

## FINANCIAL REVIEW

# The profit and pitfalls in microcaps

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Small companies were the market darlings of fiscal 2004. But some investors continue to pick though the under-researched microcaps. Martin Pretty spoke to Trent **Capital's** Andrew Brown and **Cadence Capital's** Karl Siegling.

What attracts you to the microcap sector?

Andrew Brown: The average non-escrowed equity capitalisation of a listed company is about \$624 million but the median company has an equity market of only \$30 million. Most professional fund managers focus on the top one-third or so of the market by company number due to the small value of tradeable shares of this area, and stockbrokers and other suppliers of research also focus on the top one-third to one-half of the market by company number due to an inability to derive commercial levels of brokerage return outside this area. As a consequence, significant anomalies between the market prices of certain companies and their intrinsic value will exist at any given time within this microcap area.

Karl Siegling: Since many of these stocks are not researched, you can find tremendous investment opportunities and I believe that by sifting through many of these stocks you can improve your risk-reward ratio relative to investing in stocks that are widely covered and well understood. Dealing in the small and medium end of the market is interesting in that when you talk to senior management you are more likely to also be talking to a major shareholder and founder of the business. As such, these managers tend to be more involved in their businesses.

How do you deal with the inherent illiquidity and the tendency for microcap stocks to be overrun by day traders either piling in or diving out?

Andrew Brown: I don't have the risk of people wanting their money back. Trent **Capital** can afford to take positions in microcaps and hold on if it falls 10 per cent or 15 per cent in value. The assets are very illiquid so you have a very long-term outlook but I tend to prefer to leave a bit on the table for someone else and exit rather than risk a liquidity problem. Even though the market picked up since May, the smaller stocks have trailed larger stocks. There were a lot of initial public offerings in the microcap arena and a lot of stuff that was speculative in terms of saying, "Here's a business, please give us some money." You definitely started to see hedge funds and other short-term players in the small caps and microcaps. At the end of the day there was no fundamentals about that. It was all money flows. Then the music stopped.

Karl Siegling: All market participants create liquidity and in this respect day traders are no different. Lack of liquidity can be both an advantage and disadvantage. When a stock that is not well researched and is cheap is "discovered" by the market and you have an existing position, the lack of liquidity tends to drive prices higher quickly. Conversely, unexpected negative news about an illiquid stock tends to drive the price down quickly. Lack of liquidity tends to act as a double-edged sword. We tend to invest on fundamentals rather than speculation so that we are not likely to be competing on a particular stock unless we are investing in a stock based on fundamentals at the same time as there is speculation around about that specific stock.

The Australian sharemarket is considered by many to be one of the most over-researched in the world. But in the microcap space there is a distinct lack of information. How do you find microcap stocks? And how do you research them? Andrew Brown: You've got to talk to a lot of people and hear different views from what you would if you invest only on what is widely known in the market.

Karl Siegling: Sometimes it's as simple as running a pen down the listed stocks in The Australian Financial Review and picking 10 or 20 stocks we have not visited before or have not visited for a while. At other times we read broker research on stocks or attend company visits or broker lunches with key management of companies we may be interested in. We then look at recent announcements, full-year and half-year results and ring the company up and arrange to meet the management. Managers love talking about their businesses and smaller companies in particular, where the manager is also often a big owner of the stock. What I have described so far is more than most investors have time to do before they invest. We then

assess the prospects for the business over the next two years and formulate some basic earnings and cash flow numbers for the business.

What are your key holdings at the moment? And why?

Andrew Brown: We are one of the largest shareholders in Strathfield Group and in Snowball Group, of which I have been appointed chairman. We've got 34 investments all up, ranging from peanuts to our largest holdings of about \$1 million.

Karl Siegling: We started buying Reckon at 15 ¢ [a share] when the company had 11 ¢ [a share] of cash in the bank. This meant we were paying 4 ¢ for the underlying business, which at the time was earning 2 ¢ a year in cash based on the half-yearly cash-flow statements submitted to the ASX. Every now and then an opportunity like this comes along. We started buying Reinsurance Australia at 6 ¢ after researching the balance sheet and having an actuary evaluate its net assets. We estimated the net assets to be worth about 20 ¢ a share with tax losses and accumulated losses having value as well. Over time the net assets have risen to about 58 ¢ a share, excluding tax loss benefits, and there may be future unrealised value in the company entering the general insurance market.

\* Andrew Brown is the managing director of listed investment vehicle Trent **Capital** and Karl Siegling is portfolio manager of the boutique hedge fund **Cadence Capital**