

[00:00:00] **Rory Cunningham** Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I'm Rory Cunningham, Senior Manager of Investment Products at ASX, and this is our regular podcast, covering everything from investment trends, through to different ways to invest using a variety of products.

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[00:00:46] **Rory Cunningham** Hello and welcome to the Ideas Exchange. I'm your host, Rory Cunningham from ASX. Today we will be talking about the exciting world of small-cap Australian shares. To educate us on investing in small caps we're joined by Simon Shields, a founder of and portfolio manager at Monash Investors. Simon, welcome to the podcast.

[00:01:06] **Simon Shields** Hi Rory. Great to be here.

[00:01:08] **Rory Cunningham** So Simon, before we jump into it, can you please give our listeners some background and information to yourself and also Monash?

[00:01:15] **Simon Shields** Okay, well, I've been a equities analyst and portfolio manager my whole career, which is going back quite a long way now because I started in 1987 and for the vast majority of my career I've been at big-fund managers. I was at Westpac Investment Management, Rothschild, Colonial First State during its heyday, in fact, I ended up being head of Aussie equities at Colonial First State for a while. I then moved to UBS and I was head of Aussie Equities at UBS, as well as being an analyst and portfolio manager, which is something I've done all through my career. About 12 years ago, a colleague of mine, Shane Fitzgerald, and I decided we'd set up our own firm. Having learnt a lot from being at the other firms we'd been at over the course of our careers, and that was the beginning of Monash investors. Since that time, Monash Investors is predominantly invested in small companies and we have a listed small companies trust now called the 'Monash Investors Small Companies Trust'. The code for that is 'MAAT' and it's been running now for about two years, on the market. Since we started, we've beaten the small

companies total return index by about 4% per annum after fees. And we've been doing that sort of order for the last two years that we've had this listed fund. It's not the only fund we manage, but it's been a relatively poor time for small companies over that, over that time.

[00:02:39] **Rory Cunningham** And so if I was to say you've seen a few cycles in your time, which I'm looking forward to, to getting into...

[00:02:46] **Simon Shields** There's always something going on when you look back.

[00:02:48] **Rory Cunningham** Yeah. So what we thought we'd do is, is break this podcast into effectively two sections. Section one is let's set the scene and talk about what are Australian small caps. And then in section two I would be really interested to get the view of Monash, how you're positioning your portfolio, what your outlook is for small caps, and also to share with us some stock stories which we love on this podcast. So kicking us off in Section one, how about we do an overview of small caps now? Simon, so generally, how many companies on the ASX are defined as a small cap, and what's the typical profile of a small cap stock?

[00:03:22] **Simon Shields** Okay, well, there is a small cap index and it is the companies that are in the Small Ords. And those companies comprise the companies that are in the ASX 300 except for the top 100. Right. So we're talking about companies 101 to 300. The cut off is around about 4 billion, for the top 100. So there are a few exceptions for dual-listed companies, but generally it's about 4 billion for the largest small company. And it's about 200 million for the smallest small company. Now we don't limit ourselves to that pool, we consider any company outside the ASX 100 fair game for our portfolio. And this is probably another 100 companies or say that that are around that 200 million market cap but are outside the official Small Ords index.

[00:04:09] **Rory Cunningham** Okay. So what does that mean in terms of how small you will go? Maybe just for the benefit of our audience. On the ASX, there's about 2000 listed companies, but a lot of those will be in the very junior mining sector. Usually they're at the very early stages, raising initial capital to effectively prospect for possible reserves, which means that we do have a very long, very microcap tail on the Aussie equities market. So I suppose, question back to you, Simon. How low do you go in terms of market cap or business size?

[00:04:45] **Simon Shields** Well, we generally don't invest in things that's got less than a \$200 million market cap. And of those there are only a handful of those in the portfolio. In any case.

[00:04:55] **Rory Cunningham** Got you. Okay. Opportunities and challenges for investors looking at the small cap universe. There's obviously opportunities

when you're looking at high-growth businesses. But what also are the challenges of that segment of the market?

