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Microcap fund managers bring in exceptional returns

JAMES GERRARD THE AUSTRALIAN 12:00AM August 22, 2017

Do active fund managers really add value? They certainly do so in the area of microcaps — that sector of the market most brokers fear to tread. In fact, a new report shows anyone who depended on passive returns from this area would have missed out substantially.

The report by independent Investment Research shows the ASX Emerging Companies - Accumulation Index returned -2.8 per cent over the past 12 months. In contrast, every fund manager in the sector — all 19 of them — beat the index. (The Emerging Companies Index is defined by the stock exchange as all companies falling outside the Top 300 stocks by market captitalisatoin).

The results were not as uniform for Listed Investment Companies in the sector with three funds finishing below the benchmark — Monash Absolute Investment Company (-9 per cent), Contango Microcap (-6.1 per cent) and BIP Emerging Companies (-2.9 per cent).

Outside those headline numbers there are marked variations, with a number of microcap managers shooting out the lights such as the Forager Australian Share LIC Fund (25.2 per cent), Cromwell Phoenix Opportunities Fund (24.4 per cent), Terra Capital New Horizons (24.3 per cent) and Micro-equities High Income Value Fund (22.5 per cent).

Looking a little closer at the figures, the independent Investment Research report shows a large variance in returns from microcap managers ranging from -9.0 per cent to 25.2 per cent, however the majority did beat the index.

There is an argument to take the index with a grain of salt as it contains a mixed bag of stocks.

Steve Johnson, chief investment officer from Forager Funds, a boutique value-investing fund manager based in Sydney, topped the charts with the highest return in the microcap sector over the past 12 months and says "the index that everyone rates themselves against is a joke. It is full of speculative mining companies that fund managers would never invest in".

Cherrypicking small and microcap stocks is key.

Smaller ASX-listed companies are not as stable and reliable as their larger blue chip cousins, which are more established with healthier cashflows. Although larger companies are by no means resilient to drops in share price, as we witnessed with Telstra last week, smaller companies do have more risk factors that they need to contend with such as lower barriers to entry, smaller market share and managing sustainable growth.

Wider range of returns

Carlos Gil, chief investment officer of Microequities, another outstanding performer in the past year, suggests: "If you look at the investment grade of companies in the microcap sector, it's fair to say there is a huge divergence of quality. My advice to DIY investors is that if you don't have the time or disposition to roll up your sleeves and do significant research, which is prerequisite for this asset

class, it's not a good idea to invest directly".

Johnson agrees, and warns: "Be careful, when it goes wrong at the small end, it goes really wrong."

It is not unknown for the value of businesses at this end of the spectrum to go to zero and investors should expect lumpy and volatile returns from fund managers in this sector.

Having said that, investors are looking for good stories and narratives, and have been finding them outside the ASX 200.

But expect tougher conditions ahead. Johnson says: "Multiple expansion won't happen again so be careful when investing in small caps". In other words, investors have driven up the prices of smaller companies as they've been less concerned about the risk premium that goes with investing in smaller companies.

Current trading conditions aside, Johnson sees small and microcap managers as an important part of a diversified portfolio, and says: "Almost all of our clients use us for an active exposure to sit next to their blue chip or passive share exposures to generate alpha (above benchmark returns).

"Due to the risk, we recommend that small and microcap investments form less than 20 per cent of an equities exposure within a portfolio."

So why do some active managers outperform index/passive managers in the smaller companies space? Gil says: "The advantage that we have as an active fund manager in the small cap space is that company access is good. Getting an appointment with the CEO of a big cap such as Telstra or a major bank is very difficult. But in the smaller cap space, we get to meet with the management team and view our equity investment as a business partnership. Before we invest, we need to be comfortable with the competency and ethical and moral compass of the company as it drives investment outcomes".

Johnson at Forager adds: "There is less research and less competition in the small and microcap space and thus greater opportunity to outperform".

But Johnson also warns of the risks. "It's easier to make money on $20m than it is on $200m. Small and microcap managers can run the risk of moving the market when they trade in and out of stocks so when reviewing performance numbers of a fund, make sure it's about the same size as before. If it's grown significantly in size, it is much harder to repeat the same outperformance."

For those thinking about investment in smaller companies on the ASX, consideration needs to be given to individual stock selection versus using a fund manager. If using a fund manager is decided, an active vs passive strategy needs to be chosen then due diligence performed on which fund manager to select given the huge spread of potential returns.

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