Are small caps worth a look?

HYDE PARK: Many share investors are ignoring the investment potential of small companies listed on the JSE. In the last 3 years, they have had a very difficult time and have been outperformed by the larger companies. As any experienced investor will tell you, there is a benefit in having some small companies in your portfolio – you just need a strong stomach, good research and lots of patience.

SMALL COMPANIES OFFER GROWTH

Investors in small listed companies have had a torrid time over the last three years. To illustrate, the average small company unit trust has only grown by 0.66% per year in the three years ending March 2011. By comparison, the average large company unit trusts grew by 5.61% per year over the same time. These are not great returns when you consider that inflation was 6% per year but the difference in performance between large and small companies was still massive. This sustained underperformance by small companies has resulted in sharp decline in the number of small company unit trusts in the market. When too many people disinvest from a unit trust at the same time, it becomes unsustainable and is closed down or merged with another fund. In the case of small company unit trusts, large numbers of investors (or their advisors) lost patience and sold out at the bottom of the cycle.

The investing herd that exited these small company funds forgot how much value these funds can add to a portfolio. Over the last 10 years, the average small company unit trust has grown by 21.22% per year. This compares favourably to the All Share Index which only returned 18.2% per year over the same time. This difference in performance equates to R34,000 additional capital on a R100,000 investment over the 10 years. Even the best of the General Equity unit trusts could not beat the best Small Company unit trust; the difference in performance was again about 3% per.

This does not mean that you should be investing all your money in small companies but you are missing out if you have no exposure to this sector. Private investors who have direct share portfolios have a real advantage over the institutional herd because they can buy great assets at a massive discount to their real value. Large pension funds and most large unit trusts do not invest in small companies because they are too small to make a difference in a big portfolio. This means private investors have a competitive advantage but you have to do the research yourself and you need the patience to live through years of underperformance. I think too many investors lose patience at the worst time which is why they always lose out.

THE TREND

Our market normally follows the major trends started by the US market but with a substantial time lag. As an example, if Tech firms become popular investments in the US, it will take a few months or years for our Tech companies to follow suit but they will eventually benefit from the trend. For long term investors, it is worth tracking these major trends in the US so that you know what might be coming our way.

Recently the herd in the US has moved away from large companies in favour of small companies. For the year ending March 2011, the small company index in the US (The Russell 2000) grew by 26% while the Russell Top 50 only grew by 11% for the year. Over three years, the small company index has outperformed by nearly 8% a year. There is some logic to this process because investors always flock to large companies in times of difficulty. When stock markets have already recovered, the impatient investors who have remained in cash since they sold their shares at the bottom of the market crash, start piling into the market again. At this time, the patient, savvy investors who remained invested through the turbulent times now sell their existing shares at a profit. They use some of the proceeds to invest in better value stocks i.e. medium-sized companies. These companies will also eventually become overvalued which finally results in money flowing into the smallest listed companies. Because these companies have such poor liquidity, the share prices jump up really quickly when money starts flowing into the sector. This means that most of the growth happens really quickly and most investors will miss out because they invest too late.

IS THE TIME COMING?

Given the way that the JSE has performed over the last two years (28% per year) it is likely that the herd is going to start migrating into the JSE again. I am wondering if the clever money is not looking for better value again. If so, one should be looking at the small companies in the JSE again. I am fully aware that many of these small companies are real dogs and deserve their abysmal valuations but there are some real gems in the sector too.

	Share Price (c)	PE Ratio	Div Yield %	NTAV* (c)	Price Move YTD %
Afrocentric	190	5.8	4.0	33	+19
Afrimat	340	6.6	4.7	332	+2
Austro	50	9.6	8.0	73	-4
Buildmax	14	N/A**	0.0	14	-18
Control Instruments	70	N/A**	0.0	120	-7
ELB Group	1900	6.6	2.4	1427	+10
Jasco	105	11.0	2.9	155	-30
Transpaco	1335	7.2	5.0	875	+9

** Net Tangible Asset Value (excludes goodwill)*

***Historic loss makers. Expected to show a significant profit turnaround this year.*

I am not a stock broker or fund manager so I don't track specific stocks however; the table above is a selection of shares held by the Hermes Osborne Flexible Fund which is managed by Hermes Osborne. I don't hold the fund or any of the specific shares but Niall Brown (one of the founders) is a great judge of small companies and his picks are worth considering.

As a final point; to be a small company investor you must always do your own research and must have the patience and iron stomach required to have long term success.