[00:05:08] **Simon Shields** It is very different investing in small caps to investing in the large caps. First of all, there's much less coverage of the companies by brokers, so it's not as easy to get up-to-date information and forecasts, in particular analyses of the balance sheet, cash flow and so forth. For many of the small companies. The second thing is the disclosure. It is a lot more rigorous. Again, in the large cap companies. When you're dealing with a small company, it's probably only got one business unit, so you don't get a divisional break-up. And because it's just one unit, there are a lot more sensitive about what they disclose to the market. It might be commercial in confidence. They don't want to give their competitors a heads up and so forth, so they can be a little bit a little bit coy. Also, dealing with a smaller organisation, they won't have the same sort of structure for investor relations, in place. So, you know, it really comes down quite often to the individual who is the CEO or who is the CFO.

[00:06:01] **Rory Cunningham** And so then the opportunities that that might present to you as an investor?

[00:06:05] **Simon Shields** Well, pluses and minuses, obviously. You have to be careful because you don't want to be exposed to inside information. But on the other hand, there are many public sources of information now that didn't exist previously because of the internet. And you can leverage those public sources of information with, if you like, tidbits of disclosure from the company to come to conclusions that perhaps you're on your own about, because there aren't very many analysts covering the stock.

[00:06:32] **Rory Cunningham** Okay. What do you see when you're talking to investors in your fund in particular, or perhaps your peers that are professional investors? What are the common misconceptions about investing in small cap stocks?

[00:06:43] **Simon Shields** Well, I think when it comes to finding small cap stocks, you really need to be very concerned about risk and how strong the, if you like, the investment thesis is. And there's a view that small cap companies must be better because they're going to be high growth. But there are a lot of small cap companies out there that are just drifting or struggling. And there's an element of mispricing that goes on, in regards to that. In that those companies can be on similar prices to companies that are actually on much sounder footings. The growth might be a little bit further out, it might not be as obvious. But it really pays as a small companies investor to really understand the business that your in, look at the stability of its earnings and the opportunity for growth, rather than just assume, it's listed on the stock market, it's going to be okay. In a way that, to some extent you can for the top 100 companies, even if they stuff up it's... generally, I'm saying this... not saying, you know, there aren't exceptions but generally, you know, the only disappointments are 5% or 10%, they're not 30% or 40%.

[00:07:47] **Rory Cunningham** Thanks, Simon. Now, small caps have underperformed over the last 12 months and also three years. That's relative to the large cap index, which is the S&P ASX 200 index. Why is that?

[00:08:00] **Simon Shields** Well, they've been particularly impacted by the increase in interest rates and you go, well, why, why would that be the case? And inflation. Both those things increase discount rates and small cap companies trade already on a higher discount rate than large cap companies and so they are more impacted when you get a rise in discount rates. Particularly also when we come to these tech companies that have been small cap companies, they have been particularly de-rated because of their growth. And so when you're valuing a company, obviously has cash flows out into the future. If it's a growth company and has more cash flows out into the future than the average company, and if you're discounting those cash flows at a higher rate, it's going to impact the valuation more. So last year, in particular, there was a very large underperformance and that's impacted the three-year numbers.

[00:08:50] **Rory Cunningham** Okay. Understood. Extending our time horizon a lot longer. How have small caps performed over the long time?

[00:08:56] **Simon Shields** Pretty well. It very much depends on the point you are in the cycle of where your starting point is. So if you think about what was the tech boom in the nineties, small caps did extremely well during that period and then they underperformed in the in the tech wreck, which went on for another few years after after the year 2000. Then we were into that whole boom leading up to the GFC and again small cap companies did extremely well during that period off a low base, obviously, at the GFC and they they underperformed greatly. We had the COVID where they got slammed, but many did very, very well during COVID because of that whole move to people staying at home, buying more things on the web. And so there was a real run in some of the small caps. But then as we, you know, we saw those supply chain inefficiencies and inflation play out and inflation became persistent and then interest rates started to go up, small caps got slammed again. So it really is a matter of picking the point in the cycle where you invest in small caps, if it's a choice about how much money you're allocating.

