
NAB faces task of rebuilding corporate culture

Buyback deadline looms for CBA

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Recent strong returns show patience is a virtue for investors in small companies

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Taking a long-term approach is the key when investing in small cap stocks.

Investment in smaller companies was the success story of 2003, but views vary on whether this success will continue. For much of the past two decades, the stocks of larger companies (large caps) have outperformed the stocks of smaller companies (small caps).

However, if you look at the performance of small cap managed funds and specific small cap stocks over recent years, it appears that small caps have made a strong recovery.

In the 12 months to January 2004, small company stocks, as measured by the ASX Small Ordinaries Index, delivered returns of 30.4 per cent, double the 14.9 per cent return indicated by the ASX 100.

Managed funds specialising in small caps performed even better and have significantly and consistently outperformed their ASX benchmark and large cap mainstream funds. Mercer surveys show that median small cap managers have delivered returns of 13.6 per cent a year over the last five years, compared with the 4.7 per cent gains represented by the Small Ordinaries Index and 7.7 per cent delivered by mainstream funds.

So is this a sustainable trend or a market glitch? There are many possible reasons for the outstanding performance of small cap stocks and managed funds. Proponents of the "small cap effect" believe that small is good because it has the potential to be big.

The theory is that small caps will outperform large caps in the long run because they start from a smaller base and can grow at a faster rate; they are less restricted by bureaucracy and therefore able to respond quickly to changing market conditions; they may be niche firms operating in a new product or market with little competition; and the manager is likely to be a major owner with interests closely aligned to those of shareholders.

The growing interest in small cap investing in Australia may also reflect economic conditions. Small caps do better in periods of economic upturn as investors are optimistic and have a greater appetite for risk.

Also, small caps are generally protected from global forces because small companies tend to have a local focus and are sheltered from the effects of an appreciating dollar.

Perhaps the key to success achieved by small cap funds is their focus on a largely under-researched sector of the market and their active management style.

So what is the outlook for small caps? Some fund managers advise caution, believing that small caps have been pushed hard over recent years and may now be due for a correction. Others believe that momentum and interest is with the small cap sector and there are still opportunities to be had.

The main message is for balance and diversification. The performance of small caps indicates that they can be a valuable part of a balanced investment portfolio.

The proportion of your total investment that is held in small caps may be increased without necessarily increasing the risk of the overall portfolio. In fact, an exposure to small caps helps to reduce the risks associated with concentrating investment in a small number of large companies.

However, as with most worthwhile investments, patience and a long-term perspective are essential.

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