![2008 INVESTOR GUIDE]

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Often overlooked, micro-cap stocks can offer good value and big returns. But they are not for the faint-hearted. Report: Anthony Sibillin

LITTLE BEAUTIES

● It may be called "going public", but for most listed companies, life on the Australian Securities Exchange is a lonely affair. Analysts ignore them: banks, brokers and other research providers do not cover about three-quarters of stocks, the ASX says. So investors do too: the less researched a company, the less often it trades.

This is bad news for the smallest companies since research coverage and market capitalisation tend to rise and fall together. But it is good news for investors willing to brave the uncertainty and volatility that swirls around these so-called "micro-cap" stocks.

The returns can be spectacular. Among stocks with a sub-$150 million market capitalisation, the top 20 performers last year achieved returns ranging from almost 300 per cent to a breathtaking 1053 per cent (see table). By comparison, the S&P/ASX Small Ordinaries Index, which covers the 101st to the 300th biggest companies, increased by 18.5 per cent over the same period.

There are also bargains to be had. Listed companies without research coverage trade at a 20-30 per cent discount to "covered" stocks, studies from the United States suggest. Moreover, this group of unloved and undervalued stocks is growing. The rise of discount, non-advisory stockbrokers such as E*Trade has forced those still providing research to cut back.

"There is a huge void of quality advice and therefore lots of quality opportunities in the micro-cap space," the managing director of Cygnet Capital, Jonathan Rosham, says.

Cygnet, which was ranked 25 in the 2007 *BRW Fast Starters* list, is raising a $50 million fund focused on listed companies worth less than $100 million as well as those looking to list within the next 12 months.

Rosham warns that micro-caps are a world away from blue-chip stocks. "You have got to have a vision when you are investing of where you think a company is going, and if the management can achieve what they want to achieve," he says.

Accordingly, Cygnet works closely with the managements of its portfolio companies, especially those yet to float. "It is definitely a partnership approach. Very rarely do we have passive investments pre-[initial public offering]."

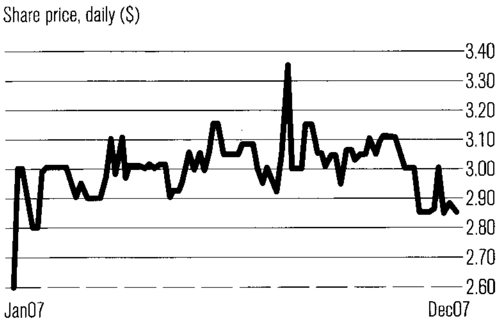
Indeed, it is the labour intensiveness of micro-cap investment that accounts for the small number of dedicated funds. Fund-watcher Morningstar tracks only four in Australia – from BT Financial Group, Challenger Financial Services and Acorn Capital – and can identify a further 11 that favour micro-caps.

The manager of Challenger's micro-cap fund, Michael Courtney, says it is not only the amount of work that goes into picking each stock that deters managers; it is also the diminutive size of those investments. Considering that even a 10 per cent stake in a $50 million stock is only a $5 million bet, "you don't get much bang for your buck", he says.

As a result, micro-cap portfolios tend to be adjuncts to small-company or small-cap funds. In fact, it was the success of Challenger's small-cap

5 STOCKS TO WATCH

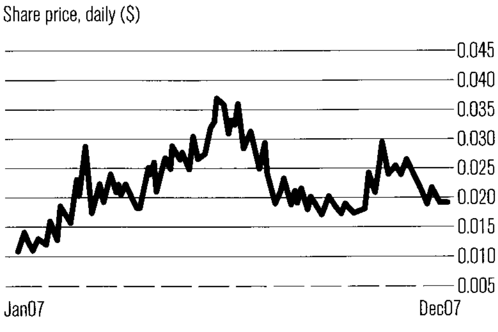
1300 SMILES (ONT)



Market cap: $57.4m	▲ **High:** $3.35
TSR: 13.9 per cent	▼ **Low:** $2.51

The marketing and buying group headquartered in Townsville is rounding up the nation's dental practices in the same way ABC Learning did with its child-care centres.

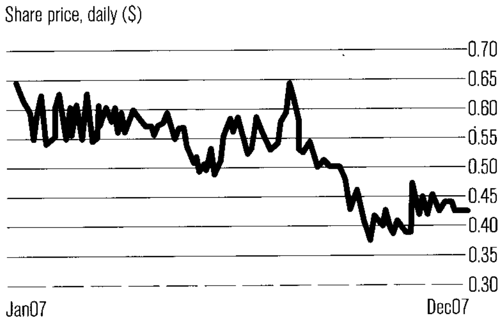
COMTEL CORP (CMO)



Market cap: $50.4m	▲ **High:** $0.03
TSR: 90 per cent	▼ **Low:** $0.01

Despite its share price halving since June, the acquisition of Empowered Communications positions the mobile phone service reseller to ride the mobile marketing wave.

MEDICAL DEVELOPMENTS INTERNATIONAL (MVP)



Market cap: $24.2m	▲ **High:** $0.66
TSR: -32.5 per cent	▼ **Low:** $0.38

Transformed an animal tranquilliser into Penthrox, a six-second pain relief drug used by Australian Football League players and licensed in the Middle East.