



# Why Invesco for small caps?

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## Introduction

In this article we consider the benefits of including smaller companies equities through a managed fund as a longer term, structural position in investors' portfolios, and as a complement to holding direct equities.

We also consider the benefits of including the Invesco Wholesale Australian Smaller Companies Fund as the solution when implementing portfolios in smaller companies.

## Why small caps?

The smaller companies or small cap sector of the Australian sharemarket (ex top 100 stocks) offers outstanding long term investment opportunities including:

- potential for strong growth in earnings
- an under-researched sector offers plenty of new investment opportunities and the potential for sustained high returns with not significantly more risk than the large cap sector
- reasonable valuations compared with large caps over the last 10 years
- increased portfolio diversification
- a sector that traditionally performs well in the earlier stages of economic recovery
- investment in emerging technologies and dynamic, nimble companies

The best way to capture these opportunities is to allocate a portion of your equity portfolio exposure to small caps on a strategic, long term basis. Successful small cap investing is best rewarded with a patient, long term approach.

The early to mid stage of the economic and investment recovery means that now is still an ideal time to allocate a portion of your clients' equity allocation to domestic small caps.

For advisers seeking a suitable small cap investment vehicle, Invesco's small cap capability is an ideal choice. We outline the many reasons for this in the next section.

## Why Invesco for small caps?

The Invesco Wholesale Australian Smaller Companies Fund ('the Fund') is a 'best of breed' portfolio and is virtually unique among peer fund managers for a number of reasons:

### 1. An outstanding performance track record across market cycles

The Fund has the longest continuously managed small cap track record in Australia with proven outperformance over more than 20 years. In dollar terms, for an initial investment of \$10,000 the Fund has delivered \$127,996 above its benchmark S&P/ASX Small Ordinaries Accumulation Index, since inception, to 31 December 2010 (see Figure 1 below).

Figure 1 - \$10,000 invested since inception

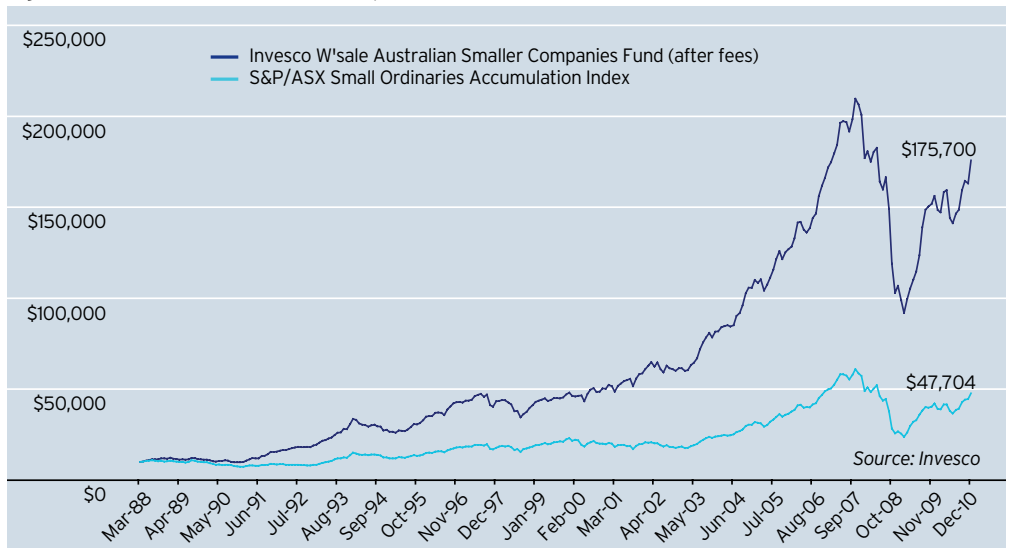
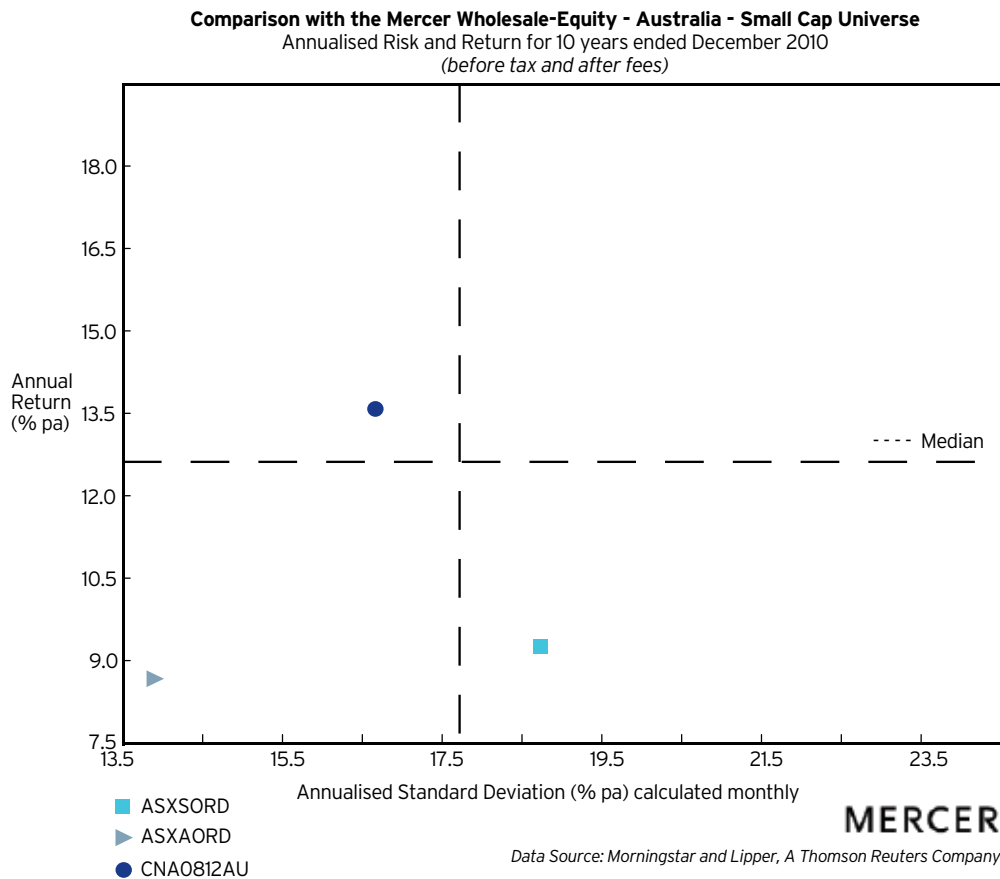


