Alex Patten: Why Aussie small caps could be good value right now

By Perpetual Asset Management
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Small cap stocks can help diversify portfolios – and there looks to be good value on the ASX right now, argues Perpetual's ALEX PATTEN

- Small caps could be good value right now

- Consider value investing approach
- [Find out more about Perpetual's Smaller Companies Fund]

SMALL cap stocks are typically trading at cheap valuations as a rapid rise in interest rates over the past 18 months triggers a flight to larger, more liquid stocks and cash.

But dislocations in valuations can be a good time to get exposure to smaller companies, which can help diversify an equity portfolio and offer attractive dividend yield and strong downside protection, argues Perpetual's Alex Patten.

Patten is the co-portfolio manager of Perpetual's Small Companies fund (which invests in stocks outside the ASX50) and Pure Microcap fund (which invests in stocks with a free float market capitalisation of less than $300 million).

"Valuations in small and micro-caps have been crunched – and typically, when you've seen such significant underperformance, it could be a good time to allocate to small caps.

"Small caps have quite materially underperformed over the last 18 months and that should mean- revert at some point."

Lower rates suits value investing

Where to hunt for small cap equities right now?

The changing interest rate environment is increasing the attractiveness of value investing, argues Patten.

"There is a big dispersion between the expensive stocks in the market and the cheapest stocks in the market.

"Even though value has performed better in the last 12-18 months, the expensive part of the market is still trading on very big valuations.

"That's especially so when you think about where interest rates are today versus where they've been over the last sort of decade or so."

Four ways to filter small caps

Simply looking at valuation is not enough though, cautions Patten.

The Perpetual team uses four quality filters to select stocks:

- Business quality
- Earnings
- Balance sheet strength
- Management effectiveness

“We only invest in profitable businesses with good balance sheets and good management teams.

“We believe the bucket of stocks that meets those filters and come into our quality universe should materially outperform the broader index over time.

“By remaining disciplined around those filters and the process, we aim to have a head-start in terms of outperforming the index and competitors.”

A profitability screen is particularly important when investing in small caps because the sector by its nature has many unprofitable, speculative or early-stage companies.

“It’s easy to be caught up in the stories and management spin — more often than not, they don't work,” Patten says.

“For us, it's black and white: if the business is not generating cash flow, we will not invest.”

Strong balance sheets are important for smaller companies, he says.

“You want them to have as much of their destiny in their own hands as possible where they're not reliant on capital markets or debt markets to lend them money to continue their operations.”

About Perpetual’s Australian small cap equities team

The Perpetual Smaller Companies Fund aims to provide long-term capital growth and income by investing in companies outside the S&P/ASX 50 Index (when first acquired).

The portfolio leverages the growth potential of smaller and emerging companies through a proprietary stock selection process.

Perpetual is a pioneer in Australian quality and value investing, with a heritage dating back to 1886.

We have a track record of contributing value through “active ownership” and deep research.

Find out more about Perpetual’s Smaller Companies Fund

Want to find out more? Contact a Perpetual account manager