

Growth vs Value in Australian Small Caps

Growth vs value is a well-documented discussion in stock investing. It describes two fundamental approaches or styles to investing where in a basic sense, the growth approach seeks to invest in companies that exhibit strong growth characteristics (whether this be in the sales, earnings and/or cash flow of a company), while the value approach seeks to invest in stocks that are undervalued (based on several measures including a low price to earnings (P/E) ratio, low price to book (P/B) ratio or high dividend yield etc). These measures aren't exhaustive and different investors will have their preferred metrics.

At Flinders Investment Partners, our approach to investing in Australian small companies is unequivocally growth. In fact, it's our belief that a focus on growth when investing in small companies, delivers superior returns. To us, this is intuitive since small companies typically strive to become larger companies over time. They aspire to grow – finding the ones that have a sensible growth strategy in place with competent management who can execute on the strategy is the challenge that we face as investors.

There are three ways that a company can grow. First is organic growth which is clearly the most desirable and sustainable, whereby companies look to grow by reinvesting profits back into the business. In the right sort of business (where the reinvestment generates decent returns), this type of growth can drive earnings and hence the valuation of a company over many years. Second, companies can grow by making acquisitions. This can provide scale and/or capability to a business but typically also increases the risk profile. Finally, a company's growth can be driven by cyclical factors, but this is usually shorter duration in nature and investors need to understand these finite cycles to generate investment returns.

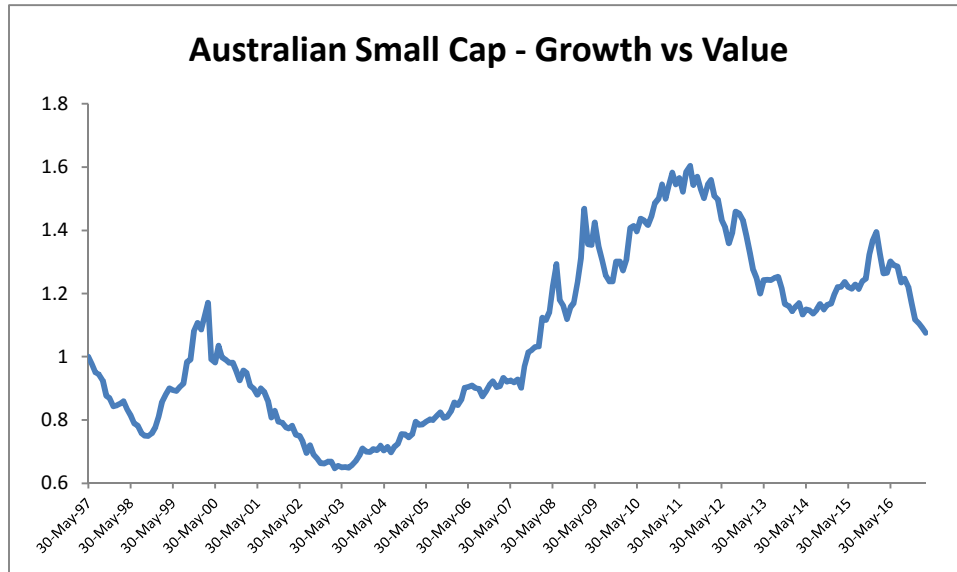
We acknowledge the value approach has significant merit (no one wants to overpay for a stock!¹). It essentially seeks to pay a price for a stock that is a discount to the intrinsic value. This value can be measured in a number of ways. The reason for the discount can be many – perhaps a company has fallen out of favour for some reason despite exhibiting solid fundamentals, or maybe a company is yet to be fully recognised by investors. A 'margin of safety' is sought, and the intrinsic value of a stock should be realised with the passage of time.

It's our contention however that a growth approach to small companies investing delivers superior returns to the investor over the medium to long-term. While past performance is no guarantee of future performance, it can be instructive. Focusing on the Australian market, Chart 1 shows the performance of the MSCI Australia Small Cap Growth index versus the MSCI Australia Small Cap Value index since the inception of the two indices 20 years ago. While there have been periods when a particular style has been in favour, the growth approach has yielded outperformance in the Australian small cap market over the long-term.

