Mid-cap investing: where active management makes powerful sense

September 2024

We are strong believers in active management and so it should come as no surprise that we strongly advocate for it in the less covered mid-cap domain too. Within the mid-cap realm, it is especially compelling, we believe, for three broad reasons.

- Investing in mid-cap Australian stocks, which we define as those outside the S&P/ASX top 20 (that is the ASX 200 ex-20), provides access to strong long-term earnings power capable of driving potentially greater total returns.
- The mid-cap domain has a more even spread of sector weights providing greater diversification than the financials and resources heavy S&P/ASX 200 index (ASX 200).
- Last, but certainly not least, there is a far wider dispersion of returns in the mid-cap space, compared to the ASX 200, which provides active managers greater scope for adding value through stock selection.

Complementing ASX 20 stocks

The 20 largest companies by market capitalisation (ASX 20) form the core of many investors' Australian equity exposure – whether as individual shareholdings, managed funds, Exchange Traded Funds (ETFs) or Separately Managed Accounts.

Many investment managers benchmark their performance against Australia's leading share market index, the ASX 200. Because it is a capitalisation weighted index, it means these managers will naturally be exposed to its largest stocks.

High dividend yields with franking credits provided by some of the largest companies, such as the Big Four banks, Telstra, and Woolworths, for instance, are valued by many and this also contributes to many investors' large cap bias.

The dividend yield issue deserves a little more unpacking as it offers an important compare-and-contrast between large cap investing and investing outside the ASX 20.

Large cap stocks' high dividend yields often stem from the reality that mature companies generally have lower capital needs owing to their relatively lower growth potential than their mid-cap and smaller counterparts. Consequently, returning a lion's share of earnings to shareholders through high dividend yields is an obvious use of large cap stocks' capital.

By contrast, mid-cap stocks — those outside the ASX 20 universe — are typically less mature and offer higher capital appreciation potential, but lower dividend yields than their large cap counterparts. These companies generally have greater growth prospects than large cap stocks and thus a greater share of earnings is reinvested for growth.

Some consequences of ASX 200 benchmarking

We estimate the ASX 20 soaks up a touch over 60% of the ASX 200 index's market capitalisation, leaving relatively little elbow room for active managers following the benchmark to add value through stock-picking from the remaining 180 companies in the index.

BHP, for instance, represents around 10% of the ASX 200 index's market capitalisation and benchmark conscious investment managers are compelled to hold the stock, even if they may be unenthusiastic about the company's outlook. Not holding BHP would risk an investment manager blowing out a portfolio's tracking error against the ASX 200.

To be clear, we are not arguing for reducing, let alone dropping ASX 200 related investing. Ours is not a zero-sum proposition. Rather, we believe Australian equity investing can potentially be more rewarding by going beyond the confines of the ASX 20 into the rich terrain on offer in the ASX 200 ex-20 world.

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Outcomes from going beyond ASX 20

Now for some details and evidence to support our pro ASX 200 ex-20 assertions.

Over multiple time periods, mid-cap Australian stocks have delivered competitive earnings per share growth against other components of the Australian stock market, and for the three and 10-years ending March 2024, delivered superior earnings growth against those same parts of the local equity market (Chart 1).

