

ROUND TABLE

Is bigger better? Sizing up the

Sharemarket majors ate the dust in 2010 as small caps set the pace. M&A activity, IPOs, Australia's economic resilience and the global financial crisis all played a role, as did China's insatiable appetite for resources. But, write **Justin Bailey** and **Brendon Lau**, the jury is out on whether small will be as beautiful this year.

AFR: What is your outlook for 2011 and can small caps continue to outperform the large caps? Why?

John Campbell: Since the trough of the global financial crisis in March 2009, the Small Cap Index has outperformed the Top 100 Index by some 35 per cent (and 20 per cent in the past six months). However, this follows a period of 30 per cent underperformance in the preceding two years leading into March 2009. Such volatility relative to large caps is typical of the small-cap sector, which tends to outperform strongly during periods of economic expansion and underperform significantly during periods of economic weakness.

With that as a backdrop, in terms of the outlook for 2011, we anticipate that small caps will underperform large caps, potentially significantly. It is important to understand that resource stocks (including energy) now represent some 45 per cent of the Small Cap Index. In addition, another 10 to 15 per cent of the benchmark comprises mining services-style companies. Accordingly, it is clear that the future performance of the Small Cap Index will be highly dependent on the future direction of commodity prices.

It is our view that commodity prices have already peaked and will likely decline over the course of 2011. Central to this call is our belief that commodity prices in general are now at levels that are driving a very strong and sustained supply response. Additionally and more importantly, we believe China is suffering real inflationary pressures and will be forced to lift interest rates, impacting the demand side. This combination of supply-side and demand-side effects will, in our view, see commodity prices begin to weaken during 2011.

Noel Webster: We are generally positive on 2011, albeit there are many structural potholes across the global economy. We believe small caps will continue to provide good leverage to the strong domestic economy. Through the small-cap end of the market it is possible to get more direct and higher leveraged exposure to the faster-growth segments of the economy, such as mining, mining services and IT services, than the larger-cap end of the market. Small caps also provide exposure to a number of high-quality structural growth franchises and ongoing mergers and acquisitions and initial public offering activity. So in our view it remains likely that small caps can continue to outperform.

Matthew Kidman: I believe there will be a major change in market performance during 2011. While the small resources may well continue to outperform in the first part of the year, I believe the heat will come out of these stocks as China looks to kill off inflation by slowing economic growth. This will result in commodity prices easing and a pullback in resource stocks. Stocks that have run hardest based on the most blue sky, such as the rare earths sector, will be hardest hit. In contrast, the small industrial market will find it difficult to perform at the beginning of 2011, with the burden of higher interest rates and a slow economy weighing heavily on earnings. This should improve as the year progresses. Domestic interest rates are probably close to peaking and once this flows through the system earnings should stabilise in the second half of 2011, resulting in stocks starting to re-rate. Overall, I do not think the small capitalised stocks can outperform the larger stocks during 2011. Small caps have

enjoyed a golden run and this will mean revert during the course of the year as better value emerges among big industrial stocks. The worst performer will be the small resources.

Neil Carter: The combination of continuing global economic recovery and expansionary US monetary policy will provide a good environment for equity markets in 2011. Australia in particular stands to benefit from the knock-on effects of growth in commodity demand and we believe that will continue to drive our market higher.

Small caps ought to outperform large caps in a rising market. Small companies' margins were hit harder in the GFC than large caps, so there is more to catch up as the economy recovers. And resources make up almost half of the Small Ords Index, so, as the commodity bull market continues – as we believe it will – then smalls will outperform.

But we have to be mindful of the risks. The key ones for small caps are commodity prices falling and the SA weakening, possibly due to a sharp slowdown in China and/or a sovereign debt crisis.

AFR: What sort of returns can small-cap investors hope for and what are the key drivers behind this?

Campbell: The S&P/ASX 300 has rallied some 45 per cent in absolute terms from the trough of the GFC in March 2009. Clearly, the once-in-generation value that was available at the trough is no longer there. That said, the market is still some 30 per cent below its October 2007 peak. In a value sense, the sharemarket on a prospective P/E of around 13 times looks fair value, being around its long-term average. Further we remain relatively positive on the global recovery that has been under way since mid-2009. This is a positive backdrop for Australian equities for 2011.

In terms of small caps, small industrials are similarly priced to large industrials at around 13 times prospective earnings but this is some 10 to 15 per cent above the long-term average relative P/E. In other words, small industrials are somewhat expensive. However, our key concerns reside with resource stocks – and small resource stocks in particular. Given our view that commodity prices will decline during 2011, and that small resource stocks are significantly more leveraged to movements in commodity prices than large resource stocks, we see potentially large declines in small resource stocks during 2011. With small resource stocks representing 45 per cent of the small-cap benchmark, it follows that investors should be much better placed being mainly exposed to large caps.