[00:09:55] **Rory Cunningham** Okay. That's a great segue into our next section, which is turning to how Monash is investing in small caps. So, with rising interest rates, I suppose everyone is feeling the pain. It seems it doesn't necessarily matter what sector you're in, whether it's consumer, retail, tech, which we talked about, parts of the property industry, it feels like there's nowhere to hide really. What's the view of Monash looking forward for small caps in general, but also if you can take us through certain sectors whether you're either more bullish or more bearish on.

[00:10:27] **Simon Shields** Okay, well look, I'll start by saying I think it's a pretty good time to be investing in small caps because of that cycle. They've been

slammed. And so if you can find the right stocks, you should get quite a decent re-rating as well as enjoying the growth that those stocks are providing. But when it comes to what's going on in a macro sense in the economy. The economy has held up pretty well during this high inflation, high interest rate period. If you think back to previous cycles in Australia, it's been much worse. You know, we had collapsing property prices, we had unemployment going to 10%, so we've had quite high interest rates, quite high inflation and we've sort of been doing okay. In fact, the RBA is puzzled as to why unemployment hasn't been worse than what it is. Now, having said that, our economy in Australia from a consumer point of view, has had much more of a shock than, say, for example, the American economy. In America, they have 30-year fixed interest rates on their on their mortgages. Obviously we have variable rates in Australia. Our rents have gone up a lot more in Australia, not just because of the cost to landlords but because of the very high levels of immigration we've had. At the same time we've had the shocks on electricity and gas prices. So cost of living have really gone up a lot more in Australia and that's led to, if you like, a consumer reaction in Australia that's been more severe than in the United States. When it comes to property, like I said, property hasn't fallen in a way that it would have previously. Maybe that's been because of the high rates of immigration we've had over many, many years in Australia. And just the amount of property being built hasn't kept up. For example, in England at the moment, property prices are falling. So their cost of living shocks haven't been as great as ours and yet they are getting property prices falling in the United States. Property seems to be pretty good at the moment. Okay, so where does that leave us? We're heading into our reporting season. Well, I think, you know, other things being equal, we should see some very weak sales from discretionary retailers. Right. So people have to pay for the utilities, have to pay their rents, pay their mortgage. What have they got left over? Well, we did see a boom in travel coming out of COVID. That seems to be tailing off now. But in particular, we think things like furnishings, homewares, durables, consumer discretionary, should be quite weak. Now, having said that, we've seen our consumer stocks rise quite a lot over the last six weeks or so, but that seems to be following more the American market. And it'll be very, very interesting to see the responses when our Australian retailers start to start to report. In a wider sense, I think it's a great time to be investing in small cap. I think you've got many technology stocks that have been derided very significantly. Obviously in different sectors they're different winners. And so I can point to individual stocks and maybe we can talk about some later, but also there's there's some broader themes going on in the economy. There's just, globally, there's this vast spending on electrification, which affects many minerals like lithium, for example, but others like graphite and so forth. And then all that spending on infrastructure for the poles in the wires that we're seeing coming through as well. So that's quite a big theme in the portfolio to take advantage, if you like, of all that all that spending that's been going on in the economy there.

[00:13:44] **Rory Cunningham** Okay. I'd be interested in your views on the tech sector. Obviously, through COVID, lots of tech companies were benefited and

saw huge increases in their stock price, through that period. Whether you're an early stage tech company or a later stage tech company. But is it fair to say that in recent times we've seen a real divergence between profitable and unprofitable tech companies? And what's your outlook for profitless tech companies?

