Small Caps – Why now might be the time to consider an allocation

Australian small companies are currently sitting at a relative valuation discount to large Australian companies. We feel that this has been overdone by markets and now might be the time to re-balance portfolios towards small caps. Given the Flinders Emerging Companies Fund invests the bulk of its portfolio in growing and attractively valued small companies, we believe the Fund is well positioned for what we expect to be a rotation back to small caps.

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This article has been prepared by Flinders Investment Partners, the underlying investment manager for the Flinders Emerging Companies Fund, distributed by Warakirri Asset Management.

Since the inception of the Flinders Emerging Companies Fund in August 2015, there have been a few occasions where the Australia Small Companies sector has underperformed Australian Large Caps, including:

1) September 2016 to June 2017: In response to the so called "reflation trade" ignited by the pro-growth policies of the newly elected Trump Administration in the US.
2) June 2018 to January 2019: Declining global growth; Australia cushioned to an extent by falling currency; rate cuts cycle begins.
3) March 2020: Flash crash in equity markets associated with the onset of Covid.

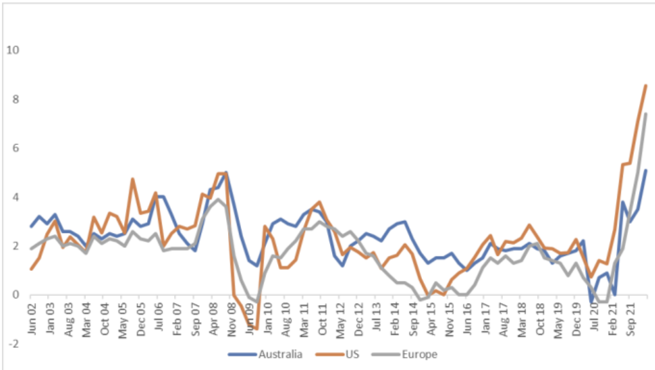
Since the "flash crash" in March 2020, the global response has included near zero interest rates and substantial quantitative easing, providing liquidity which boosted markets until late 2021. This also led to the outperformance of small companies primarily due to their growth characteristics.

Chart 1. Relative Accumulation Performance of Small Caps versus Large Caps

Source: IRESS; Flinders Investment Partners

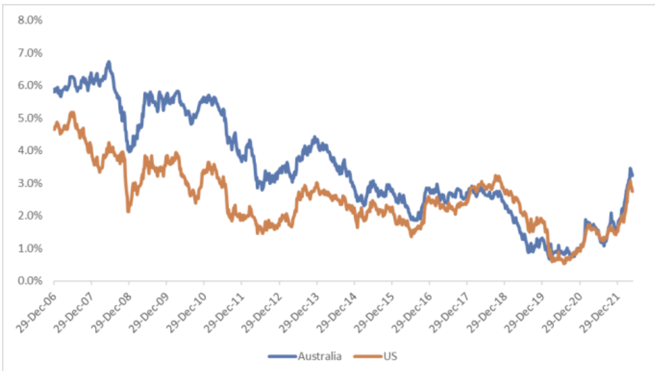
However, in late 2021, a rise in costs from supply chain delays, together with availability and absenteeism of staff as well as higher energy prices, have led to a spike in inflation (Chart 2). This in turn has led to a steady rise in interest rates across the curve, as Central Banks tighten rates to control inflation (Chart 3).

Chart 2. Global Inflation (CPI yoy%) indicators



Source: FactSet; Flinders Investment Partners

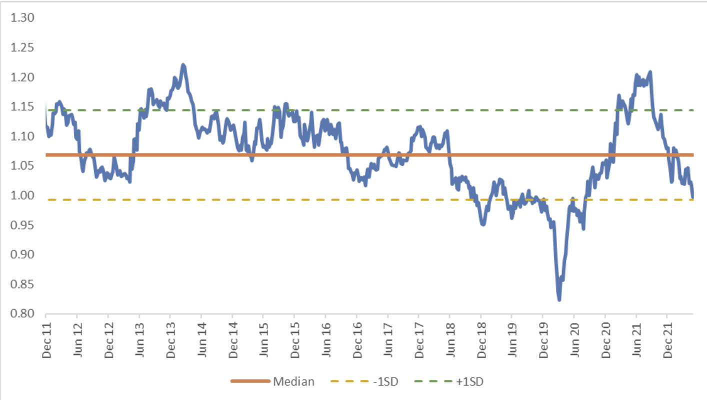
Chart 3. Australian and US 10-year government bond yields (%)



Source: IRESS; Flinders Investment Partners

The knock-on effect from this is that risk assets such as equities have been re-priced lower, including small caps. The de-rating has resulted in the valuation of small caps falling to a 1 standard deviation discount to large caps as compared with the median level over the last 10 years (Chart 4).