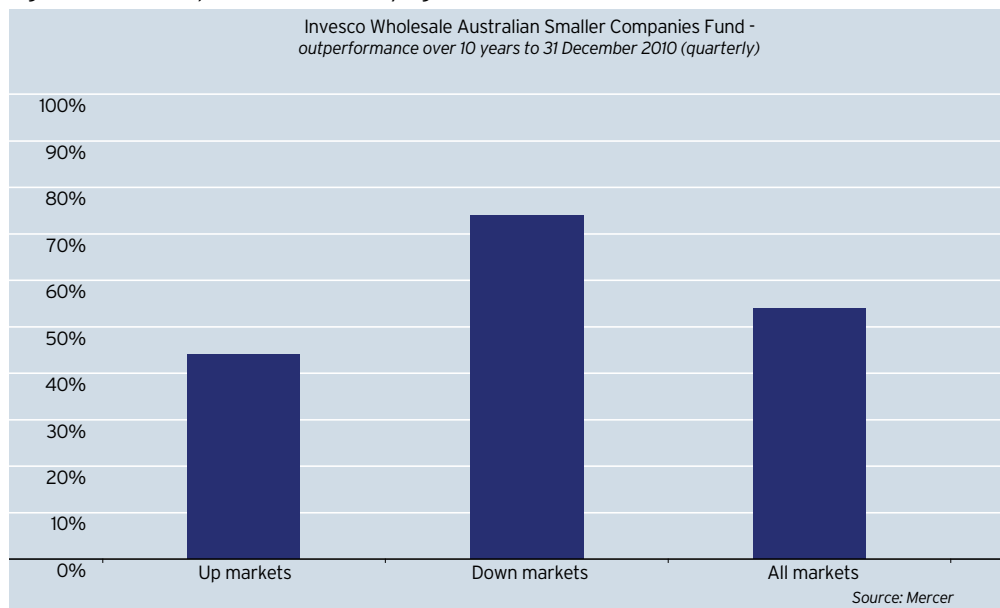
Figure 2 below shows the Fund's risk-return track record over 10 years. Over this period the Fund (blue triangle) has returned 11.8% p.a. after fees with a risk (standard deviation) of 16.5% p.a. This compares very favourably against both the Small Ordinaries Index (blue square) return of 6.2% p.a. and volatility of 18.5%, and the All Ordinaries Index (red circle) return of 7.4% p.a. and volatility of 13.8% p.a.