[00:14:10] **Simon Shields** Yeah, look, there was a real model where companies would run themselves fairly lean and then have a capital raise. Even though they weren't profitable, they could they could raise money at very good market caps. And that was an ongoing source of cashflow for them until they got to profitability. And that's not to that's not to denigrate these companies in any way. They're just companies that perhaps came to the stock market earlier than what they would have in previous decades. But there have been some magnificent companies that have been running at losses over time that have gone on to be hugely profitable and very high market caps in time, on the stock market. However, with interest rates going up, the party sort of stopped. And prices collapsed. Of course, the companies were reluctant to raise capital at those low prices, but eventually were forced to. And that diluted shareholders terribly. So many of these companies are not going to get back to the share prices that they originally got back to, even if they get back to the market caps because they've issued so many shares, they just they just won't get those share prices back to the same level. But there is a split between those that need the cash and don't need the cash. And certainly the ones that don't need the cash are the ones where they're recovering their ratings. And I think it doesn't just apply to the tech companies, it applies to any company on the stock exchange. If your balance sheets at risk, you're valued in a different way. All of a sudden all bets are off because if you go bankrupt, you're worth nothing.

[00:15:33] **Rory Cunningham** We've got earnings season coming up. You talked a little bit about that earlier. Now, I suppose two questions for you. As an investment professional, can you talk us through your process during earnings seasons? What is it that you do on a daily basis? Sure. Yeah. And then if you were to pick your top three things that your most looking forward to out of earnings season.

[00:15:53] **Simon Shields** So what do we do as investment professionals during reporting season? Well, I suppose, first of all, let's talk about the companies that we we do own. We know the day they're going to report. So we're sort of ready for them. We have our own models and we know what the market expectations are for revenues and profit at the different levels, whether that's EBITDA or EBIT or net profit. We know what the cash flow expectations are. We know sort of what the balance sheet should look like, inventory builds or whatever. And then the result comes out and we look at that straight away. That could be anywhere from 15 minutes to 3 hours before the company does a conference call. And so in that time, we're trying to work out, what we're looking at. Is it meeting our expectations? Is it meeting the market's expectations? And is the stock live or is it pre-market? If it's pre-market, the pressure's off a little bit. You know that you've got some

time. But, you know, if the markets live and the stocks starting to move, you're looking at the share price and going... does that share price make sense? Now sometimes the share price moves in the wrong direction after the result comes out because somebody's looked at the result, put trades on and they haven't drawn the correct conclusion or perhaps the wisdom of the analysts over time draws more importance from things that those first investors have put less importance on when they've looked at the results. So that can be quite discomfoting if you've got a strong view about what the result means and the share price prices going the wrong way. And then you're also thinking about, well, what do I want to do now? Do I want to put a trade on? One of the things we have to assist us is what we call signposts. So these are things we're looking for that we expect to see in the result. If it's a company with a store rollout. It might be how many stores did that roll out in that in that period? If it's a tech company that acquires business through a marketing spend, well, what sort of pay off do they get for the level of marketing spend that they put off? What are those ratios looking like? So, we're looking for these things and then we have the company presentation. And so you get on a conference call, you've got the you've got the presentation, you've got the CEO and the CFO talking and you get the opportunity to ask questions and that might elicit some more information. We listen to what they say and how they say things. Are they avoiding answering certain things? Are they changing the way they spoke about things previously? That can be good, but more generally it's probably bad. Are they talking down something that you expected to be a highlight of the result or just ignoring it completely, for example? So these are all really interesting things and the day can fill up. Sometimes you only have one or two results in a day. Sometimes you might have four or five. And it's it's very busy and it can be hard to keep up.

[00:18:31] **Rory Cunningham** Understood. This reporting season, what are you most looking forward to or what makes you most nervous about this upcoming report?

[00:18:38] **Simon Shields** Well, the retailers always make me the most nervous. I think. You know. When I look at the results reporting season after reporting season, it's almost always the case that the retail stocks have the greatest volatility in their share price, both surprises up and surprise down. And the reason for that is there's so many opaque parts of their business. You don't really know how much discounting they've been doing. You don't really know how much inventory's been going through or getting aged. You don't really know, you know, whether the cost of those goods have been going up or not, or whether transport costs and how much they're impacting. You know, we've seen a lot of inflation in wages and in energy costs. Are they more than making up for that in their price rises or not? You know, you might be very bearish because costs have gone up so much. And then you look at the result and you go, holy cow, they've put their prices up, their volumes have been, you know, impacted a little bit, but not enough to offset those price rises and the revenues have actually surprised positively and the margins have gone up. You know so we will see winners and losers and retail is

probably going to be where the greatest action is. Like I said, we're relatively bearish on the consumer. So we'll see how that plays out in this reporting season.

