How to ride the red hot small-cap rally

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Small-cap stocks are leaving blue chips in the dust as the sharemarket roars back to life and investors pile into gold, technology and other winners after COVID-19.

Fund managers are buying small caps exposed to the boom in remote working, online learning, debt collection, elective surgeries, e-commerce, auto parts and services, fast food, rare earths and even domestic tourism.

“Interest rates have fallen, oil prices are very low, commodity prices are down and a large part of the global labour market will get cheaper,” says Karl Siegling, founder of Cadence Asset Management.

“If demand picks up faster than expected, companies will be boosted by margin expansion as their costs fall. Everything depends on virus containment.”

Siegling, a veteran contrarian investor, has gone “all-in”. His fund swung from 60 per cent cash in late March to 110 per cent invested in Australian shares (with borrowings). Yet he cannot say if the sharemarket offers value given high earnings uncertainty.

“Any fund manager who says the market is cheap is guessing,” he says. “Nobody knows what short-term earnings will look like and the market has written off financial year 2020.

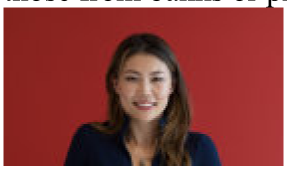
"To buy stocks now, investors must look two to three years out, believe there will be an earnings recovery, and hold financially strong companies that can last that long. To some extent, investors are flying blind.”

That has not stopped a remarkable rally in small-cap stocks after the sharemarket turned higher in late March.

Small-cap rally

The S&P/Small Ordinaries Accumulation index, a barometer of stocks ranked 101 to 300 by market value, is up 21 per cent since April 1. The S&P/ASX 100 index is up 9 per cent since then, defying the view that investors gravitate to the largest stocks during crises.

In this market, recurring earnings from tech and healthcare companies look more reliable than those from banks or property trusts.



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Care is needed with index comparisons. Unlike the ASX 100, the Small Ords has a low weighting in financials and real estate stocks, two of the hardest-hit sectors during COVID-19. The Small Ords’ higher weighting in resource and tech stocks is another performance tailwind.

Also, the small-cap rally has to run a lot further to erase losses in March. On a year-to-date basis, the Small Ords is down 11 per cent, a few points better than the ASX 100. Most of the 177 small-and mid-cap funds that Morningstar surveys have a negative return over one year.

Some fund managers are concerned about the rally’s speed and wary of chasing small caps higher. The Australian sharemarket in April had its best monthly gain in 30 years despite unemployment skyrocketing, companies collapsing and the economy stalling.

Steve Black, co-manager of Pengana Emerging Companies Fund, says it is too early for investors to bet on the “other side of the pandemic”.

He says: “We are two months into a health crisis that could take years to play out. Investors are drawing too many conclusions about the shape of economic recovery, the flattening of the COVID-19 case curve and a possible vaccine.

“Investing on the basis of possible structural change in the economy and society is speculation at this stage. We would prefer to wait, preserve capital and take risk when there is greater earnings certainty. We are especially wary of stocks heavily leveraged to the economy, such as in retail or tourism.”

Defensive stance

Black favours more defensive small-cap exposures such as insurance brokers Steadfast Group and AUB Group. “Business insurance is a bit like electricity: it is among the last things a company turns off in a crisis.” After almost halving during the market sell-off, Steadfast has rallied.

Cleanaway Waste Management is another in Pengana’s focus. “We expect higher demand for waste services in coming years as governments spend more on infrastructure projects to jump start the economy and thus generate enormous waste volumes,” says Black. “That should offset lower demand for waste services from housing construction.”

Black also favours emerging telcos OptiComm and Uniti Group. OptiComm, a mid-2019 listing, provides fixed-line telecommunications networks for new housing estates and has a long pipeline of locked-in work. Uniti Group, backed by telco entrepreneur Vaughan Bowen, provides network services for apartments and other developments.

“Both companies have exciting prospects,” say Black. “One certain change after COVID-19 is more people working from home and higher broadband demand.”

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Small caps left behind in the rally are another target. Black rates Hansen Technologies, a provider of billing services that had a positive trading update this week. Unlike many tech stocks, Hansen is just starting to rally after heavy falls this year.

“It is a good example of a small-cap stock that is poorly covered by brokers and overlooked, even though 70 per cent of its earnings are recurring and it provides mission-critical billing software.”

Pendal Group portfolio manager Patrick Teodorowski favours gold stocks, tech, fast-food providers and retailers with strong e-commerce potential. Pendal’s top-rated small-cap fund sold highly geared companies in early March and has cautiously re-entered the market.

Gold producers such as Saracen Mineral Holdings, a star performer this year, were an early focus. “We had a positive view on gold given the amount of monetary support provided by the US Federal Reserve, so bought select gold stocks during the sell-off,” says Teodorowski. “The period after the 2008-09 global financial crisis was supportive of gold and we believe that will be the case again."

