

AFR – ROUND TABLE – MONDAY 19th JANUARY
WHERE THE MARKETS APPEAR TO BE HEADING AS SLUMP CONTINUES

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1. What catalysts are needed for a recovery in small caps?

The stock market in general has gone from being 'risk seeking' to 'risk avoiding'. Before investors start taking risk again they will need to see clear evidence of the ability to make rewards commensurate with the risk being taken.

2. Do you expect small caps to lag a recovery in the wider market

The recovery in the market overall and small cap stocks in particular will be very much dependant on individual stocks. Whilst many stocks have fallen by fifty per cent or more, some companies business models have been shown to be almost destroyed whilst other companies business models remain largely intact. The general sell off in stocks will create good buying opportunities for those companies who have robust business models.

3. How will further interest rate cuts affect the sector?

Further interest rate cuts will have more of a sentiment effect than a tangible earnings effect on many stocks in the sector. Earnings and earnings expectations for the two years ahead as well as cash flows will have a greater effect on the sector than further interest rate movements.

4. There are plenty of cheap valuations in the sector. Is now a good time for investors to buy back in?

One consistent theme in 2008 was that seemingly cheap stocks became cheaper. This could be explained by a general lack of confidence in expected earnings. In many cases earnings have in fact fallen dramatically, so that valuations have proved not to be as cheap as originally thought. We should get some visibility on earnings at the half year results which will be important. Buying ahead of earnings results in a generally falling market is risky.

5. What stocks/sectors do you like?

Stocks with little or no debt, with stable business models and generating cash are proving more resilient in this environment. In addition opportunities are starting to arise where stocks are trading at significant discounts to cash backing and on lower multiples than unlisted, private companies. RHG is an example of a small cap stock trading at a significant discount to cash backing as well as a 1x to 2x cash flow multiple.

6. What stocks/sectors are you avoiding?

Companies with high levels of debt or debt that needs to be rolled over in the next year or two are vulnerable in an environment where debt is increasingly difficult to obtain. Sectors that rely

on asset price appreciation to generate profits but do not generate cash flow are vulnerable. These include property trusts, particularly developers as opposed to landlords, infrastructure companies with under performing assets and diversified financial service companies with seemingly strong profits but little or no cash flow. We remain cautious on consumer discretionary and retail companies. Underfunded resource companies, particularly exploration companies, may struggle to raise additional funding in the current environment.