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Small Ords danger zone

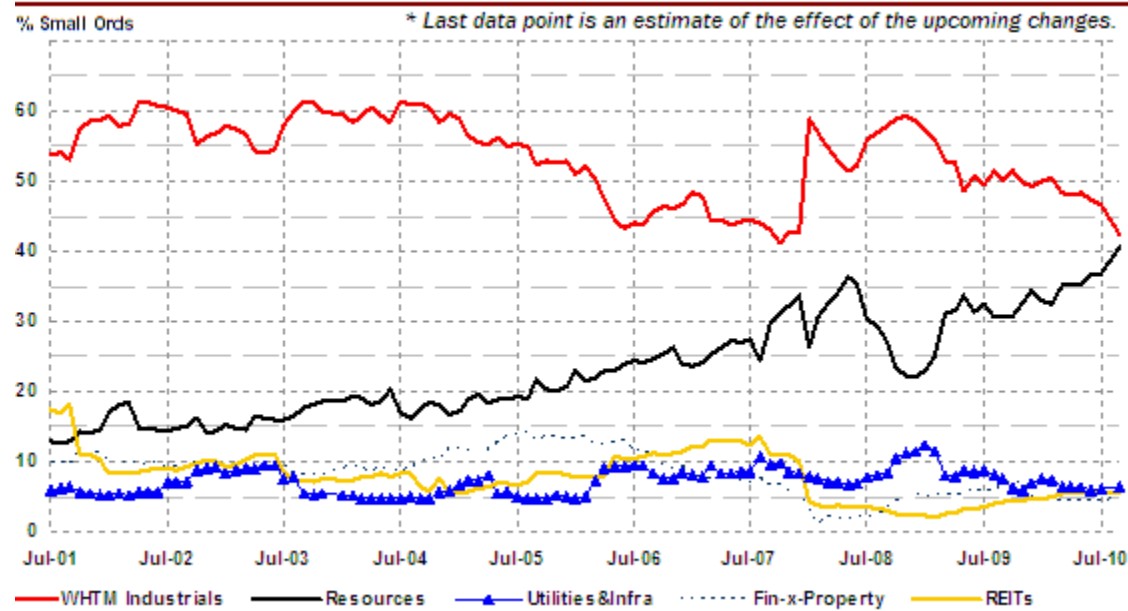
By Damien Klassen
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PORTFOLIO POINT: More loss-making resources stocks are moving into the Small Ordinaries index, making it more volatile.

The makeup of the Small Ordinaries index is changing, making it a much tougher place for investors to turn a profit. Ten years ago industrial stocks outweighed resources stocks by almost five to one. Soon they will be almost equally weighted.

In the current quarter, the index – which covers stocks within the ASX 300 but outside the ASX 100 – will lose up to seven of its largest, most-profitable stocks. They will be replaced mainly by loss-making resources companies, making the index much more volatile.

Proportion of the Small Ordinaries *



Source: IRESS, Wilson HTM

Ten years ago, if you had the view that small caps would outperform, you could conceivably buy a small cap fund or invest directly in a range of stocks and trust that “a rising tide would lift all boats”. Now, the sheer number of loss-making companies – primarily in the resources sector – means stock picking is much more important.

Just because a resource project is loss-making it doesn't mean it is a poor project; often it means the company is developing a sizeable resource and will make significant profits in the years to come. These types of companies usually carry higher risk than those that are profitable now, and although it is often

useful to spread your investment over several of them, having too many means you will start to run some pretty big risks.

Keep in mind that many of these resources stocks are “flavour of the month” and could be out of vogue in the near future. The median life of a resource or resource services stock in the Small Ordinaries in 2010 was just 18 months, compared with almost 10 years for companies in other sectors.

Most small-cap fund managers benchmark their performance to the Small Ordinaries index, which has idiosyncrasies that are not found in other indices. The makeup of a typical index (such as the ASX 200, for example) is such that the worst performers end up a small part of the index and then eventually drop out to be replaced by the best of the outsiders.

