
FINANCIAL REVIEW

Small caps face crisis of confidence

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It is difficult for many to have faith in the small companies sector amid the recent collapse in confidence associated with an incredible 87 profit warnings for this financial year.

The S&P/ASX Small Ordinaries has shed 10 per cent of its value since it peaked in March, while the S&P/ASX 100 Index recorded a 7 per cent loss.

Some small-cap investors were happy to take their profits at the end of the March quarter and sit on them for the remainder of the year. After all, a 14.4 per cent return from the Small Ordinaries for that quarter is reasonably handy.

And some large managed funds have begun reallocating money from small caps back to larger stocks.

"As an overall grouping, it's safer to be in large caps," said Ausbil Dexia director Paul Xiradis. "But there are some interesting opportunities beginning to present themselves among small companies.

"There are some pockets there, among small companies, that have come back rather severely. I think most of the damage has been done and there are some pretty good opportunities here."

The 87 profit downgrades recorded by Macquarie Equities have investors worried that more could be announced in the next couple of weeks as boards review their companies' March quarter performances.

Analysts have been particularly severe on auto parts maker Pacifica Group. Over the past 30 days, the consensus forecast for Pacifica's annual earnings has slumped 40 per cent, according to StarMine Professional. Analysts have also slashed expectations by 22 per cent over the same period for printer PMP another company to warn of lower earnings recently.

Those who haven't issued warnings are being tarred with the same brush. Estimates for retailer Brazin, for example, have edged 2 per cent lower over the past month as other retailers warned of a tough environment.

But some investors have broader concerns about the outlook.

"You're going to have downwards earnings revisions in the small-cap sector, and on top of that you are going to have PE [price-earnings ratio] contraction, in an environment where, if inflationary pressures are there and interest rates go up, then all asset prices are going to go down," said **Cadence Capital** portfolio manager Karl Siegling.

"That pressure is more significant in the small and mid-cap sector because of the inherent fact that they should trade at a discount to the larger sector. They are more vulnerable."

History shows that the small-cap sector generally reverts to trading at a discount to large caps.

Small-cap industrial stocks are trading at 14.2 times expected earnings for 2005, based on data from Goldman Sachs JBWere (excluding loss makers, banks, insurers and finance stocks).

Already compression of the PE ratio has begun. On March 21 when small-cap stocks were at their peak, Goldman had them priced at 15.3 times expected earnings.

Larger stocks were at that time trading on a PE multiple of 17.9 and have since come back to 16.2.

UBS strategist David Cassidy this week revised his portfolio strategy and remains underweight in small-cap

stocks.

"In general terms, we continue to prefer financials and resources over non-bank financials," he said. "The Australian industrial market remains expensive, at 16 times financial year 2005 earnings peak cycle and we see downside risk to financial year 2006 earnings forecasts of around 8 per cent given slower demand and higher costs.

"While fundamentals do not suggest the onset of a bear market . . . we are now in a more difficult phase for equities."

MMC Asset Management executive director Erik Metanomskiis one investor who has been sitting on the sidelines in anticipation of a correction. During the March quarter he held 67 per cent of the MMC Contrarian portfolio in cash and cash equivalents.

"You may argue that we should have invested more in equities over this short period, however this ignores the long-term risk of investing in an overvalued market," he told investors in his quarterly update.