[00:19:50] **Rory Cunningham** All right. Let's get into two stock stories. What are two stocks that you're most excited about in the small cap space? And perhaps lay out your investment thesis for those stocks.

[00:19:59] **Simon Shields** Okay. So, the greatest thing that can happen for us as an investor, in this space, is identifying a stock that's a great business before it goes into the small cap index. Then it gets extra coverage. It gets more people who are prepared to invest in it, it gets re-rated. And of course, the stock goes really well and perhaps even graduates into the top 100 stocks over time. And we're in a stock that's on a path like that at the moment. A company called Telix. Telix is an Australian health care business. And what it does is it provides a drug that is used for imaging cancer patients, right? So the drug is radioactive. It sticks to the cancer and it makes it really easy to image the patients. And this is a real advance over the last ten or 15 years, and it's right at the forefront of that. So, at the moment, its main product is a prostate cancer product and it's selling literally hundreds of millions of dollars per year now in the United States, that's been ramping up over the last couple of years. It's going to Europe, it's going to other countries. It's got a renal or kidney imaging product that's coming behind that. And then, of course, there are a number of other products, you know, whether its brain cancer or bone cancer and so forth, and it also has applicability too. So that's really that's really coming through. And then the blue sky, in addition to all that, if that's not enough, is what's called therapy, but we call treatment. So if you up the dose, does that actually help reduce or eliminate the cancer? So, Telix, code is 'TLX'. We're very excited about that. Comes out with quarterly results and it's been doing extremely well. So we're looking forward to seeing how that's going to go, in this, in this period. Another stock that we've been on the journey with, as well, is a stock called Lovisa. Some of our listeners might know it from seeing it in shopping centres. It sells modestly priced jewelry. And yes, we expect its sales to be impacted by the downturn in consumer activity, but that's not where the main game is. The main game is that it's now rolling out of stores to over 30 countries. At the moment, it hasn't done this overnight. It's been building over the last ten years, or so. It's now rolling out strongly in the United States, strongly into Asia, strongly into Europe, United Kingdom. It should be growing its stores at a rate greater than 20% per annum in terms of the number of stores. Its CEO has been with the company now for probably about a couple of years, the latest CEO. And he came from Zara where he was rolling out stores in India, in China. So it sort of flags what it intends to do in this store rollout. And it's a company that's had very stable margins. It owns its own supply chain. It's not sold by other stores. It's not sold by other people over the internet. You can only get the product from Lovisa. And we think that's what's going to be dominating the understanding of the business for this reporting season. So we're very excited about it.

[00:22:55] **Rory Cunningham** Brilliant. Thank you, Simon. Thank you for taking us through, I suppose, an overview of the small cap sector clearly for investors interested in small caps, a lot of research required in order to understand the businesses, the opportunities, but also the challenges of investing in small caps. And thank you also for sharing with us your outlook and those two wonderful stock stories. Before we finish off, any closing comments for our listeners?

[00:23:21] **Simon Shields** I think we're going to look back on this time, Rory, and think, gee, what an interesting time, you know. The way interest rates and inflation have gone up. But we're getting to the end of that period. You can see the pauses in the Reserve Bank. You can see that inflation is starting to fall away again. Australia has gotten through this period without a major rise in unemployment. We're crowding the country with new people living here. So, you know, that's going to be reflected, I think, increasingly in our share market over the next two years. So I think it's, I think it's actually a very good time to be investing in, particularly in small caps.

[00:23:53] **Rory Cunningham** Fantastic. Simon, thank you again for joining us today. And thank you to all of our listeners. We look forward to seeing you next month on the Ideas Exchange.

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