

Perennial Perspective

Closing the Gap - Is Value Small Caps the ultimate Contrarian Call?

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We all know that good investors aim to buy low and sell high. Whilst we do not recommend trying to time markets, and in fact perfect timing is very unlikely, the current market environment for Value Style Australian Small Caps may offer the perfect opportunity for astute investors. The valuation anomalies in this market may make a good entry point for a good long-term investment for contrarian investors.

Large and Small Caps Valuation Differences

Since 2012, buoyed on by the search for yield generation, Large Cap stocks have substantially outperformed Small Cap stocks (as measured by the S&P/ASX 100 Accumulation and the S&P/ASX Small Ordinaries (the Index) Indices from 1 February 2016).

Evidenced by the chart below, the gap in valuation differences peaked in mid-2015, with Large Caps declining since that time.

What is stark in this chart is actually how far the Index needs to rise to reach its all-time highs again – a staggering 52.0%.

Small Cap underperforming Large Cap- Gap starting to close



Source: Factset and Perennial. As at 29 February 2016

Value, Growth and Momentum Styles – Value providing Investors with the best opportunity

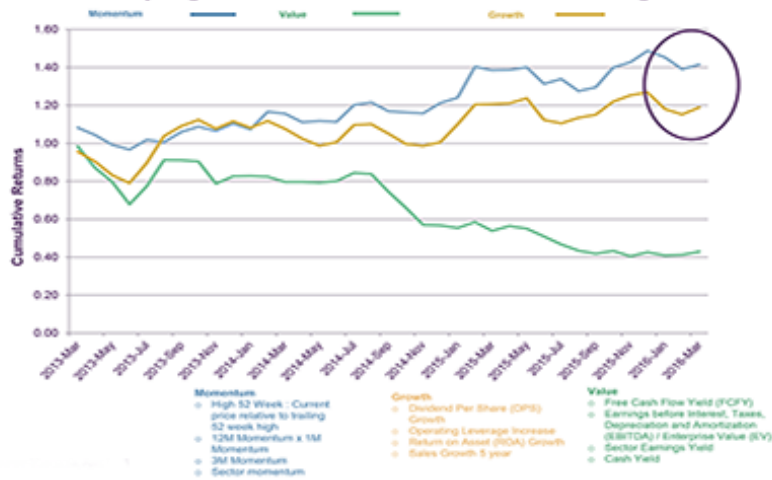
Over the past few years, it has been very clear that Value style stocks in the Australian Index have been out of favour. Value style stocks are those companies/portfolios who offer the following characteristics:

1. Lower Price Earnings (P/E's) ratio when compared to the market;
2. Higher Dividend yield than the market;
3. Lower Price to Free Cashflow ratio when compared to the market; and
4. Lower Price to Net Tangible Asset (NTA) ratio than the market.

Below is a chart by Macquarie comparing the returns of Value, Growth and Momentum stocks in the S&P/ASX 200 Accumulation Index. The chart illustrates that the Growth (blue) and Momentum (yellow) stocks have run significantly since 2013, and Value style stocks have underperformed the Index over the same time period. As at December 2015, the difference between Growth, Momentum and Value styles was at its greatest.

As many astute investors are aware, when valuations diverge significantly, it is more likely that a correction in valuations may occur. You can also see in the chart that Growth and Momentum Styles have started to tick over and this valuation gap is, possibly, at the very beginning stages of closing.

Recent style performance in Australian Small Caps



Source: Macquarie, 29 February 2016

Perennial Value's Smaller Companies Portfolio offers astute investors the opportunity to take advantage of both valuation differences in one portfolio.

The attractive valuation metrics offered by the Perennial Value Smaller Companies Portfolio are outlined in the table below. On a FY 17 view, the portfolio is offering investors a portfolio of shares where P/E's are lower than that market and Price to Free Cashflow is also at a substantial discount, and where Gross Yield is at a premium to the Index.

Portfolio Characteristics vs Ex-100 on FY17

Prospective FY17	Price to Earnings (times)	Price to free cashflow (times)	Gross Yield (%)	Price to NTA (times)	Net Interest Cover (times)	3year EPS growth (%p.a.)
Perennial Value Smaller Companies Trust**	10.0	8.6	6.3	1.4	21.1	14.5
Market Average Ex-100*	14.5	13.3	5.0	2.3	9.1	14.3
Premium/ (Discount) to Market	(31%)	(36%)	27%	(41%)	132%	1%

Source: *Macquarie Securities, Goldman Sachs and UBS forecast as at 4 April 2016. **Perennial forecast as at 1 April 2016

Portfolio true to label 'Value' style

The chart below also shows you the current valuations in Small Caps (as measured by the Index), pushed to one standard deviation above its long run average by many momentum and growth stocks such as index-heavy constituents like Dominos (in the Index until June 2015), Blackmores, Sirtex, Veda, Corporate Travel, Invocare, Mayne Pharma, Bellamys etc. all of which traded on 20 to 40 times 12 month forward P/E's over the last few years. Instead, Perennial Value's Smaller Companies Portfolio is offering investors not only great value on the metrics above, but also good value at 10 times forward P/E, one standard deviation below long run Index averages.

Current Valuations in Small Caps



Source: CS, Perennial Value, 29 February 2016

We believe that the Perennial Value Smaller Companies Trust is a great value portfolio offered at an opportune time for astute investors looking to take advantage of valuation differences not only in Small Caps but also in Value style stocks.

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