NB all charts below are based on total returns (which includes dividends). Charts 1 and 3 have been rebased to 1, with an increasing unit indicating outperformance in growth, and a decreasing unit indicating outperformance in value.

¹ It's worth making a comment on valuation which forms part of our growth approach. It's reasonable to say that some growth stocks (certainly not all) can exhibit above market P/E ratios as the stronger growth may justify a higher valuation. The risk is that the higher growth expected may never be realised and a stock de-rates as a consequence. At Flinders, we place a great emphasis on valuation. Regardless of which style the investor practices, there is never a benefit in paying too much for a stock. As growth investors our focus is on assessing how likely and reliable growth for a particular business is, but we do not overpay for a stock. Similarly, we will exit a stock that we deem to be overpriced, as opposed to letting momentum take over.

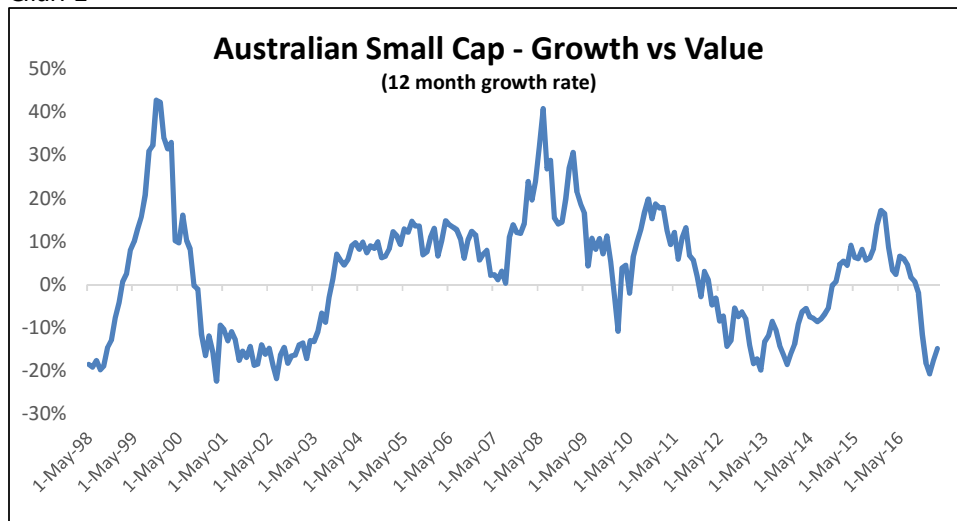
Chart 1



Source: Thomson Reuters Datastream

Chart 1 shows that the quantum of the cumulative returns has been superior for the growth style in the Australian small cap market i.e. the current value is >1 . In addition, when reviewing the series plotted for a rolling 12 month return (Chart 2), growth remains positive $\sim 61\%$ of the time over the time series (a reading greater than 0% in the chart). This illustrates that as a signal, growth has a material rate in the small company's universe. The final observation from Chart 2 is that we seem to be at a turning point between styles in growth vs value (more on timing in the second half of this report).