Figure 2 - Fund risk/return vs. benchmark and All Ords



Mercer data also shows that the Fund is a strong performer in down markets. For example, over a 10 year period to 31 December 2010, the Fund outperformed on 74% of occasions and by 1.35% per quarter on average in down markets (see Figure 3).

Figure 3 - Fund outperformance in varying market conditions



The Fund's typically strong performance against benchmark in volatile, adverse market conditions is due to our consistent approach to small cap investing. That is, we only invest in stocks that are: well run businesses; going concerns; have strengthening balance sheets; have a point of difference in their market; and have high quality management.

## 2. An excellent complement to large cap equities

The Fund is an excellent complement to large cap Australian equities, whether investing directly or investing via a managed fund.

Investors who obtain their domestic equity exposure via direct equities typically focus on large cap stocks because they are more familiar, more established, and more easily researched. However, this can limit an investor's opportunity for a higher risk-return outcome and greater diversification through a small cap exposure.

But investing directly in small cap Australian equities is inherently more problematic than large caps. Investors would benefit by having a detailed knowledge of the small cap market, and also, the companies and issues surrounding those smaller capitalised companies.

By adding an exposure to small caps, via the Invesco Wholesale Australian Smaller Companies Fund, investors can improve their portfolio returns without increasing risk, while increasing their portfolio diversification, lowering trading costs, and ensuring maximum peace of mind given the Fund has a top independent research rating. Moreover, the Fund has a long track record of outperformance driven by a robust, clear and repeatable investment process.

The Fund is also an excellent complement to a client's existing exposure in a large cap managed fund, creating opportunities for a better risk-return outcome and increasing portfolio diversification. By investing in the Fund, your clients can not only achieve this desirable outcome, but also gain greater peace of mind knowing that their small cap exposure is through a top performing, highly rated and award-winning fund.

The example to the left clearly shows that a structural shift to Australian small caps can significantly improve an investor's long term risk-return outcome.

## 3. An award winning and highly rated product

The Fund has earned a top five star rating from S&P Research, strong ratings from van Eyk and Lonsec, and was a winner in 2008, and a finalist in 2009 and 2010 in S&P's small cap award:



### For example

If a client added a 15% exposure to small caps, via the Fund, to their existing exposure to the S&P/ASX 50 Index, their returns over 10 years would have increased by almost 1% p.a. with the same level of risk

(Source: Invesco, data at 30/4/10).

#### 4. A top investment management team and asset management approach

The Fund is managed by one of Australia's most experienced small cap teams, headed by Cynthia Jenkins. Our three-strong small cap unit has generated a proven track record of strong returns during a period of more than 20 years:

- 6.3% p.a. of outperformance after fees over the Small Ordinaries benchmark since inception (March '88) to 31 December 2010.
- 1.3% p.a. outperformance over seven years to 31 December 2010; and
- 1.5% outperformance over 3 years to 31 December 2010.

In delivering such strong returns for clients, our small cap team consistently applies a patient, subtle and time-proven investment approach, which could be best described as 'growth at a reasonable price' or GARP.

The team looks to buy quality smaller companies where change is taking place, which can enable those companies to achieve earnings growth not yet reflected in their current share prices.

There are a number of key implications of our small cap investment approach:

- **Greater depth and breadth for strong value add opportunities** - Our small cap team can go both 'deeper' and 'wider' outside the ASX 100 Leaders Index. The index we use is the S&P/ASX Small Ordinaries Index, where we typically invest in companies with a market capitalisation outside the top 100 stocks but within the top 300. Most of the value (around 60%) that has been added by our small cap Fund has been in this range, though at times we can and do look for compelling opportunities outside the ASX 300 (i.e. the 'micro cap' end of the market).

