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Why investment approach matters more than sector exposure in the small-cap market

By Perpetual Asset Management

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The current small-cap environment is a reminder that index-level numbers can obscure more than they reveal – and that active stock selection, grounded in fundamentals, matters most

when the market is under pressure. ALEX PATTEN explains

- Finding opportunity in the small cap divergence
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- Find out about Perpetual Smaller Companies Fund and Perpetual Pure Microcap Fund

Finding opportunity in the small cap divergence

Small-cap investors have faced a difficult few months. But the real story isn't at the index level – it's what's happening beneath the surface.

Alex Patten, co-portfolio manager of Perpetual's Smaller Companies and Pure Microcap funds, points to February as a case in point.

While the small-cap index fell 2.6 per cent and the large-cap index advanced more than 4 per cent, the divergence within small caps was just as striking.

"Small industrials were sold off pretty hard – down 4.5 per cent. Small resources were up about a per cent," says Patten.

For investors relying on index exposure or riding sector momentum, that gap is consequential.

Much of the strength in small resources has been concentrated in early-stage, non-producing companies – businesses whose performance depends heavily on commodity prices and continued access to capital markets.

It's a narrow, higher-risk slice of the universe.

Fundamentals over trends

In an environment where small industrials have effectively been in a bear market, Patten argues that returns are more likely to come from businesses with genuine balance sheet strength, operational discipline and earnings drivers that aren't solely hostage to the economic cycle.

That thesis is playing out in the portfolio. Capral, one of Australia's largest aluminium extrusion suppliers, delivered results that came in ahead of profitability expectations and guided to earnings growth into calendar year 2026.

"The company is still quite leveraged to the residential housing cycle, which is at cyclical lows – but it's expecting that to pick up through the balance of the year and be stronger in the second half," says Patten.

"So that will be a nice tailwind. But that stock is still on sub-six times price to earnings."

Southeast Queensland construction materials supplier Wagners was another standout in the February reporting period, upgrading its earnings guidance by close to 20 per cent on the back of strong infrastructure activity and ongoing network expansion.

"There are a lot of tailwinds in the company's markets – what they're doing with new concrete batching plants and building out that network," says Patten.

Navigating a rate repricing

The portfolio carries meaningful domestic cyclical exposure, and Patten is candid about the headwind that has emerged as markets reprice Australian interest rates expectations.

"In general, what we've seen in the last three or four months is a revision in terms of how people are thinking about rates here in Australia – now pricing in a number of rate rises, which is not great for our domestic cyclicals," he acknowledges.

But that's precisely where active stock selection earns its place.

"The point is that we're trying to pick companies that have more than just the cycle going for them. We'd like to think these businesses have a lot more control over their own destiny – whether that's structural tailwinds, competitive advantages or the ability to take share and grow, even if we're coming into a tougher period on the back of a few rate rises."

In a market that rewards selectivity, it's a disciplined approach built for conditions exactly like these.

About Perpetual's Australian small and micro-cap equities team

Alex Patten is a co-portfolio manager of Perpetual Smaller Companies Fund and Perpetual Pure Microcap Fund.

Perpetual is a pioneer in Australian quality and value investing, with a heritage dating back to 1886.

We are one of Australia's most respected and longstanding active investment managers, with a proven investment process that has been refined through more than 50 years of experience.

We have a track record of contributing value through "active ownership" and deep research.

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