under the radar report
SMALL CAPS

SPECIAL REPORT
22 JUNE 2022

WE'RE BUYING SHARES!

We're buying shares. Our in-house portfolio manager The Idle Speculator spent more buying stocks in one day last week than he has in the entire 12 months. In this special Q&A we find out why he's gone on a buying spree for his personal SMSF.

the questions

Q: Why buy now?

A: Last week global markets got whacked, the S&P/ASX All Ords declining over 7%. Obviously, most investors were selling, what made you step in and buy stocks?

Quite simply, we've been holding cash and we see stock specific opportunities after indiscriminate selling, which included stocks we like.

AFTER ALL, CASH EARNS NO INTEREST!

Why not invest in bonds, then? With interest rates going up, bonds seem to be a poor bargain putting some of our principal at risk without any upside.

In stocks that represent value (paying a consistent dividend yield, for example) your money is put to work in the form of dividends and/or a higher share price. The upside is unlimited; the downside is limited to the amount invested.

The key for us was when the selling got indiscriminate. Early on it was technology focused. Then, because of the huge leverage in global stock markets, investors were forced once again to use stocks as an ATM. That's when we really saw value emerging. We felt that we had waited long enough.

REMEMBER, WE ARE NOT EXPECTING TO CATCH THE BOTTOM OF ANY MARKET. WE WANT TO GUARANTEE THAT WE ARE INVESTED WHEN STOCK PRICES DO RECOVER.

99% of all financial news relates to the 40 to 50 biggest companies. So what about the rest? They're Under the Radar.

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45 Evans Street, Balmain NSW 2041
Telephone 1300 100 343 Email radar@undertheradarreport.com.au

Editor Richard Hemming **Publisher** Caroline Mark
ABN: 65147404662. AFSL: 409518.

www.undertheradarreport.com.au

Once we realised early last week was likely to be a bad day for the market, we arranged the trades in a short window around 11 in the morning, after prices had had a chance to settle down from the open.

Q: How much did you invest?

A: We invested around 10% of our uninvested cash, maybe a little more, which represents just under 10% of our total portfolio late last week.

One of the reasons we don't expect or even want to find a bottom in the market quickly is because we still have 90% of cash to invest.

During the global financial crisis, we counted seven separate major down legs in the market, and buying at the bottom of any of the first five of these turned out to be short-term correct , medium-term wrong, but longer-term great. However some of the best stocks hit their lows six months before the rest of market. We would expect the current bear market to have at least one further serious downward leg in the US, possibly a couple more in Australia which is operating on a slightly different cycle. We have to husband our resources for a long campaign.

The important lesson to remember is that even in a pronounced long-term downward trend, there are often short-term trading opportunities on the buyside.

These can be exploited if we are ready, if we have cash, and if we remember the ultimate goal is to find some great companies at reasonable prices, and hold on for a long ride.

CRYPTO VS STOCKS

There has been huge selling in the market for all things crypto. Bitcoin has declined from US$47.5k in late March to trade under US$20k less than three months later.

Whether Crypto recovers is a real question. On the other hand, companies that generate sales and profits, delivered to shareholders in the form of dividends have an intrinsic value, even if interest rates keep climbing.

IN STOCKS THAT REPRESENT VALUE (PAYING A CONSISTENT DIVIDEND YIELD, FOR EXAMPLE) YOUR MONEY IS PUT TO WORK IN THE FORM OF DIVIDENDS AND/OR A HIGHER SHARE PRICE. THE UPSIDE IS UNLIMITED; THE DOWNSIDE IS LIMITED TO THE AMOUNT INVESTED.

Q: What stocks did you buy and why?

A: We will talk about the specifics of the blue chip stocks, which can be accessed at around current prices. In the small cap space, we have by no means finished our buying!

We bought AMP Limited (AMP).

We bought quite a lot, really, say 5% of our total portfolio at around $1. This was our biggest single investment, and is a full position. The key to AMP is that it has already agreed to sell three of its AMP Capital businesses, and will bank around two thirds of its current market capitalisation in cash. There will be some tax payable and some debt to repay, but we would guess around 50% of the current share price will come back in a capital return within the next six months. That would leave a residual holding which we think is substantially undervalued, the very least by reference to AMP's net asset value which should be close to $1.50 a share on our estimates after the AMP Capital sales.

We bought Woodside Energy (WDS).

Woodside has just completed its acquisition of BHP's petroleum business, catapulting it into number 1 position in the domestic market for energy production.

The company has ambitions for hydrogen to be a future source of commercial energy supply, and obviously the current oil and gas price environment should be favourable. Since the price jumped 5% at the beginning of the month after the merger was implemented, we went for a half size position, and would happily build this up as circumstances dictate. We had no energy exposure before, and therefore some WDS could be something of an inflation hedge. There is also the possibility that the market has underestimated the potential for the newly merged group, which would not be unusual.

SMALL CAPS:

The SMSF bought three of the five digital economy plays that we have been accumulating in the Under the Radar Report Portfolio.

Under the Radar's Portfolio slowly started building holdings in five growth stocks with what seemed like good businesses, at much lower share prices than were available for much of last year. However, the nature of this bear market has been so brutal that we have been much too early, and even though one of those stocks has managed to bounce 100% before falling back again.

Small Cap stocks we have bought:

We made three starter investments in small caps which together amount to half a full position, having fallen heavily in 2022.