The table below shows the Fund's market cap exposures versus benchmark:

Weight for period ending 31 December 2010	Fund %	Benchmark† %	Active weight %
1-20	0.00	0.00	0.00
21-50	0.00	0.00	0.00
51-100	5.12	0.00	5.12
101-200	57.41	72.18	-14.76
201-300	16.36	27.82	-11.46
301-500	16.64	0.00	16.64
500+	2.77	0.00	2.77
[Cash]	1.70	0.00	1.70

† S&P/ASX Small Ordinaries Accumulation Index

- **A focus on long term rather than momentum investing** - Our concentration on finding quality, well valued small cap Australian equity stocks has been justified over time, with sustained long term (i.e. 10 years-plus) added value (alpha) for clients. The small cap part of the domestic equity market is often lucrative for value-oriented fund managers because it can be susceptible to a high degree of research neglect. This is because potentially large cap analysts focus more so on the larger end of the index.

Examples of value adding small cap stocks we've unearthed are detailed below:

#### **ARB Corporation (ARB)**

ARB supplies after-market equipment to the four wheel drive (4WD) market and is the dominant player in the growing 4WD market. ARB has a diverse customer base including resource, agriculture, construction and leisure customers. It is well managed, has no debt and trades at an attractive valuation.

**Over five years to 4 January 2010, ARB has risen 160%. The Fund has held this stock during this period.**

#### **Mermaid Marine (MRM)**

MRM provides services to the offshore oil and gas sector in Australia through dry and wet vessel charter, supply base and slipway services. Its Broome and Dampier supply bases are unique, difficult to replicate, and provide a comparative advantage it can offer to all offshore oil and gas operators. The step up in exploration and production in the North West Shelf over the next three years and beyond should support MRM's growth.

**Over five years to 4 January 2010, MRM has risen 650%. The Fund has held this stock during this period.**

"Our patient, long term and value-oriented approach to small cap investing has delivered consistent added value for our clients over more than 20 years"

*Cynthia Jenkins*

- **Low turnover approach is cost and tax-effective** - Because we are patient, long term investors in small cap stocks, our portfolio turnover is typically low at 20-30% per annum. This means that 'frictional' costs such as taxes and broker commissions are typically lower compared to higher turnover funds. It also enables us to deliver a very tax-efficient result. For example, over each of the last eight years, the Fund has not returned any short term capital gains, i.e. they have always been discounted capital gains.
- **A highly competitive fee structure** - Unlike many other small cap funds in the Australian marketplace, the Invesco Wholesale Australian Smaller Companies Fund does not attract a performance fee. The management fee (MER) for this Fund is a flat 1.25% p.a.

Our Fund's MER is flat-fee and is backed up by a strong, long term performance track record driven by a stable, highly experienced and proven small cap team.

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#### Outlook and summary

Cynthia Jenkins offers a few comments about the current environment for small cap stocks:

*"The pace of corporate activity remains strong, with around 10% of portfolio holdings having been approached for takeover in the past year."*

*"There remain several standout examples of stocks which started small then increased their market capitalisation, e.g. Iluka, Sims, Incitec Pivot, Ramsay Healthcare."*

*"Overall, the smaller companies sector remains fertile ground for incubating niche businesses attractive for potential acquisition."*

As ever, investing in the small cap sector contains risks. However, we believe those risks, when managed effectively by seasoned small cap investment professionals, are more than outweighed by a host of investment opportunities, including:

- *investing in dynamic companies with strong growth prospects*
- *investing in an under-researched sector with plenty of 'alpha' opportunities*
- *greater portfolio diversification*
- *potential to invest in leading edge technologies and the sectors and stocks of tomorrow*
- *investing in a sector that traditionally performs well in the earlier stages of economic recovery.*

The **Invesco Wholesale Australian Smaller Companies Fund** captures all the above benefits and delivers yet more, including:

- *the longest continuously managed small cap track record in Australia*
- *an award-winning team of small cap investment experts*
- *the confidence of investing in a highly rated Fund*
- *a Fund with plenty of spare capacity*
- *a tax-effective, low cost and risk-aware investment approach*
- *a Fund that is available across a range of platforms.*

Critically, the longevity and consistency of our small cap investment approach and performance track record (20 years-plus) means that, unlike some peer managers, we have experienced many, varied investment cycles - e.g. the early 90's recession and recovery, the 'TMT boom' in '99/2000, the market bubble of 2004-2007, and the Global Financial Crisis of 2008-09.

Our time-tested, proven small cap approach works throughout all cycles, delivering particularly strong performance in times of volatility. Our team and process is carefully configured to add wealth for investors over the long term, rather than being susceptible to shorter term market gyrations and emotion.

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