Webster: At present broad consensus forecasts for smaller companies suggest double-digit earnings growth and a near 5 per cent dividend yield. So, assuming sentiment remains positive, double-digit returns are possible. Small caps are trading at a forward P/E of 13.5 times, which appears to be fair value from a longer-term perspective but offers some upside if the sustained higher growth rates we saw in the mid-2000s return and push the P/E up further. With the two-speed economy, earnings growth rates and potential for P/E reratings are increasingly divergent. However, continued M&A activity is likely to broaden good returns to less favourably positioned stocks and companies.

Kidman: I think, overall, small-cap investors will be lucky to achieve a



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JOHN CAMPBELL UBS Global Asset Management portfolio manager



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NEIL CARTER Macquarie Funds Group portfolio manager

Participants

Neil Carter, Macquarie Funds Group portfolio manager

Matthew Kidman, Wilson Asset Management portfolio manager

John Campbell, UBS Global Asset Management portfolio manager

Noel Webster, BT Investment Management portfolio manager

positive return this year. Resources are trading with a lot of blue sky in share prices and historically high commodity prices. This will result in a major pullback sometime in 2011, probably after the first quarter is complete. Small capitalised industrial stocks will fare better over the year but will need to get past a disappointing earnings season in February. The key for industrials will be the course of official interest rates during 2011. If they have peaked already, small industrials could perform strongly in the second half of 2011. Overall, though, flat to down for the sector.

Carter: Total returns to the Small Ords Index are likely to be 10 to 15 per cent in 2011. Dividends will provide 3 to 4 per cent of that return, with around 10 per cent coming from earnings growth. The potential upside would be if the market P/E increases from its current 13 times (one year forward) to its long-term

average of around 15 times. This could add another 15 per cent, but we are not forecasting that.

Investors have historically been well served by professional fund managers in the small-cap space, with long-run performance averaging about 5 per cent ahead of the market. In 2011, though, we would expect small-cap funds to do better than usual because we expect a raft of takeovers, capital raisings and initial public offerings to provide more opportunities than normal. As a result, investors in small-cap funds could be looking at a 15 to 25 per cent total return for the year.

AFR: What were the key events in the sector over 2010 and will these continue to shape small caps next year? How does this differ for large caps?

Campbell: The continued strong performance of the small-cap sector in 2010 can be explained away in terms of two phenomena: the

giant leaps of market minnows

Stocks that have run hardest based on the most blue sky, such as the rare earths sector, will be hardest hit. In contrast, the small industrial market will find it difficult to perform at the beginning of 2011, with the burden of higher interest rates and a slow economy weighing heavily on earnings.

MATTHEW KIDMAN Wilson Asset Management portfolio manager



In terms of avoiding laggards, best stay away from out-of-favour stocks in out-of-favour sectors. This would include poor performers in segments of the economy such as retail, pharmaceutical distribution, housing and commercially focused construction markets, which are likely to remain tough in 2011.

NOEL WEBSTER BT Investment Management portfolio manager



Carter: The two key indicators for the year for me were gold and oil. Our small-cap fund outperformed by 10 per cent after fees in 2010 and the top five contributors have been in gold, oil, oilfield services, coal and copper.

The rally in gold is indicative of the extremely accommodative US monetary policy. When the Fed starts to tighten again gold will come off, potentially very sharply, but that doesn't look likely until 2012 at the earliest.

The oil price of nearly \$US90 is remarkable given how much of the world is still growing slowly. Once the Organisation for Economic Co-operation and Development countries get back to trend gross domestic product growth, possibly as early as next year, oil will spike up again well over \$US100.

Small caps are now half resources, with gold 10 per cent of the index on its own. In contrast resources comprise just 35 per cent of the large-cap index. So if you are a China bull, buy small caps.

AFR: What type of small caps do you think will outperform over the next 12 months? Can you give a few specific names?

Campbell: We believe the best relative performers in small caps over the next 12 months will be reasonably priced traditional industrial names. Some of our preferred exposures include Adelaide Brighton, Super Cheap Auto and ResMed. We also like Transpacific Industries as a turnaround play.

Webster: Companies with high earnings growth and increasing visibility of future growth are likely to outperform. We are looking to high-demand sectors such as mining services and IT services for these growth and re-rating opportunities. We like mine development contractor NRW Holdings, which is likely to benefit from increasing mining activity in WA and whose pipeline of work continues to build. Technology One provides leverage to increasing expenditure on business software driven by the technology renewal cycle and demand for new functionality around the internet and mobile devices. Opportunities will also present in some deeper-value turnaround opportunities as either internal or external (being acquired) fixes turn things around. In this category we like Boom Logistics, which provides crane services to the resources and industrial markets in Australia. Good underlying demand in its key markets should drive the restoration of margins and restore positive sentiment toward the stock.

Kidman: Given my sanguine view of the market I think you have to revert back to small-cap companies that have resilient earnings despite the economic cycle. Reckon and Primary Healthcare are two such companies that should prove strong performers during this period. Other defensive stocks that we still like are RHG, the former Rams Home Loans, which is in run-off and trades at below its cash backing. Deeper into 2011 we will see the more economically cyclical stocks re-emerge such as the retail and building materials sectors.

