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Emerging leaders: The opportunity for long-term compounding and growth

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Research & Insights

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Mid-cap equities offer investors one of the most dynamic and potentially rewarding world of opportunity. This exciting market segment offers compounding benefits from successful emerging leaders and growth potential from fast-growing and ambitious smaller companies. David Lloyd, Co-Head of Emerging Companies and Portfolio Manager of the Ausbil Australian Emerging Leaders Fund discusses the dynamic mid-cap sector and the opportunities for investors in this Q&A.

David Lloyd
Co-Head of Emerging Companies and Portfolio Manager, Emerging Leaders Fund

Key Points

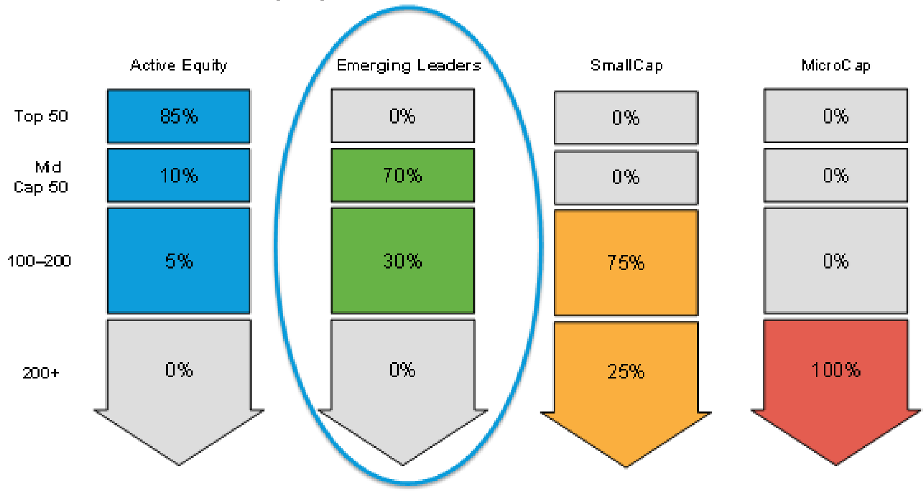
- Mid-cap equities may offer an 'alpha-rich' sweet spot of opportunity as companies emerge as leaders in their sectors.
- The sector can generate long compounding returns, and benefit from smaller fast-growing companies.
- Some of the mid-cap equities offer a balance of dividend and growth opportunities. A catalyst-rich environment adds to earnings growth potential, such as M&A potential in the mid-cap space and index rebalancing as companies grow.
- Potential for earnings and growth momentum above that of larger peers.

> "Mid-cap equities are companies defined as being in the 'middle' of the market, not large caps, not small or micro-caps but the stocks transitioning to becoming larger companies"

Q: What are mid-cap equities?

A: Mid-cap equities are companies whose market capitalisation is defined as being in the 'middle' of the market, not large caps, not small or micro-caps but the stocks transitioning to becoming larger companies. The Ausbil Australian Emerging Leaders strategy focuses on this dynamic segment between small and large caps (Chart 1).

Chart 1: Ausbil's mid-cap equities universe



Source: Ausbil as at September 2024.

Q: What can mid-cap equities offer investors?

A: Mid-cap equities are a dynamic space. The sector can generate long compounding returns, and also benefit from smaller fast-growing companies. Afterpay, now part of Square (Block), is an example of a fast-growing company, rising through the micro and small cap sectors, becoming a mid-cap and then graduating as a large cap when it was acquired by Block in the US. There are also turnaround stories for larger caps that have experienced difficult periods and have reset themselves for a strong growth trajectory.

Q: What are the key attributes you look for in a good mid-cap stock?

A: A good mid-cap stock is one that is now mature enough in its core business to generate a number of years of earnings growth, without the requirement for additional equity capital. It is more resilient than a small cap, but not yet large enough to sit with the big players.

Great mid-cap stocks might be those that are beginning to dominate their market and peers, pulling ahead of the pack and standing out. Earnings growth may come from a product that is seen as generating more sustainable earnings growth than competitors.

Some may be creating their own market with products that have not been seen before. Again, Afterpay is a great example of creating the buy-now pay-later alternative to credit cards. Life360 is another name making a market where it is not challenged. Earnings growth in these companies is entrepreneurial, as it often cannot be compared to peers, and is a new idea.

