"WE FIND VALUE IN SMALLER INDUSTRIAL COMPANIES THAT WE UNDERSTAND AND CAN VALUE. IDEALLY, THESE COMPANIES HAVE GOOD RETURN ON CAPITAL EMPLOYED AND ARE RE-INVESTING THEIR EARNINGS."

CYAN INVESTMENT MANAGEMENT

Under the Radar Report speaks to a small cap fund which has been going for just over 18 months, but has already wracked up a return of 52% after fees. We think that the pair's common sense philosophy will keep delivering.

IT'S ABOUT THE COMPOUNDING EFFECT OF RETURN ON EQUITY

It's been just under a year since we spoke to Cyan Investment Management and it's clear that their focus on return on equity is still working. The team of Graeme Carson and Dean Fergie have chalked up an impressive return of 52% to the end of March, from when their fund kicked off about 18 months ago.

Both have extensive experience analysing and investing in small caps, and both agree that the secret to a small cap's success isn't dividends. The pair's fund is currently invested in 25 small caps whose market caps are generally between $200m and $500m in market cap. Big performers for the fund have been the Telstra store owner Vita Group (VTG), organic baby formula marketing group Bellamy's (BAL), the asset manager BlueSky (BLA), the outsourcing specialist Freelancer (FLN) and the panel beater AMA (AMA).

INVESTING IN SMALL CAPS IS NOT ABOUT DIVIDENDS

Dividends are last on their list of priorities. Each has the common trait of not needing much capital to stay in business, hence producing strong returns on equity, says Carson:

"We find value in smaller industrial companies that we understand and can value. Ideally, these companies have good return on capital employed and are re-investing their earnings.

"There is no point having a good return on equity if you're not investing in your own company. You won't get that compounding earnings growth, which is the key to any small cap success."

"Not investing in stuff we don't understand or which we think is too risky" is something you hear often from the team, but they actually do what they say and don't consider investing in resources, biotechs, mining services or listed property stocks. This leaves a universe of about 160 companies from which they are looking for three factors: high return on capital employed; cash generative and "a clear growth strategy".

Both come from a small cap background, Carson, having been an analyst for a number of big name broking firms, while Fergie has managed a small cap fund for National Asset Management. For each company the pair value the stock at the end each financial year based on a net present value (NPV) of its projected earnings stream from its dividends; as well as an NPV based on its re-invested earnings, which is based on its return on equity.

"We value the two steams separately and, having a growth focus, it is the rate of return on the re-invested earnings that truly interest us," says Fergie. "We derive a valuation of our holdings both historically and going forward in 12 month increments to clearly identify entry and exit points."

STILL CAUTIOUS ON THE OVERALL MARKET

The two remain cautious on the market overall and have maintained cash at 30% of their total fund since its inception. But this doesn't mean they aren't still taking risks. Current holdings include Under the Radar Report favourites Nick Scali (NCK) and Melbourne IT (MLB), as well as construction industry software provider Aconex (ACX), fintech group Praemium (PPS) which provides financial advice and recently listed Link Administration (LNK), which is up almost 20% on its listing price in less than eight months.

SMALL CAPS YOU MIGHT NOT HAVE HEARD OF

> **THERE IS NO POINT HAVING A GOOD RETURN ON EQUITY IF YOU'RE NOT INVESTING IN YOUR OWN COMPANY. YOU WON'T GET THAT COMPOUNDING EARNINGS GROWTH, WHICH IS THE KEY TO ANY SMALL CAP SUCCESS.**

Other holdings, you might have never heard of. Does Touchcorp (TCH) ring a bell? This is an online payments platform which connects businesses and consumers. For example, if you buy a phone recharge voucher or an iTunes gift card through Optus or from a 7-Eleven store, then it's probably Touchcorp's cloud-based platform providing the real time communication between the supplier, the merchant and the consumer.

Heard of the satellite services group, Speedcast (SDA)? "We like this stock because the company doesn't own any assets but is a reseller of satellite services. It might need to raise capital for further acquisitions soon, though," says Carson.

What about Adacel Technologies (ADA), a developer of simulation and control systems for the civil aviation and defence sectors? "This company is in a sweet spot because of its development of annuity style revenue streams," says Carson.

The pair describe PSC Insurance (PSI) as a "mini-Steadfast" because its business model also involves purchasing privately owned insurance brokerage firms. The difference is that PSC focuses on more distressed assets, which it buys on the cheap.

BRAVERY PAYS OFF

Like any good small cap investor, Cyan is going where others fear to tread (or simply don't know about). The one thing that should keep them on track is their laser like focus on return on equity. We can relate to that.