Chart 4. Relative 1 year forward PE of Small versus Large Caps



Source: FactSet; Flinders Investment Partners

Couple this valuation gap with the fundamental characteristics of the sectors (Table 1) and given the superior growth characteristics of small caps in an environment where global growth is being pared back in response to rising interest rates, a safe place to support income/capital growth is by investing in Australian listed small companies.

Table 1. Market Fundamental Attributes, FY23

	Large Caps	Small Caps
EPS GROWTH	0.4%	11.9%
PE	12.7	12.6
DIVIDEND YIELD	5.1%	5.1%

Source: FactSet; Flinders Investment Partners. As at 22 June 2022.

Sectors in Focus

The near 40-year bull market in bonds has seemingly ended, with the outlook for cheaper money no longer providing the tailwinds that markets have enjoyed for decades. Instead, investors must focus on the fundamentals, simply put, companies generating earnings that are attractively valued. An active approach to this should yield above average returns over the medium to longer term.

In recent months, global growth has pared back in response to rising interest rates and exogenous shocks like the Ukraine war, lockdowns in China etc. It's certainly a tough environment for many companies with cost pressures a feature, and while risks are rising**, the data to date does not suggest to us that a recession should be the base case** – the consumer is still spending, unemployment remains at historic lows, and consumer's balance sheets are in good shape. With many factors at play, below we explore some segments of the market that look interesting.

Resources

Broadly speaking, from an inflationary perspective, **commodities offer protection or a hedge against rising prices.** It's important to focus on producers (as opposed to explorers), who are exposed to rising commodity prices in this environment, and consequently producing substantial cashflows. No more is this evident and topical currently than in the domestic gas market where supply / demand is extremely favourable to domestic gas producers, including Adelaide based companies **Beach Energy (ASX:BPT**) and **Cooper Energy (ASX:COE).** The confluence of strong demand and suboptimal supply in the gas market has resulted in record gas prices which we expect to remain elevated over the medium term.

Industrial Services

With domestic activity remaining robust, services industries benefitting from heightened demand are looking attractive. A focus for us has been on companies who have managed their margins well given the cost pressures that virtually every industry is currently facing, and companies with some element of pricing power in place. A striking aspect from the next group of companies, while from different underlying sectors, is how cheap these individual opportunities are currently trading at. All are profitable with cash earnings that we expect to grow at double digit rates over the medium term: Service Stream (**ASX:SSM**, utility services, 10x FY23 PE), PeopleIn (**ASX:PPE**, workforce services, 8x), NRW Holdings (**ASX:NWH**, mining services, 7x), Silk Logistics (**ASX:SLH,** warehouse and logistics services, 8x), Shine Justice **(ASX:SHJ**, legal services, 5x).

Financials

Pockets of financial service business remain attractive supported by the endless requirement for capital by small to medium sized businesses and the need for adequate commercial insurance, both delivered as efficiently as possible and competitively priced. These dynamics remain a feature of the Australian economy with underlying business conditions remaining strong as well as insurance premiums continuing to harden. From a listed perspective, identifying growing business that are attractively valued requires selectivity however, appealing names include **EarlyPay (ASX:EPY,** financing to SMEs, 8x) and **AUB Group (ASX:AUB**, insurance broking to SMEs, 16x).

Technology

We've been wary of profitless technology companies for quite some time now, and despite the large drawdown in this sector, still find it hard to get excited about the sector and remain very cautious, particularly given the headwinds of increasing rates. There are always exceptions of course, and again with the proviso of growing earnings, some opportunities exist. **ReadyTech (ASX:RDY,** software company to education, corporate and government clients, 16x).

Conclusion

Flinders remains focused on **identifying growing small companies which are attractively valued to deliver the best returns to our investors**. The above highlights some of the individual sector and company opportunities that exist in the market. The characteristics of our Fund are superior to both the large and small cap sectors **(Table 2)** and given the magnitude and speed of the derating that Small Caps have endured, we feel the time may be right to rebalance portfolios towards small caps.

Table 2. Market and Flinders Emerging Companies Fund Fundamental Attributes

	Large Caps	Small Caps	Flinders
EPS GROWTH	0.4%	11.9%	30.1%
PE	12.7	12.6	10.3
DIVIDEND YIELD	5.1%	5.1%	3.6%

Source: FactSet; Flinders Investment Partners. As at 22 June 2022.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au