Other names come in the form of challengers to existing large-cap players, either because they are closer to their customer needs, can change faster than larger players, and may have better and more advanced ways of doing things. Within the real estate sector, names like Charter Hall and Goodman Group were at one stage challengers to large caps like GPT and Stockland, which they have now surpassed in scale and ambition. In the banking sector, names from the past like Aussie Home Loans, and more recently Judo Bank are taking competition to existing players. In insurance, the rise of consolidated brokers has taken power and business from companies like Steadfast. These names passed through the mid-cap sector on their journey.

In addition to earnings growth, we expect good mid-cap stocks to score well on our ESG assessment. This is because mid-cap equities are likely to have good governance arrangements and a strong risk culture. They also have business leaders and a workforce that are aligned strategically and to the performance of the company, with a focus on generating a return for shareholders.

In mid-cap equities, we are also more likely to be able to join the journey with founder-led businesses. Here, the leaders of the business are aligned with other shareholders in building return on equity. Large caps have often moved beyond their founders, but in mid-caps, many of the names we see are still on their entrepreneurial growth paths that began before they were listed companies.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 31 August 2024, Ausbil manage over $19.2 billion in funds under management.

Q: What kind of themes are you capturing in your portfolio?

A: We are looking at a range of interesting thematics at the moment for potential alpha. Our house view is that economic growth will bottom in calendar 2024, after which we see it firming into calendar 2025 as the impact from central banks reducing interest rates takes hold. On this basis, we see some return of select cyclical exposures in addition to key thematics like decarbonisation and technological change, in exposures like Seven Group and Reece.

Decarbonisation and the energy transition remain significant themes that are driving value across resources, energy, utilities and the mining services sector with respect to critical commodities. We like copper, uranium and rare earths for the central role these will play in renewable energy, energy storage and upgrading electrical grids worldwide. Companies that are capturing this thematic include Sandfire Resources (Copper), Boss Energy, Paladin, Illuka and Lynas Rare Earths.

We are also seeing structural earnings growth in technological transformation, the rise of artificial intelligence (AI), and the enablers and businesses that increasingly operate in the digital environment, including communications companies. These enablers include data centres, energy and energy storage that backs up data processing, telecommunications and internet companies that support the web of connectivity and data. Companies that stand to benefit include names such as NextDC, AGL, Zip Co and Aussie Broadband.

We also like beneficiaries of the digital revolution, companies that can leverage the networking and processing power offered by enablers to capture more business, more customers and at lower costs. Examples of companies that stand to benefit from this growth includes Block, Carsales.com, Webjet, REA, Life360, Judo Bank and HUB24.

> “Decarbonisation and the energy transition remain significant themes that are driving value across resources, energy, utilities and the mining services sector with respect to critical commodities”

Q: Can you explain the dynamic of mid-caps and index rebalancing?

A: Stocks start small and may become large over time. Mid-caps sit in the middle of this journey from small cap to large cap. Some opportunities come from companies rapidly growing out of the small-cap index and into the mid-cap benchmarks, and those de-rating from the mid-cap benchmark back to small caps.

Ironically, when companies have derated back into the small-cap index from the mid-cap universe, they are often nearing the end of their earnings downgrade cycle and potentially entering a period of post-restructuring upgrades. Moreover, in mid-cap investing the biggest challenge is that you are compelled to reallocate profits from your most successful positions as they graduate into large-cap indices and out of your universe. The key discipline is sticking to names with a strong earnings growth outlook and with a positive rerating outlook ahead. For all these reasons, in mid-cap investing portfolio construction is particularly challenging, and with your best positions constantly ‘leaving home’, you must be nimble and creative in where you find new earnings growth.

Q: How does a mid-cap strategy perform over time?

A: It has been shown, based on long time periods of multiple decades, that smaller companies outperform larger companies consistently, an assertion supported by the empirical evidence from researchers such as Siegel (2015), Banz (1981) and Fama and French (1992), and in the basic comparison of market data. Investors in smaller and mid-cap companies require a higher risk premium for various reasons such as liquidity, maturity, general risk and many other factors.