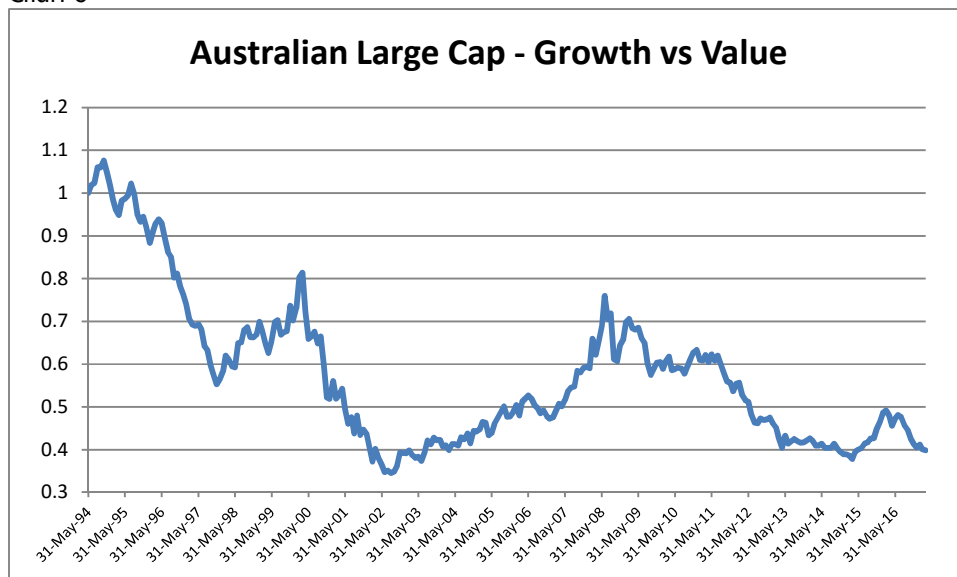
Chart 2



Source: Thomson Reuters Datastream

It's also interesting to compare the performance of the two styles in the large cap segment of the Australian market. Similar to the analysis above, Charts 3 and 4 shows the performance of the MSCI Australia Large Cap Growth index versus the MSCI Australia Large Cap Value index since inception (23 years ago).

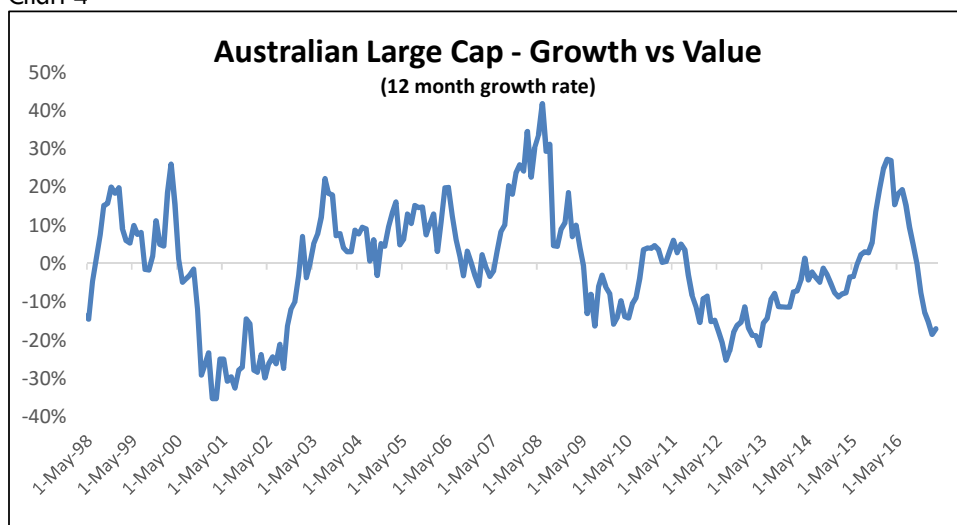
Chart 3



Source: Thomson Reuters Datastream

Value has clearly performed better than growth in the Australian large cap market (the cumulative returns for value is larger). In the rolling 12 month return (Chart 4), value remains positive ~56% of the time over the time series. Perhaps this is function of larger companies finding it tougher to grow on a larger base.

