Why ASX small and micro caps are starting to outperform

By Perpetual Asset Management

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Economic conditions are turning in favour of small and micro caps. Perpetual portfolio managers Alex Patten and James Rutledge explain what to look out for

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- Falling rates drive interest in small and micro caps
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- Find out about the Perpetual Smaller Companies Fund

Small and micro-cap stocks are showing strong outperformance compared to large caps, as the prospect of declining interest rates and moderating inflation set the scene for improved earnings.

Alex Patten and James Rutledge, co-portfolio managers of Perpetual Pure Microcap Fund and Perpetual Smaller Companies Fund, say the economic backdrop is now decisively turning in favour of smaller companies.

The improved outlook played through during the August earnings reporting season, when the S&P/ASX Small Ordinaries index lifted 8.5 per cent, while the biggest 100 stocks added around 2 per cent.

“You’re starting to see some decent outperformance from small caps and micro caps,” says Patten. “This is the first time that’s happened in a number of years.

“Over the past few years, when rates were going up quite quickly, that’s not typically a great environment for small caps.

“But now that rates are starting to come down, we’re seeing more interest in small and micro caps and bit more liquidity in the market.”

Domestic economy focus

Smaller companies benefit from their higher exposure to the Australian economy compared to their larger counterparts, says Patten.

“A lot of small caps are domestic cyclicals – whereas in the top 100, there’s more global businesses,” he says.

ASX earnings season saw positive trading updates from small-cap retailers, which reported robust consumer activity, while building materials companies reported signs the residential construction cycle was starting to pick up.

Smaller companies are also benefiting from moderating wage growth.

“Small caps have been historically impacted a lot more by domestic wages. You’ve seen wage inflation moderate over the last six months, and the forward outlook is for much more moderate wage growth,” says Rutledge.

“Unlike for large companies, which are more capital intensive and less hampered by wage growth, moderating wages is another tailwind for small caps going forward.”

Attractive valuations

Despite the improving performance, valuations still look attractive across smaller companies, says Patten.

“The Perpetual Pure Microcap Fund has had a good 12 months, but the stocks in the fund are still very cheap.

“The companies in the fund are going better than they were 12 months ago, the earnings outlook is more positive – but valuations are still very attractive, and we’re seeing a lot of opportunities still.

“We have a very disciplined process where we only invest in profitable businesses. They’ve got to have strong balance sheets – most of the positions have net cash balance sheets.

“We are always thinking about the downside, which sounds a little bit contradictory for a microcap fund, but we’ve proven over the last 12 years that if you can focus on the downside and you avoid speculative stocks, then the upside takes care of itself.”

Sleep well at night

The effectiveness of Perpetual’s approach is demonstrated by the fund’s capture ratios over the past 10 years, which show it capturing more than 90 per cent of up markets but less than 60 per cent of down markets.

Capture ratios measure the performance of an investment relative to the benchmark in upwards and downwards markets trends.

“If the market falls 5 per cent in a month, the fund generally should fall less.

“For investors who want to get some microcap exposure but don’t want something that’s going to be massively up and down, this is a great fund that gives that kind of sleep at night exposure and a bit of downside protection,” says Patten.

Available capacity

Perpetual Pure Microcap Fund is designed to manage around $200 million before closing to new investors, meaning its current portfolio size means it still has capacity for an additional $60-$80 million.

“It’s a well-established, high performing microcap fund that does actually have some capacity – unlike many others.

“We think it’s a great time to get involved.”

About Perpetual’s Australian small and micro-cap equities team

Alex Patten and James Rutledge are co-portfolio managers of Perpetual Smaller Companies Fund and Perpetual Pure Microcap Fund.

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

We are one of Australia’s most respected and longstanding active investment managers, with a proven investment process that has been refined through more than 50 years of experience.

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

Want to find out more? Contact a Perpetual account manager



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