With respect to the economic cycle, the performance of mid-cap stocks offers longer-term leverage to a growing economy, but less defensiveness. In the recovery and growth phases of the cycle, mid-caps are likely to benefit from stronger sentiment and support, potentially outperforming larger caps. As the economy enters slowing then contractionary phases, mid-cap companies are more likely to be traded at discounts to larger and more defensive peers, effectively discounted for their exposure to growth. However, mid-cap companies are seen as less burdened than established players and can be more proactive across the cycle in harnessing growth opportunities, and resetting for the future in slow-growth environments. Overall, a long-term view on positive economic advancement, give or take some recessions and market drawdowns on the way, tends to favour the overall growth path of mid-cap and smaller companies.

> "Ausbil's ESG Team provides proprietary research and ESG guidance on the top 200 stocks on the ASX which supports the application of ESG across our investment decisions"

Q: Can you tell us what ESG integration brings to your mid-cap investing?

A: Ausbil has integrated ESG across our investment strategies including our approach to mid-caps, in the Ausbil Australian Emerging Leaders strategy. Based on research, and our experience in constructing better risk-adjusted portfolios, we believe the inclusion of ESG in the investment process, supported by well-founded ESG research and engagement, can improve our ability to identify mispriced stocks, better assess a company's earnings sustainability and, ultimately, lead to better-informed investment decisions. ESG can help us understand risks to earnings growth better, and it builds out a much larger distribution of potential investment risks that can improve our ability to find and invest in good companies.

Ausbil's ESG Team provides proprietary research and ESG guidance on the top 200 stocks on the ASX which supports the application of ESG across our investment decisions. Ausbil also believes that ESG factors can positively impact the performance of investment portfolios, add value in excess return (alpha), over both the short and long term, and materially reduce portfolio and earnings risk.

Q: What do you think differentiates Ausbil's Emerging Leaders mid-cap strategy?

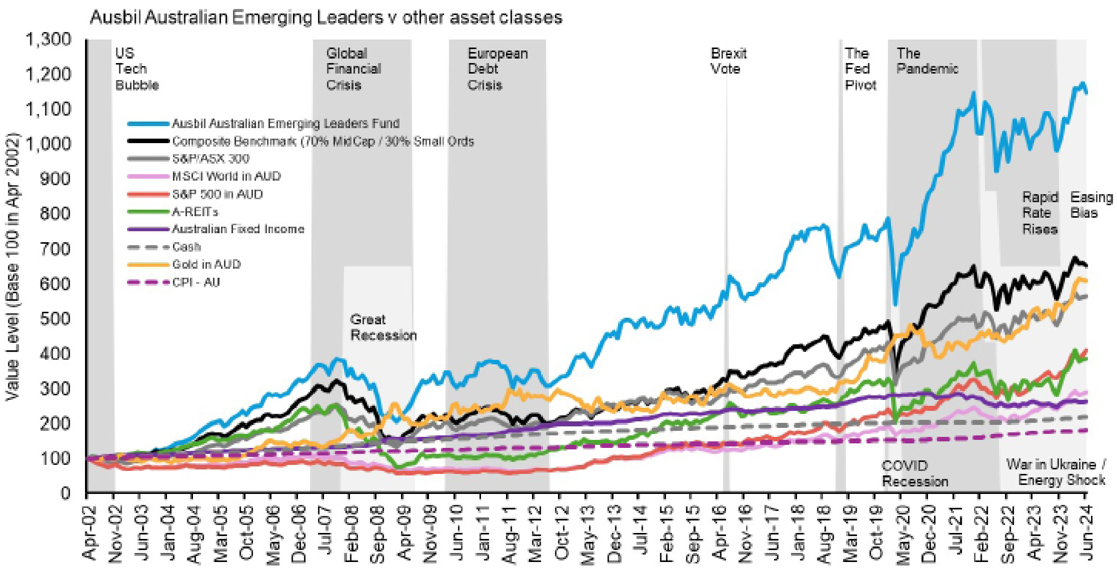
A: We believe combining a macro understanding with our fundamental focus on superior earnings growth, with the added risk mitigation that comes through the application of ESG in our investment process, differentiates our approach. Ausbil's ex-50 investment strategies and analytical knowledge of smaller companies, paired with our intimate knowledge of the top 200 ASX listed companies through our Equity Research and ESG Teams means that we possess multiple viewpoints on both opportunity and risk that help us build our mid-cap portfolios.