Chart 4



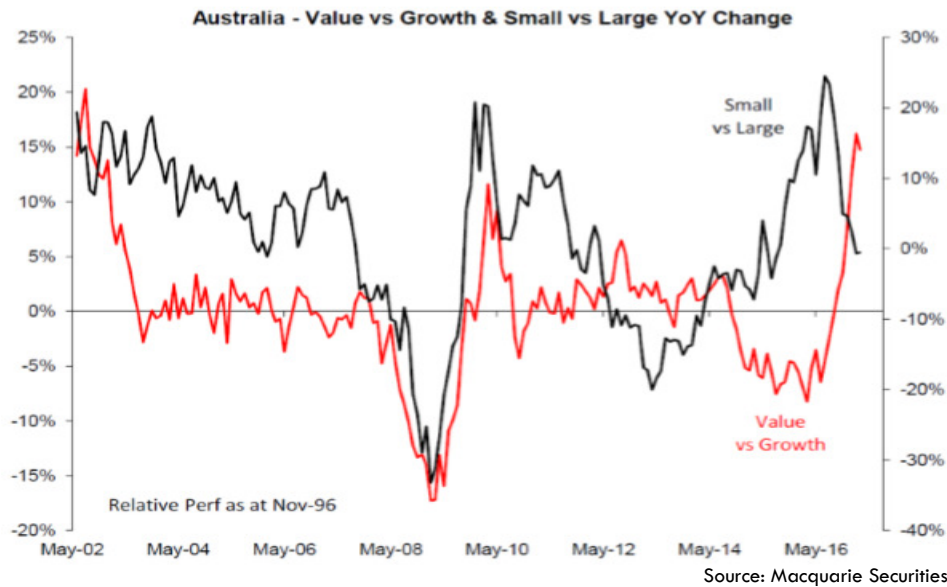
Source: Thomson Reuters Datastream

For small caps however, the key conclusion is that a focus on growth when investing in small companies delivers superior results for investors over the medium to long-term. Clearly, the outperformance of a particular style will vary depending on which point of the cycle we are in, however over longer periods, an investment style based on growth in this part of the market has great merit.

Finally, we wanted to cover off on the very recent performance across styles in the Australian market. Below is a time series which compares the relative performance of growth vs value and small vs large cap companies (Chart 5). What is clear is the dramatic divergence in performance in an extremely short time frame (since mid-2016), with value outperforming

growth, and large caps outperforming small caps. In regards to the value vs growth series, there have only been two prior occasions in the last 15 years where this level of divergence in performance has occurred. Importantly, in each of these cases, growth companies proceeded to materially outperform value stocks in the subsequent period.

Chart 5



So, when could this reversal occur? The prevailing economic conditions suggest that the recent de-rating of both small caps and growth companies has been unwarranted. From a global perspective, Chart 6 illustrates that current economic growth conditions are benign compared with the post tech bubble period of 2001 and the remnants of the GCF. Critically, Australian investment conditions (as illustrated in Chart 7) remain supportive given both the stable level of consumer sentiment and improving business conditions.