Chart 1: Mid-cap stocks have exhibited competitive earnings growth…

Earnings Per Share (EPS) growth of various Australian share market constituents

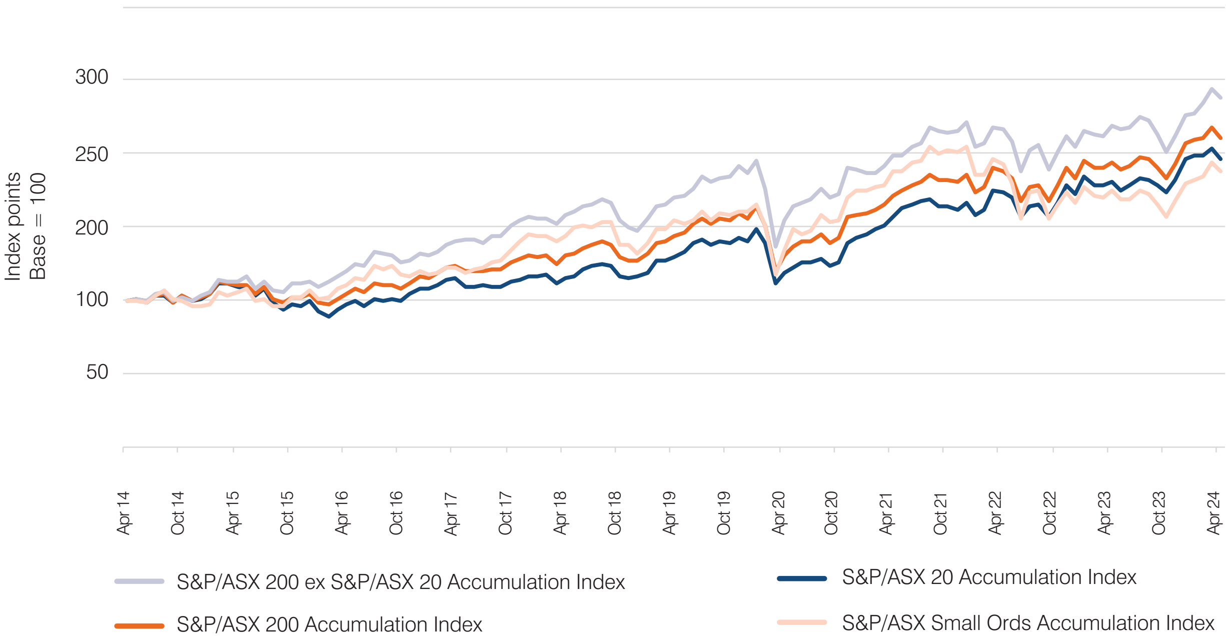
	EPS cumulative annual growth rate: one-year to March 2024 (%)	EPS cumulative annual growth rate: three–years to March 2024 (% per annum)	EPS cumulative annual growth rate: five–years to March 2024 (% per annum)	EPS cumulative annual growth rate: seven–years to March 2024 (% per annum)	EPS cumulative annual growth rate: 10–years to March 2024 (% per annum)
ASX 20	-6.56	7.26	5.17	4.60	1.47
ASX 200 ex-20	-6.85	13.42	2.44	4.49	5.71
Small Ordinaries	-14.26	10.58	6.50	5.37	4.97
ASX 200	-5.75	9.95	4.80	4.99	2.80

The full and formal designations of the indices listed in the above table are:
S&P/ASX 20 index for the 20 largest companies by market capitalisation listed on the Australian Securities Exchange
S&P/ASX 200 ex-20 index for mid-cap companies listed on the Australian Securities Exchange
S&P/ASX Small Companies Ordinaries index for small companies listed on the Australian Securities Exchange
S&P/ASX 200 index for the widely quoted benchmark of Australian share market performance
Past performance is no guarantee of future results. Data is for periods to 31 March 2024. Source: Macquarie

Intuitively, earnings growth should drive share market returns and this is supported by chart 2, which shows ASX 200 ex-20 stocks, as a group, outperforming other indices, including the ASX 20 and ASX 200 benchmarks.

Chart 2: …which has translated to strong total returns over a decade

Total returns of various Australian share market constituents: 30 April 2014 – 30 April 2024



Past performance is no guarantee of future results
As of 30 April 2024
Source: FactSet financial data and analytics

