

Big end of town back in favour

PUBLISHED: 02 Apr 2011 PRINT EDITION: 2 Apr 2011

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China's insatiable demand for resources has minted paper fortunes for shareholders in mid-sized explorers and mining services companies but shareholders in the big four banks, giant retailers and insurers have been lucky to break even.

The big end of town has been left in the dust over the past year, as investors scrambled to get a piece of the action in the middle of the market.

In the past 12 months, the Small Ordinaries Index has rallied 7.5 per cent. The top 20 stocks, meanwhile, have shed 6 per cent.

Over the past two years the difference in returns is even more stark. The Small Ordinaries has jumped 73 per cent, compared with a 23 per cent return in the top 20.

After two years of such strong returns at the smaller end of the market, some investors are betting this year will bring a rotation back into large cap stocks.

The "equity risk premium" (or the excess return that investors expect for putting their money in the sharemarket instead of the bank) is about 6 per cent. An investor buying large, liquid, blue-chip stocks typically expects a return of about 10 per cent to 12 per cent a year. For delving down into the middle of the market and taking a bit more risk, an investor would hope for at least 15 per cent per year.

Over the past two years the top of the market has returned 12 per cent a year (although all of that was in 2009).

The Small Ordinaries, meanwhile, has delivered an annualised return of 32 per cent.

Clime Investment Management managing director John Abernethy says the outperformance of the smaller end of the market in recent years has become so extreme that only the most optimistic investors would expect an additional 10 per cent this year.

If higher risk stocks are unlikely to deliver 15 per cent returns this year, he argues, why would an investor pay the prices now being asked?

"The trick is to not get caught in the trap of thinking you're clever for buying a stock that is ratcheting up," he says. "It could be a fad or just a bubble that's attracting more money, and you certainly don't want to be the last guy to enter the market because you'll be the bunny."

After a year of negative returns in large cap stocks, Abernethy believes a switch back to the big end of the market is due.

Clime has identified nearly 20 large cap stocks it says are trading at at least a 10 per cent discount to their estimates of fair value.

These companies included JB Hi-Fi, National Australia Bank, BHP Billiton, Woolworths, Rio Tinto, The Reject Shop, Telstra, Australia and New Zealand Banking Group, Commonwealth Bank of Australia, Myer, OneSteel, Westpac Banking Corp, Pacific Brands, Brickworks, Aspen Group, QBE Insurance and Seek.

In the middle of the market, Clime reckons there are only about five companies cheap enough to still have the potential to rise 10 per cent to 20 per cent in the next 12 months.

These are Spark infrastructure, Orotan, Oakton, IMF and McMillian Shakespeare.

Indeed, the switch may already be under way. Since January 1, the S&P/ASX top 20 has added 0.7 per cent, while the Small Ordinaries has tumbled 3.1 per cent.

"Invariably when you get markets rallying the way they have in the middle market, it is because investors are prepared to take a lower return," Abernethy says.

"It's not risk adjusting, and the reason that is happening is there is too much money flowing to that part of the market. It's a rush to get invested. Investors might be buying the right stocks, but they're not paying the right price."

Wilson Asset Management head of research Chris Stott says better returns in the bigger companies are a trend he expects to continue this year.

"I think small resources stocks in particular will underperform as growth in China slows and Chinese inflation

becomes an increasing concern," Stott says.

He says that stocks such as Telstra are more likely to be strong performers this year. The telecommunications giant is poised to benefit from the rollout of the national broadband network, the Future Fund sell-down is believed to be almost over, and the stock is paying a yield north of 10 per cent.

But not everyone agrees the opportunities at the small end are over.

Pengana emerging companies fund portfolio manager Steve Black thinks there is still plenty of value to be found in small-to-mid cap stocks outside the resources sector.

The strong returns of the Small Ordinaries Index mask the fact that it is really only the mining stocks that have outperformed.

Resources stocks account for 40 per cent of the Small Ordinaries Index, the rest is made up of industrials. In the past 12 months, resources stocks have been responsible for a 25 per cent gain, while the industrials have detracted 2 per cent.

"Small cap industrial stocks are still largely out of favour, apart from mining services companies that have been carried along on the coat-tails of the mining boom," Black says. "A lot of the industrial sector has been snubbed as boring."

Black estimates the small industrials index is trading at about 10 per cent to 15 per cent below its long-term average.

His top picks in this part of the market include the listed law firm Slater & Gordon, which he says has proven its ability to grow organically, but is still only trading on nine times next year's earnings.

"Slater & Gordon is one the market seems to have left behind," he said.

Information and technology provider CSG is another. After reporting some soft earnings the stock has almost halved in value. Black reckons the stock has simply fallen out of favour because its industry is unexciting at the moment.

Pengana also likes outdoor wear retailer Kathmandu. The company had reported solid profits and was only halfway through a store expansion program, but it had failed to capture the interest of investors, Black says, because it had been lumped in with the struggling retail sector.

Although they are cheaper, small industrials come with higher earnings risks as well. Many of these companies rely on consumer spending picking up at a time when people are still reluctant to part with their cash.

More defensive plays such as Retail Food Group appear to offer value, trading below nine times next year's earnings.

Retail Food Group owns the Donut King, bb's cafe, Brumby's bakeries and Michel's Patisserie franchises, which have delivered a reliable, predictable earnings stream in tough times. While shoppers may be steering clear of big ticket purchases, it seems they are still treating themselves to a cup of coffee and a slice of cake. Management, meanwhile, have a proven record of successfully bolting on franchises to the network.

Mining services companies are technically industrial stocks, but Black says he is wary of these because of their reliance on projects from the resources sector, which tended to be "pretty patchy".

Engineering contractor Macmahon Holdings, down 22 per cent over the past 12 months, is a fresh reminder of how earnings can suffer when a company fails to win the number of projects the market expects.

Black says a safer bet for investors after exposure to mining services companies would be those with recurring revenue streams from providing products to the production process, such as Mastermind, Bradken and Mineral Resources.

Perennial Value small cap manager Grant Oshry said there were still opportunities in resources stocks, but investors had to pick their companies and commodities carefully.

"Small resources are not offering the best value, but demand for steel as Japan and Queensland rebuild will benefit metallurgical coal producers," he says.

"We still have an exposure to resources, and we're very bullish on the energy sector."

One of Oshry's top picks is Horizon Oil, based on a view that oil prices will continue to rise as the global economy recovers.

Oshry also believes there is still some good value in the small industrial stocks such as the

telecommunications carrier TPG Telecom and Gerard Lighting Group, the largest lighting manufacturer and distributor in Australia and New Zealand.

"When markets are priced for perfection, small cap valuations can get stretched and any shock to the market can cause a sharp selloff – that's where you need to be careful," Oshry says.

"We're not in that phase of a bull market just yet."

The Australian Financial Review

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