Chart 6

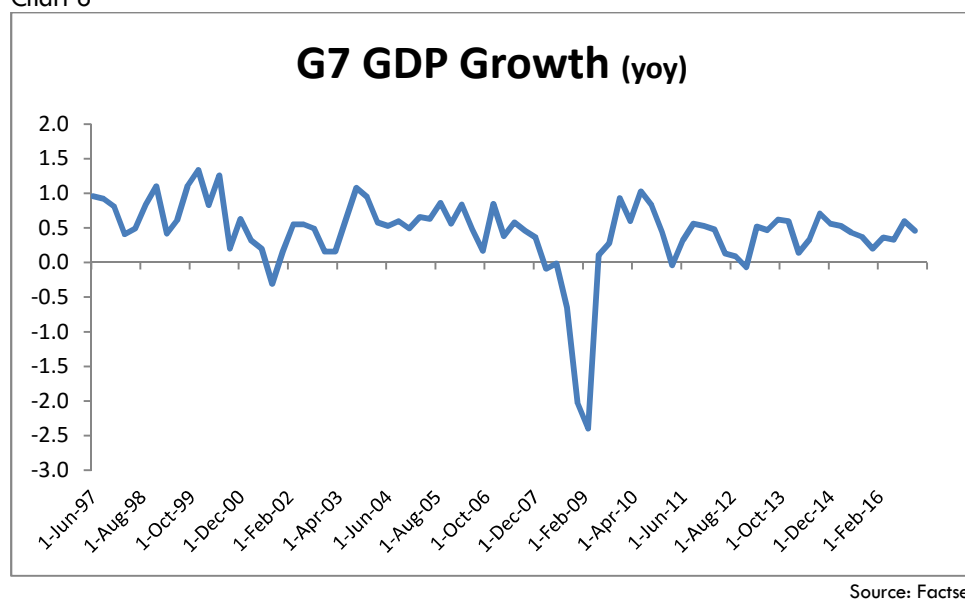
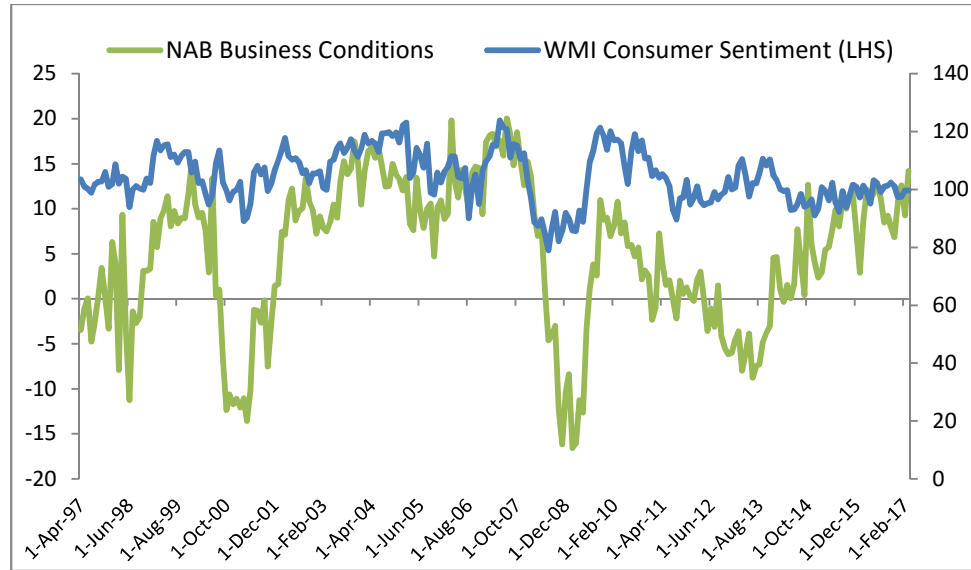


Chart 7



Source: Factset

So one wouldn't have expected a de-rating on the back of current economic conditions, yet it happened. The question is, what next? When looking at the last time value outperformed substantially and reached extreme levels, was the period following the depths of the GFC (see Chart 5). Reviewing the underlying data from Charts 1 and 2, for the period commencing February 2009, the outperformance in Australian small cap value stocks relative to growth stocks was approximately 30% over 8 months. As it currently stands (to March 2017), the outperformance in value has also lasted around 8 months. Market timing is far from an exact science. However, with many of these indicators at extreme levels plus the risk appetite in small cap equities being so low, we are sensing a major opportunity in the near-term for growth.

In addition, it's no surprise that the recent outperformance in value has led to Australian small cap value stocks looking expensive relative to small cap growth stocks (relative P/E in Chart 8). In fact, the current discount that Australian small cap value stocks are trading at relative to their growth counterparts (~10%) has only been matched once over the last 20 years.

Chart 8



Source: Deutsche Bank

As a genuine small cap growth manager, the rotation described above has of course been a headwind to performance in recent months. Yet, we remain steadfast in our view that prosecuting a growth approach to investing in Australian small caps will yield outperformance over the medium to long-term.

With regards to timing, we feel that the opportunity being presented to investors is as compelling as it ever has been. The recent underperformance in Australian small cap growth stocks is bound to reverse (we believe this is imminent) and valuation support for this view is at historic levels.

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18 April 2017

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