been a solid performer over the past five years.

"We operate away from the pack and are prepared to give a five-year time frame to non-consensus stocks," says Richard Dixon, senior investment co-manager.

"We got into resources stocks (such as Woodside, Newcrest, AWE) early when they were out of fashion and they have only been running hot for the past two to three years," he says.

"We also go short and long, so if we are fully invested we could be 125 per cent long and 25 per cent short. With stocks such as Computershare, we went short when it was \$8 and priced at 80 times earnings and we thought it would fall, and then went long when it reached \$1.50 and now it is \$7.50."

Pengana Emerging Companies fund bought over a successful team from stockbroker JB Were (now Goldman Sachs JB Were) - and is doing better than the original.

The resources boom has also aided two of the top three funds, with Prime Value Growth fund (like EQT) putting 40 per cent of the fund's money in energy and materials.

Prime's managing director Han Lee says the manager goes anywhere in the market chasing big or small companies to find value.

"When we started (in 1998) smaller companies were oversold compared to large companies," he says.

He is confident the resources sector still has legs but will favour the volume producers from here on in.

"Small-cap miners dependent on price increases will be disadvantaged," he predicts.

The fund has had success with Monadelphous Group Limited (MND), the mining engineering group.

Colonial First State's (CFS) Global Resources Fund has also been in the most favoured sector.

"The question is what the resources sector will do this financial year," says Hans Kunnen CFS head of investment markets research.

He believes the party is not over yet because of supply-side restraints and continuing demand from China, even if rising interest rates slow world growth.

"There has not been much exploration and huge new mines are not being opened. It is not a quick process and it is expensive," he says.

"Instead, there is a lot of takeover activity. Rather than fund new mines, the big players are buying them."

The Global Resources fund gets the thumbs up as a "strong buy" from InvestorWeb Research's recent Global Specialist Sector Review for 2006.

Few resources managers had the combined experience of Colonial First State's global resources team, as well as a track record throughout the full resources cycle, the review noted.

It is one of only three international funds in the league table of the best funds over the long haul period Wealth examined for this study.

This is not surprising when Australian shares outperformed international share over five years - at 12.3 per cent to -2.2 per cent, thanks to a post tech-boom market recession overseas.

Our lead has narrowed to 24 per cent versus 20 per cent over the past year. "My feeling is that Australian shares will outperform global shares again, but not as much as that five-year period," says AMP economist Shane Oliver. If you believe in outperformance reverting to the mean over time, global shares should be more attractive than local shares.

AMP has been trimming back its overweight position in Australian shares for global.

The other two international funds in the Top 20 are from Platinum Asset Management, which has made an art form of doing its own thing in pursuit of value.

"The important thing is the price you pay for assets," says Andrew Clifford, deputy chief investment officer, Platinum International Fund, and Asian Fund manager.

"We have made a lot of money out of India in the past three years and it should be strong for the next three, but prices have gone high there.

"It is a long-term story, but we are having a lot of luck with investments in China. And we are buying high-quality companies in Japan, a low-risk market."

So, while there are interesting companies to buy, will the value be overridden by interest rate pressures?

Platinum is buying in soft areas away from metals and energy, such as International Paper in the US.

Platinum's Japan fund is among InvestorWeb's six funds rated a "strong buy".

"We believe Platinum has a good understanding of the market, which should assist in longer-term wealth creation," the report said. Others included Advance Asian Equity Fund, and Platinum's Asia, European, and International Technology funds.

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