Microcaps: Where patience and active management can pay off

By Perpetual Asset Management
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Active management and patience can help identify valuable microcap opportunities early, says ALEX PATTEN, co-portfolio manager of the Perpetual Pure Microcap Fund

- Active insight can uncover overlooked microcap opportunities
- Disciplined stock selection helps manage volatility with microcaps
- Find out more about Perpetual Pure Microcap Fund

Alex Patten, co-portfolio manager of the Perpetual Pure Microcap Fund says active management can play an important role in identifying unloved microcaps stocks before broader market interest emerges

For Perpetual's small and microcaps team, Wagners Holding Company is a recent example.

The family-founded construction materials and services business listed on the ASX in late 2017 and had been on co-portfolio manager James Rutledge's radar for several years before the team took a closer look.

Finding value in microcaps before the market catches on

"We are happy to take a more patient view. We met with the company a couple of times going back to early 2024. The balance sheet was improving rapidly, even though the company still had debt," explains Patten.

"The operating environment was also improving, yet the stock continued to trade below a dollar.

"It took us a long time to build a position. We were buying on market for an extended period."

At the time, Wagners had limited sell-side coverage, low liquidity, modest valuation metrics and few obvious catalysts — common features among microcap and small-cap stocks.

Today, Wagners trades at more than $4.30, with a market capitalisation approaching $870 million.

It now attracts greater sell-side coverage, stronger liquidity, a material valuation re-rating and increased market attention.

"Liquidity has improved, and the stock is now discussed more widely in the market. You can see it appearing on the radar of other fund managers and in their holdings," notes Patten.

"It is a good example of where we are prepared to be patient. If the balance sheet protects us and we are early, the upside can be meaningful."

Knowing when to exit a microcap position

Discipline is equally important when deciding when to exit a position.

Step One Clothing (ASX:STP) is one example where the team exited while preserving capital.

After listing at $1.53, the stock rose to $3 within a month before falling below $0.50 following a failed US launch and earnings downgrades.

The team built a significant position when Step One was trading at a negative enterprise value, then progressively reduced exposure as the market shifted from valuing the business on assets to earnings.

Managing downside risk in microcap investing

Microcaps can carry higher downside risk, making disciplined stock selection and experience critical.

Before inclusion in the fund, each company must pass four quality filters: business quality, conservative debt, sound management and recurring earnings.

“Our philosophy with the Perpetual Pure Microcap Fund is to provide microcap exposure with a ‘sleep at night’ factor. The businesses we invest in are profitable, have strong balance sheets and can participate in rising markets,” says Patten.

Frequently asked questions

What's the difference between small caps and microcaps?

Both sit outside the largest ASX-listed companies, but microcaps are smaller again. Australian small cap portfolios are commonly measured against the S&P/ASX Small Ordinaries Accumulation Index, while microcap strategies target companies below that size threshold.

Why are microcaps often mispriced?

Microcap stocks typically have limited sell-side research coverage, low trading liquidity and few obvious catalysts. With fewer analysts following them, improvements in a company's balance sheet or operating environment can take time to be reflected in the share price.

What are the risks of investing in microcaps?

Microcaps carry higher downside risk and greater share price volatility than larger companies. They can also be harder to trade because of low liquidity.

How long should you hold a microcap investment?

The Perpetual Pure Microcap Fund is designed for investors with a minimum investment timeframe of seven years.

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

Alex Patten and James Rutledge are co-portfolio managers 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.

Want to find out more? Contact a Perpetual account manager

The product disclosure statement (PDS) for the Perpetual Pure Microcap Fund (Fund), issued by PIML, should be considered before deciding whether to acquire, dispose, or hold units in the Fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

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