Takeaway on the menu

Collins Food, owner of KFC stores, was another Pendal focus. "We see rising demand for cheaper fast food and greater patronage of stores with drive throughs, which suits the KFC model," says Teodorowski. "The KFC app was among the top food apps downloaded during the crisis, so we expect more consumers to be introduced to the brand. Some of the largest US fast-food stocks have made new highs during the crisis as the market reassesses their growth prospects."

Omni-channel retailers growing sales across multiple online and physical store formats also appeal, says Teodorowski. He cites homewares provider Adairs and plus-size fashion group City Chic Collective as examples.

"We are cautious on retail overall, but constructive on companies that can quickly build their online penetration. There's no doubt COVID-19 will speed up the move to e-commerce in retail."

The Pendal Smaller Companies Fund lifted exposure to tech during the crisis, adding to positions in data centre operator NextDC, language-services star Appen and network software provider Megaport.

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"We were 'long' tech before COVID-19 and have been constructive on tech companies that are reasonably immune to the crisis," says Teodorowski.

SmallCo portfolio manager Craig Miller says his fund had a cash weighting of more than 25 per cent before COVID-19 because of valuation concerns. "If anything, we are starting to see valuations creep back up and have been trimming select positions."

"In this environment, where parts of the economy have completely stopped, the hit to [company] revenue and more importantly cash flows, can be far more severe. It is as difficult as it has been for a long time to forecast where earnings are going over the short term. Our focus is on what [earnings] might look like on a two-to-three-year view and whether the company has the liquidity to get through."

SmallCo increased exposure during the market sell-off to Altium, WiseTech Global, REA Group, Seek and other growth stocks that have strong cash flows. "Liquidity is king because it provides the ability for companies to come out the other side of the COVID-19 crisis," says Miller.

Balance sheets

"It is as important as ever to focus on balance sheets of smaller companies to ensure they can withstand an extended period in a weakened economy. Clearly, the longer the virus containment measures remain in place the more strain it will place on these companies."

Low liquidity in share turnover is working against micro-cap stocks. Thinly traded stocks that would be harder to sell if a second wave of the pandemic strikes are trading at a larger discount. But that creates opportunity for long-term investors who buy companies based on their fundamentals, not liquidity issues.

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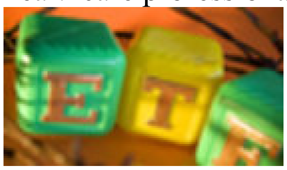
Sebastian Evans, chief investment officer of NAOS Asset Management, oversees a concentrated portfolio of "high-conviction" stocks. Its largest holding is MNF Group, a provider of voice, data and other communications services.

"Workplace change will be one of the biggest outcomes of COVID-19," says Evans. "MNF has one of Australia's largest VoIP [Voice Over Internet Protocol] networks, is expanding overseas and leveraged to the trend of more people working and learning from home."

NAOS also favours medical-products distributor BTC Health and healthcare recruiter People Infrastructure, as a play on elective surgeries.

“There is a huge backlog in elective surgeries that will need to be unwound in the next year or two. We see rising demand for surgical consumables and higher recruitment of nurses and other healthcare professionals,” Evans says.



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NAOS has a contrarian view on domestic tourism and owns skydiving provider Experience Co. “Domestic tourism could go through the roof over the next two years if international tourism remains on hold and people prefer holidaying locally,” Evans says.

“Experience Co has had its problems, but it has new management and a new board, low fixed costs and a strong position in its market. We expect it to make a complementary acquisition for the skydive business.”

Driving into autos

Evans believes some auto-related stocks could benefit from COVID-19 as fewer people use public transport to commute and traffic volumes rise. An increase in vehicle accidents would benefit listed panel-beater AMA Group and higher car usage would help parts providers such as Bapcor or car dealership AP Eagers. NAOS does not hold these stocks.

Cadence’s Karl Siegling favours Credit Corp Group. His fund took a large position in the debt collector’s capital raising last month and believes the extra funding will help it buy distressed debt from banks and utilities as more people struggle to pay bills.

Siegling also likes Money3 Corporation, a provider of car and personal loans. It plunged by more than two-thirds during the market sell-off as investors fretted about a spike in bad debts.

“Money3 was trading at its book value at one point even though there hasn’t been a large increase in defaults on its loans yet due to people getting government assistance."

In mining, Siegling favours Lynas Corporation. The rare-earths producer, down almost 40 per cent over one year, this month restarted its Malaysian plant. Siegling believes the US government’s move to secure supplies of rare earths for defence and commercial applications will support a higher price.

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“Lynas is still trading below the price ($2.25 a share) that Wesfarmers offered in its takeover bid for the company last year and looks to be turning a corner.”

Microequities Asset Management CEO, Carlos Gil, is buying microcap stocks that can “survive and thrive” during COVID-19. “They need strong balance sheets and can weather the economic fallout. Then we want to know the company can thrive after the crisis as more people use its products or services,” he says.

Gil says emerging software-as-a-service companies fit this criteria and favours medical technology firms such as Integral Diagnostics. He expects a wave of micro-cap takeover activity in the next 18 months as cashed-up private-equity firms pounce.

“A lot of quality micro-cap companies are 30-40 per cent cheaper than they were before COVID-19 and have good prospects.”