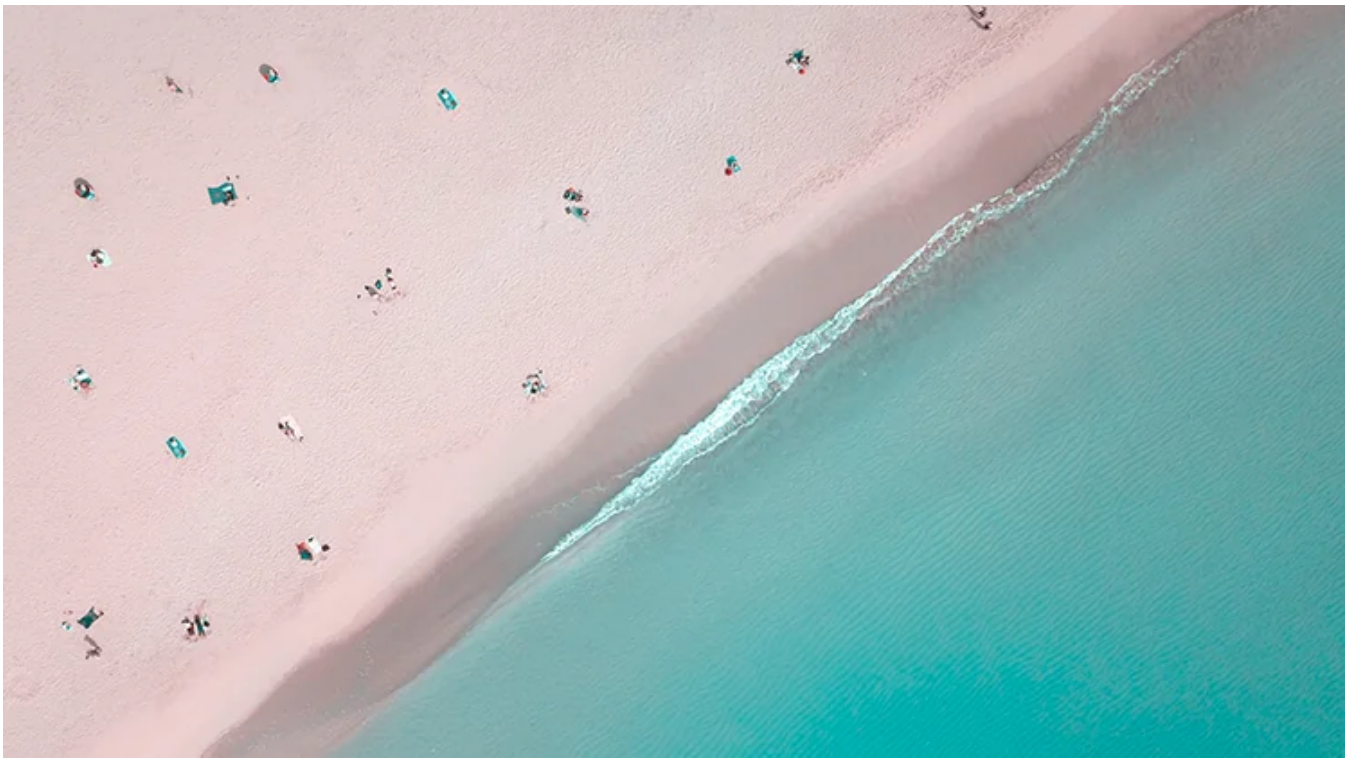
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# Why conditions are improving for Aussie small caps

**By Perpetual Asset Management**

20 August 2024



Small caps are trading at relatively low valuations – offering opportunities to investors, according to Perpetual's Alex Patten and James Rutledge.

- Valuations make smalls, micro caps attractive.
- IPO, M&A activity should return as confidence builds
- Learn more about the Perpetual Smaller Companies Fund

Investors have been closely watching ASX-listed small caps for a number of years, anticipating the moment when they start to outperform large caps.

That point is approaching, boosted by a US rate-cut narrative, argue Alex Patten and James Rutledge, co-portfolio managers of Perpetual's Smaller Companies and Pure Microcap funds.

And given the relatively low trading multiples of some small and micro caps versus large caps, opportunities are becoming available, they say.

"When the narrative around interest rates in the US changed late last year – and people started pricing in a few rate cuts in calendar 2024 – the small cap index in Australia started outperforming for the first time in a while," Patten says.

"That continued from November to February. Then again in July you saw the Russell 2000 small cap index rally very hard. That reflects optimism about the US economy and hopes for rate cuts.

"In Australia it is a different environment and inflation is a bit stickier. But once there is more confidence that rates are coming down and the economy is okay, that's the point where you will see small caps – which are weighted to consumer discretionary stocks – starting to outperform.

"Also during the last couple of years, investors shifted towards more liquid stocks. We have seen that in the underperformance of the micro caps and emerging companies index relative to smalls caps, relative to large caps.

"As people become more optimistic about the outlook, liquidity will come back into smaller stocks," Patten says.

**Historically cheap**

Many of the companies in Perpetual's small and micro-cap funds are looking cheap on a historical basis, Rutledge says.

"If you look at the starting point for the portfolios, the small companies fund is on a price-to-earnings (PE) multiple of around 13.5 times earnings. The micro-cap fund is similar on a PE of about 11 times.

"Yet there are a lot of companies in the micro-cap fund net cash and providing a dividend yield of about 5.6 per cent.

“The starting point is attractive – and with the dividend yields you’re getting paid to wait."

Perpetual’s investment process is based on value and quality – it is not deep value at any cost, Rutledge says.

Analysts look for conservative balance sheets and proven business models. There are also qualitative filters around the quality of the business and management team.

A healthy initial public offering (IPO) pipeline along with merger and acquisition (M&A) activity can help identify opportunities, Rutledge says.

However in Australia, both IPO and M&A activity has been subdued over the last 18 months.

“Growing confidence in the small and micro-cap markets is a good indicator of when the IPO market will pick up.

Once that picks up, there could be a flood of businesses wanting to come to market,” Rutledge says.

“There is a bit going on now in private markets, and I think there are a number of businesses sitting on the sidelines waiting to come back to public markets.”

**About Perpetual’s Australian small cap equities team**

The Perpetual Smaller Companies Fund aims to provide long-term capital growth and income by investing in companies outside the S&P/ASX 50 Index (when first acquired).

The portfolio leverages the growth potential of smaller and emerging companies through a proprietary stock selection process.

Perpetual is a pioneer in Australian quality and value investing, with a heritage dating back to 1886.

We have a track record of contributing value through “active ownership” and deep research.

Find out more about Perpetual’s Smaller Companies Fund

Want to find out more? Contact a Perpetual account manager





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