The new stock only makes up a small proportion and so the effect on the index is relatively minimal. Takeovers of larger stocks can have a bigger effect, however the replacement stock is usually only a small proportion of the index and so again doesn't have a large effect on the makeup of the index.

In contrast, the best companies from the Small Ordinaries graduate to the ASX 100 and are replaced poor performers relegated from the top 100. If we can compare this to direct portfolio management, it is like replacing your outperformers with underperformers.

At the same time, those underperforming stocks are bigger in terms of market capitalisation and so account for a larger proportion of the index. So, the “narrative” is that with all of the ASX 100 takeovers, the Small Ordinaries is losing its biggest, most stable stocks and getting back either mining stocks with no earnings or the worst stocks from the ASX 100.

In the last quarter alone, the Small Ordinaries has lost five of its most profitable companies ResMed (RMD), Ramsay Health (RHC), Ten Network (TEN), Viterra (VTA) and Macarthur Coal (MCC) and looks like losing Healthscope (HSP) to takeover and Adelaide Brighton (ABC) to a promotion.

In exchange, the index got back Energy Resources of Australia (first-half profits down 82%), Nufarm (just breached its debt covenants due to poor earnings), Unilife (loss making) and another eight resource companies that are currently loss-making.

12 month forward P/E for stocks in the Small Ordinaries *

* Loss making companies are shown in the >30x category

		P/E higher within group -->														
		< 6x	6-8x	8-10x	10-11x	11-12x	12-13x	13-14x	14-15x	15-16x	16-17x	17-19x	19-22x	22-25x	25-30x	> 30x
	SGM															
	CCV															
	SLR															ESG
	PRG															BOW
	ASL	SKE														BKY
	ALS	CQR														CGG
	FXL	CDI														NXS
	RMS	GNC														MRU
	HST	APN														LYC
	WTP	MAH														MEO
	FKP	ASB														IFN
	OMH	TAL														KAR
CAH	EHL	OGC														IFN
WSA	UXC	ELD														EXT
CVN	APZ	AIX														GDY
DOM	NWH	KZL														GBG
PMP	API	AJL														SFR
NFE	MPO	SPT	SLM	TPI												SLX
SRL	MCP	NMS	MCC	GUD												PRU
JML	PBG	MCR	IIF	HIL	SUL	CRG										RCY
RSG	SIP	AVO	KMD	pih	CHC	MND										PXS
NDO	SDG	AWB	TAP	SGT	PMV	IFL										ACR
MGX	PAN	CAB	SPN	FLT	KCN	MRM				IRE						ARU
AJA	IMF	CSV	SBM	MRE	TSI	GWT	GNS			IGO						WEC
ABY	WDS	HZN	OKN	BKN	TEN	ABC	RHC			PTM	AAC					GIR
TRY	COF	PNA	ABP	SXL	TOX	TPM	SAI			HSP	BPT					RIV
CER	PEM	MML	AAX	PLA	PPX	MSL	ISF			IVC	NVT					AQA
AGO	PGA	TGR	BDG	CLO	FWD	HGG	ROC	TRS	ENV	WTF	MBN	MMX	SRV			CIF
CNP	IDL	AAD	VBA	IGR	SMX	MIN	CUS	BWP	WHC	HDF	CNX	CRZ	MDL	BTA		
										PAG	AUN	RMD	VPG	COE		

Source: Wilson HTM, Thomson Reuters

These trends have already played havoc with traditional ratios. I gave up looking at small resources EPS growth or price/earnings multiples long ago because there are so many companies that are forecast to move from negative earnings to positive earnings that comparisons and multiples are relatively meaningless: often the inclusion or exclusion of a single company moving from a loss to a profit can make a significant difference.

All this makes stock selection critical over the next few years, and avoiding the most hyped resource stocks and the dregs from the ASX 100 will be the key to performance. Randomly selecting a dozen small caps based on favourable reports isn't going to cut it; you are going to have to work much harder than that.



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