Within our overall top-down macro-driven bottom-up fundamental investment approach, we believe we can position the portfolio in the stocks with favourable earnings growth outlook, and in the sectors and the right overweights and underweights to negotiate each part of the cycle.

Q: How has the Fund performed over time?

A: Ausbil's mid-cap equities strategy, the Ausbil Australian Emerging Leaders Fund is over 20 years old and has generated long-term outperformance since inception of +1.58% per annum (net of fees), outperforming the blended benchmark (70% S&P/ASX Midcap 50 Accumulation Index and 30% S&P/ASX Small Ordinaries Accumulation Index) – Table 1.

Chart 1: Performance of the Ausbil Australian Emerging Leaders strategy against other assets over time



Source: Ausbil, from inception in May 2002 to June 2024. Important note, these returns are on a gross basis before fees simply to help illustrate how the strategy has negotiated various market crises. See the table below for the net returns over time and since inception after fees. Market data from FactSet.

Since inception, Ausbil's active strategies have focused on earnings and earnings revisions as a source of alpha, particularly when consensus has not captured the potential for earnings upside. We have never changed this approach, and it has proven itself over time. Our focus on earnings and earnings growth has generated the long compound returns illustrated in Chart 1.

Since it began in May 2002, the Ausbil Australian Emerging Leaders strategy has negotiated a 'crazy' set of tail events including the US Tech Bubble, the Global Financial Crisis, the European Debt Crisis, Brexit and its aftermath, the Fed Pivot, the once in a century COVID recession and pandemic, the invasion of Ukraine by Russia and the ensuing energy crisis, the rapid normalisation of interest rates across 2022 and 2023, and the high inflation crisis of 2023/2024.

While some of these crises saw an expected drag on performance, Ausbil's process was able to adjust back to generating excess returns. Interestingly, across the pandemic, Ausbil was able to continue generating positive rolling excess returns with careful macro calibration and stock selection.

"While some of these crises saw an expected drag on performance, Ausbil's process was able to adjust back to generating excess returns"

Table 1: Fund performance (net of fees)

Performance to 30 September 2024	Fund Return[1] %	Bench-mark[2] %	Out/Under performance %
1 month	5.20	3.66	1.53
3 months	10.16	8.59	1.57
6 months	8.93	4.88	4.04
1 year	18.37	18.74	-0.37
2 years pa	14.58	13.90	0.68
3 years pa	4.50	4.42	0.08
5 years pa	10.68	8.80	1.88
7 years pa	9.35	9.52	-0.17
10 years pa	9.48	10.64	-1.16
15 years pa	8.48	8.03	0.46
20 years pa	9.39	8.17	1.23
Since inception pa Date: April 2002	10.70	9.12	1.58

Source: Ausbil Investment Management

1. Fund returns are net of fees and before taxes ending 30 September 2024.
2. The composite benchmark is 70% S&P/ASX Midcap 50 Accumulation Index and 30% S&P/ASX Small Ordinaries Accumulation Index.

Q: What is the outlook for mid-cap equities?

A: Looking ahead, Ausbil is positive on earnings growth, and more positive overall than consensus. We are expecting positive FY25 earnings growth for the S&P/ASX 200, broadening across sectors, and moving down the market cap spectrum. The consensus outlook for FY25 earnings growth in the mid-cap 50 stocks is +5.7% and for the Small Ordinaries is +14.1% (FactSet as at October 2024), offering significant earnings upside potential compared to large-cap equities. We are seeing a broadening of earnings growth across sectors for FY25 which in turn is showing a larger range of opportunities as the market moves ahead from years of monetary tightening. In the rising rate environment, a significant valuation chasm had opened between small, mid and large cap stocks, with large caps surging ahead. As we look ahead into an easing environment, we have seen this valuation gap start to close, offering significant potential for emerging companies in the year ahead.

“We are expecting positive FY25 earnings growth for the S&P/ASX 200, broadening across sectors, and moving down the market cap spectrum”

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