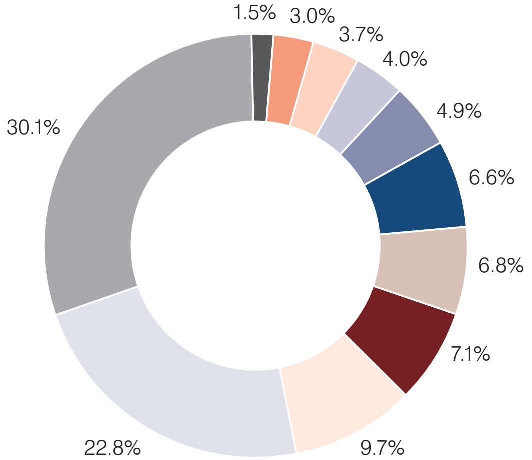
Mid-caps are more diversified

A snapshot at the ASX 200's sector composition confirms what generations of investors have known — the Australian share market is very financials and resources heavy with the Financials ex Real Estate, and Materials sectors, together, accounting for almost 53% of the broad index's market capitalisation (Chart 3). This is even more pronounced in the ASX 20 where the combined Financials ex Real Estate, and Materials sectors weighting reaches a towering 65%.

An upshot is that investors with Australian equity portfolios dominated by ASX 20 stocks, and benchmarked against the ASX 200, are tethered to the credit cycle, which is heavily property-driven, in the case of Financials ex Real Estate, and commodity price volatility, in the case of Materials (Chart 3).

Chart 3: Financials ex Real Estate, and Materials sectors dominate ASX 200

Sector composition of the ASX 200 index



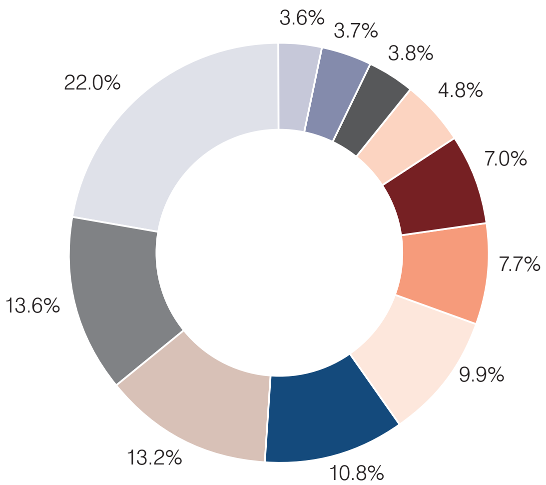
Sectors	Percentage
Utilities	1.5%
Information Technology	3.0%
Communication Services	3.7%
Consumer Staples	4.0%
Energy	4.9%
Real Estate	6.6%
Industrials	6.8%
Consumer Discretionary	7.1%
Health Care	9.7%
Materials	22.8%
Financials (ex Real Estate)	30.1%

As of 30 April 2024
Source: FactSet financial data and analytics

We think sector concentration risk can be muted by diversifying into the ASX ex-20 universe where no sector is so toweringly dominant (Chart 4).

Chart 4: ASX 200 ex-20 has more even sector weightings, relative to ASX 200

Sector composition of the mid-cap universe (ASX 200 ex-20)



Sectors	Percentage
Consumer Staples	3.6%
Energy	3.7%
Utilities	3.8%
Communication Services	4.8%
Consumer Discretionary	7.0%
Information Technology	7.7%
Health Care	9.9%
Real Estate	10.8%
Industrials	13.2%
Financials (ex Real Estate)	13.6%
Materials	22.0%

As of 30 April 2024
Source: FactSet financial data and analytics

An absence of sector over-domination in the ASX 200 ex-20 space empowers investment managers to scour the market for attractive stocks across industries, rather than fretting over the risks associated with drifting too far from benchmark sector weights, which is an issue in the ASX 200.

