WEALTH
WEEKEND EDITION | Edited by Andrew Main

Small fry worth a look amid volatility

The top 200 stocks tend to rise and fall in lockstep with crises

ANDREW MAIN

MELBOURNE funds management researcher Fiona Clark says the roller-coaster of risk-on then risk-off sharemarket volatility has pushed Australia's top 200 stocks into lockstep, causing them to jump and crash together with each new piece of news from the eurozone.

The consequence of this, she says, is that the ASX 200 cohort has lost diversity and investors would do well to re-examine quality smaller companies outside the top 200.

She cites a report from Macquarie Equities' John Conomos and Frances Lim that says the price correlation in the top 200 has moved up sharply, from 0.25 to 0.40 in less than a year, and is at its highest point in 20 years.

Clark, who works for boutique manager Prime Value, says smaller companies could provide a chance to break away from increased correlations.

"Smaller companies are often overlooked by larger managers, hedge funds and high-frequency traders, so their valuations are often a better reflection of the basic fundamentals, allowing for normal pricing anomalies," she says.

"That's not to say stocks outside the ASX 200 are not volatile too. They too are driven by macro influences and a down day on markets will put pressure on all stocks.

"But those smaller stocks can often be simpler and more easily understood by investors."

The risk profile of small companies "generally has not changed much, whereas for larger companies — even quality large companies — it has increased substantially", Clark says.

Maybe she is too diplomatic to note that smaller companies' risk profile have always been higher, but investing has always been a relative business and her point is valid.

"Picking winners among the larger companies in a highly correlated environment becomes a matter of timing.

"There may be opportunities to buy large caps when they get dragged down with every other average run-of-the-mill enterprise," she says, adding that once price volatility eases, it's easier to get a handle on true value.

So, what is the retail investor best advised to do? She says the base option of staying in cash is not a long-term strategy.

"While this may deliver less variation in your investment portfolio balance it is hardly a sensible way to plan for retirement, with a potential loss of purchasing power and little in the way of income in a falling interest rate environment," Clark says.

"Another option is to tough it out. Pick those good-quality companies to your heart's content, buy them when they get dragged down . . . and, when volatility eases, benefit as the true value of your quality investment is appreciated.

"This is a pretty smart strategy, and one that we try to take advantage of, but the downside is in the timing.

"This strategy requires a bit of patience for the dust of high volatility and high correlation to settle."

There there is the idea of backing non-correlated companies.

"The third option is to try to add something from outside the ASX 200 into your portfolio. Something less correlated," she says.

"These companies' valuations are often a better reflection of the basic fundamentals, allowing for the normal pricing anomalies.

"Smaller companies often have greater flexibility in their operations and can drive above average growth, even when the underlying macro-economic environment is weak.

"They can also be quite simple and easy to understand, rather than large conglomerates with layers of complexity.

"And smaller companies generally deliver higher returns when markets rebound." The Macquarie research takes a slightly different tack in seeking top 200 companies that have a lower correlation to the herd, and filters out the following stocks for its recommended list.

The stocks are also less correlated to market moves.

Macquarie likes Ramsay Health Care, Singapore Telecom, Transurban, JB Hi-Fi, Alacer Gold, Telstra, invoCare, Woolworths, Troy Resources and CSL.

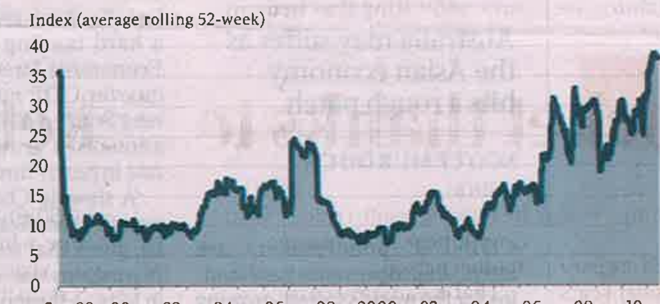
The other side of the coin, high-correlation stocks that Macquarie expects to underperform include Sims Metal, Bank of Queensland, Leighton Holdings, Aristocrat Leisure, Commonwealth Bank, Platinum Asset Management, Fairfax Media, Primary Health Care, Energy Resources of Australia and Abacus Property.

AARON FRANCIS

Fiona Clark says investors should consider small stocks, rather than running with the herd

ASX 200 member correlation

Index (average rolling 52-week)



Source: Macquarie Research