Each stock has a real business with global sales, and global potential:

- Fintech
- An enterprise software business,
- A small cap company operating in the gig economy.

Each was valued at its peak last year at many times sales, but valuations have now reduced dramatically, although none could yet be classified as cheap by most fundamental measures, although a couple are getting there.

The most money went into the stocks with the lowest valuations. The market price action is suggesting that there are serious balance sheet risks, and certainly, there will be major financial year end write-downs of intangible assets, but our bet is that the cash flow will muddle through in each case.

As we have said, we are not expecting these to be the bottom prices, and we would be slightly disappointed if they are.

WHAT ARE WE LOOKING FOR?

We are most interested in the underlying fundamentals, and we should find out within 6 months in the case of the blue chips, and 12 months in the case of these small caps, how good our analysis has held up, whatever events arise in the meantime.

> **THE ULTIMATE GOAL IS TO FIND SOME GREAT COMPANIES AT REASONABLE PRICES, AND HOLD ON FOR A LONG RIDE.**

Q: What stocks did you reject and why?

A: We might easily have bought CSR Limited (CSR)

We covered the stock in the Blue Chip Value Report last week and wanted to leave a reasonable amount of time between our coverage and making a purchase. With a historic price-earnings ratio of 11 times and a historic yield of 7%, we find the value attractive even if some of its end markets are slowing. Strong asset backing and cash flows should keep the company out of trouble and the stock has fallen 30% in a month, which seems overdone.

We have a watching brief on the banks and we are considering more investments in resources stocks.

Would webe interested in Wesfarmers (WES)?

The short answer is yes IF there was a pullback as part of a series of rolling sector corrections. WES has exposure to lithium and shareholder friendly management, and we might be interested in one of the supermarket groups since the industry's pricing power is defensible.

Online retailers have been hit hard, but their earnings are going the wrong way and that doesn't look to abate. We await more clarity on consumer spending.

We like Medical Developments (MVP)

We like this stock and the price is better than it has been for almost a decade. MVP's business prospects are very specific and the stock provides strong diversification benefits as a result.

In the current environment the business looks more speculative than it did at higher prices, as do many of the businesses without significant revenue whose share prices no longer reflect the level of optimism they did less than a year ago.

We could also have invested in one of high quality small caps that we will be talking about in our next issue, but our SMSF portfolio already had three of those, which is something which subscribers of our regular reports are aware of.

Some of the higher quality small cap stocks are in the process of being taken over, like **Infomedia (IFM)** by private equity, or **Alliance Aviation (AQZ)** by **Qantas (QAN)**, or have grown so large that we no longer really count them as small caps, like **Elders (ELD)**, where some recommendations have made more than 20 times at current prices.

WE HAVE A WATCHING BRIEF ON THE BANKS AND WE ARE CONSIDERING MORE INVESTMENTS IN RESOURCES.

Q: How are our stocks going?

A: One of the reasons to transact aggressively on a day where stocks are in free fall is because you will be able to get much better volume at a given price in the stocks that you are interested in than before or after.

It is too early to be aggressive, but it is notable that in one of the stocks we could quite easily have had a significant price impact buying the same number on any other day last week.

Since we are investing for the long-term, usually for at least a year for tax reasons, we are more than happy for a stock to go down as long as our fundamental analysis is reasonable, since we will have an opportunity to buy even more of our favourites with more information at lower prices. If we picked well. If not, we may find ourselves with an excessively large position which has to be liquidated into a market where we were the last believer.

In short, we have to try and get those initial purchases right so that we are not left holding a lemon!

Q: What's next?

A: A series of limit buy orders on these and other stocks.

In the current market you need to be owning stocks that allow you to sleep at night and not worry about their long-term prospects. These are the best of the best. The Top Guns, if you will.

Having established initial positions, we are in no great hurry to buy more. Prices returning to reasonable levels as interest rates return to reasonable levels will not be a short or painless process.

THESE ARE THE BEST OF THE BEST!

The best place to look for stocks is in our upcoming issues, which includes our popular section: Best Stocks To Buy Now.

These currently number 12, plus we will be adding to them over the next couple of weeks. This week we focus on "Small Cap Royalty". These are stocks that have a have a high measure of quality, which includes consistent and growing dividends and even more crucially, a strong customer base and balance sheet.

In the current market you need to be owning stocks that allow you to sleep at night and not worry about their long-term prospects. These are the best of the best. The Top Guns, if you will.

BUYING STOCK IN JUNE MEANS WE CAN BENEFIT FROM OTHER PEOPLE'S TAX LOSS SELLING.

We continue to take advantage in the next week, and possibly invest a further 7% to 10% of our cash in the short term, we have limit orders on this week.

There is the potential for a sharp (northern hemisphere) summer rally, maybe from lower levels, we want to make sure some initial positions are established before that.

In such a fast-moving environment, it is difficult to make long-term predictions. Depending on pricing we may make further moves in July and August, but with full year reports through August that information and management commentary will inform our next investment decisions. The key is to remain flexible and open-minded, while being realistic about the challenges that higher interest rates and higher inflation will put on economies and companies. ■

THERE IS THE POTENTIAL FOR A SHARP (NORTHERN HEMISPHERE) SUMMER RALLY, MAYBE FROM LOWER LEVELS, WE WANT TO MAKE SURE SOME INITIAL POSITIONS ARE ESTABLISHED BEFORE THAT.

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