Carter: We are in a classic two-speed economy. Resources and mining services are leading the charge and we think that continues for the next few years. Resources names are obviously susceptible to any weakness in commodity prices, but given the setback to supply growth caused by the GFC we believe current prices are sustainable. Our top picks in gold, oil and copper are Intrepid, Aurora and Rex Minerals. The mining services names we like

include NRW and Decmil.

In the industrial space there are some good opportunities. We think Seek stands to benefit from the pick-up in employment and profits will grow strongly from operating leverage. Among the fund managers we like Henderson, and our preferred healthcare play is ResMed, whose new sleep apnea product is driving strong revenue and profit growth.

AFR: Which are the probable laggards and why?

Campbell: We expect much of the small resource sector to lag during 2011, predominantly driven by declining commodity prices impacting generally high and therefore leveraged cost bases. While the mining services sector will likely also lag in such an environment, this will not be across the board given that the key economic driver of the sector — tonnes mined in Australia — will likely remain a positive driver.

Webster: In terms of avoiding laggards, we believe it's best to stay away from out-of-favour stocks in out-of-favour sectors, particularly where the business is inherently complex or the pathway to a turnaround is complicated. This would include poor performers in segments of the economy such as retail, pharmaceutical distribution, housing and commercially focused construction markets, which are likely to remain tough in 2011. I'm sure we will miss the odd surprise turnaround or takeover but the risk-reward trade-off isn't worth it. We would also avoid aggregator business models — that is, companies which essentially grow via acquisition, especially those with higher gearing levels. Potential laggards for 2011 and where the risk/reward balance doesn't feel right include stocks like Sigma Pharmaceuticals, FKP, Coffey International and Virgin Blue.

Kidman: The laggards for 2011 will be most likely the high price to earnings multiple stocks and those mining companies that have performed strongly during the past five or so months. These stocks are factoring in that commodity prices will stay at elevated levels for a protracted period when in fact a correction in Chinese growth may see these commodity prices decline quite quickly. I would also try and avoid any stocks that are heavily dependent on a high SA. In particular, retail stocks which buy most of their goods in \$US offshore will struggle to hold their margins if the SA falls. Once again I would caution that this may not happen in the first quarter of 2011 but may kick in strongly after that.

Carter: The slower half of the economy — basically anything consumer facing — will continue doing it tough as the Reserve Bank raises rates to "make room" for the mining boom. Consumers have disposable income available for spending but are using it to repair their personal balance sheets. This means it is likely to be a relatively quiet Christmas for retailers and as a result we are seeing strong discounting and this is driving many retailers to downgrade their earnings.

We are cautious on the housing-related stocks as the building cycle is yet to make a decisive move up. The real estate investment trust sector looks tougher now as the sector's overall valuation is close to net tangible asset value, although there are some good opportunities where the valuation gap has yet to close, like Aspen trading on a 35 per cent discount to net tangible asset.

continued recovery from the heavily oversold levels of the GFC, and the ongoing rise of China.

In terms of point one, the recovery phase has all but played out. Small caps are no longer at generational discounts to large caps and the Australian sharemarket overall is back to its long-term average P/E.

In terms of point two, it would take a brave person to pick the peak of China and its subsequent decline. We certainly are not making any such claims. We do, however, believe that China is in the midst of severe inflationary growing pains and must implement a period of monetary tightness to rein in these inflationary forces. So while China will continue to be the dominant paradigm in 2011 for the Australian sharemarket, it is likely, in our opinion, that this will move from a positive force to a negative force.

If this occurs, the impact will be felt significantly more in small caps

than large caps, given the 50 to 60 per cent resource exposure of the small-cap benchmark and the generally high cost/high leverage nature of these small resource companies.

Webster: In 2010 small-cap returns were shaped by the strong SA, strong commodity prices, a rebound in mining activity, M&A activity, IPO activity, a strong domestic economy and increasing risk appetite which drove interest in the smaller end of the market. All these factors appear relevant as we look forward to 2011, although the domestic economy has become more of a two-speed affair and will drive greater selectivity across sectors. Small caps typically offer greater leverage to the stronger domestic economy and to the mining sector than large caps. Plus there has been more M&A and IPO activity (particularly in the resources sector) at the smaller end of the market and this is likely to persist and drive returns in 2011.

Kidman: I believe the large-cap stocks, especially the large industrials, will enjoy a steady and sustained recovery in the US. This should see those stocks re-rate upwards during 2011. In contrast, the small industrials will follow interest rates and, just as importantly, the SA. If the SA declines against the \$US during 2011 the smaller companies, which are net importers, will find the going much tougher. On the resources side of the market, the driving factor will be the world's view on China. China has now got a potential inflation problem that will need to be quelled soon. This will see a squeeze on credit and lower demand for commodities. If this slowdown eventuates, small resource companies could be dealt with severely. The size of the decline will depend on how long the boom in commodities continues, which could be right through until March or April.