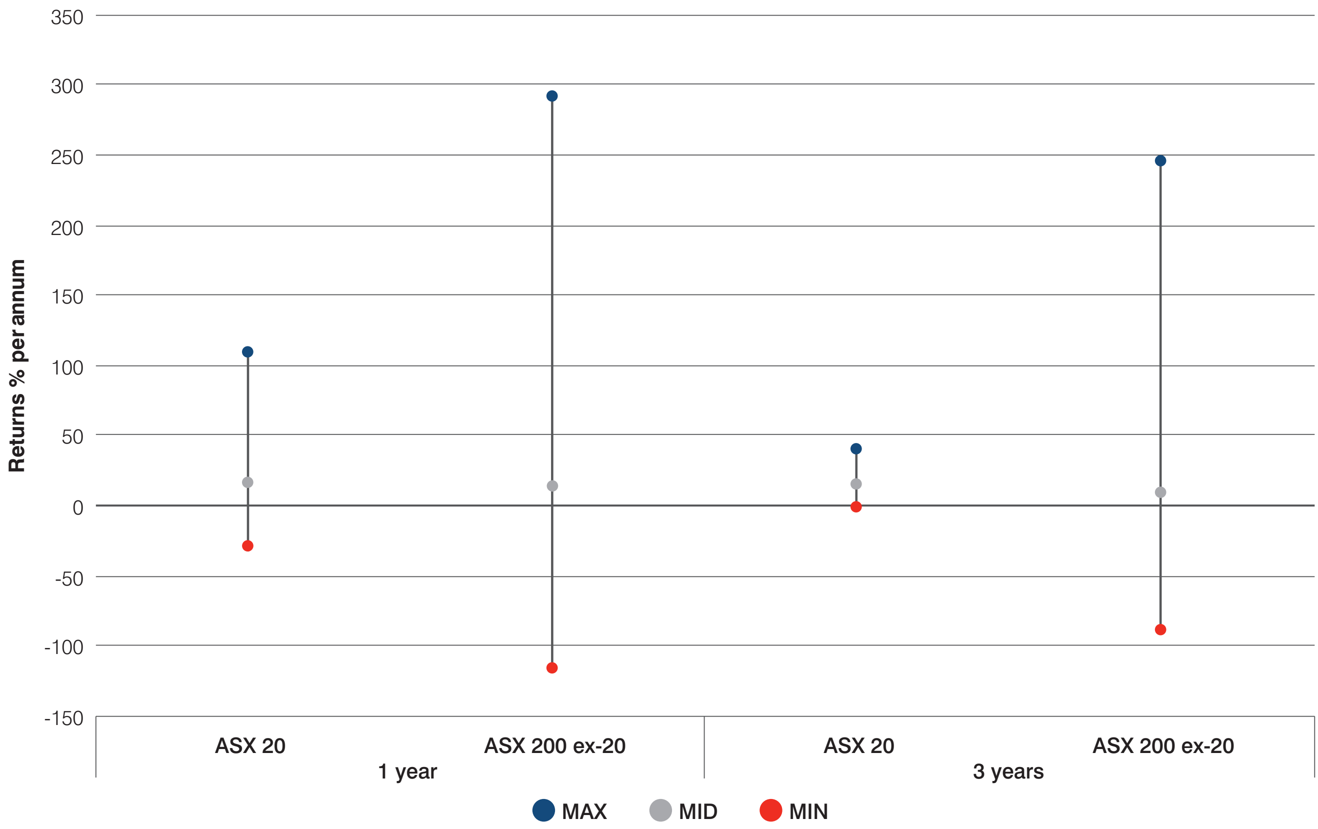
We think this is good for investors as it puts the onus on the active managers they hire. Stock selection is what professional investment managers should ultimately be judged on, less so on whether they stick close to sector benchmarks which is the domain of index funds and passive ETFs.

Wider return dispersion emphasises greater active management opportunity

We believe the active investing case is also boosted by the wide dispersion of returns in the ASX 200 ex-20 realm versus the ASX 20 (Chart 5) over one year as well as three years.[1]

Chart 5: Wide return dispersion creates greater scope for active management

Dispersion of share price returns ASX 20 versus ASX 200 ex-20 universe for one and three years to 30 April 2024



Past performance is no guarantee of future results
As of 30 April 2024
Source: Underlying data provided by Bloomberg with Antares Equities analysis

1 This refers to one and three years to 30 April 2024 returns for the ASX 20 versus ASX 200 ex-20 companies listed on the S&P/ASX 200 Index.

Over one year to 30 April 2024, there was around a 230% difference between the best and worst performing ASX 200 ex-20 stocks. Over three years to 30 April 2024, there was an almost 200% difference between the best and worst performing ASX 200 ex-20 stocks.

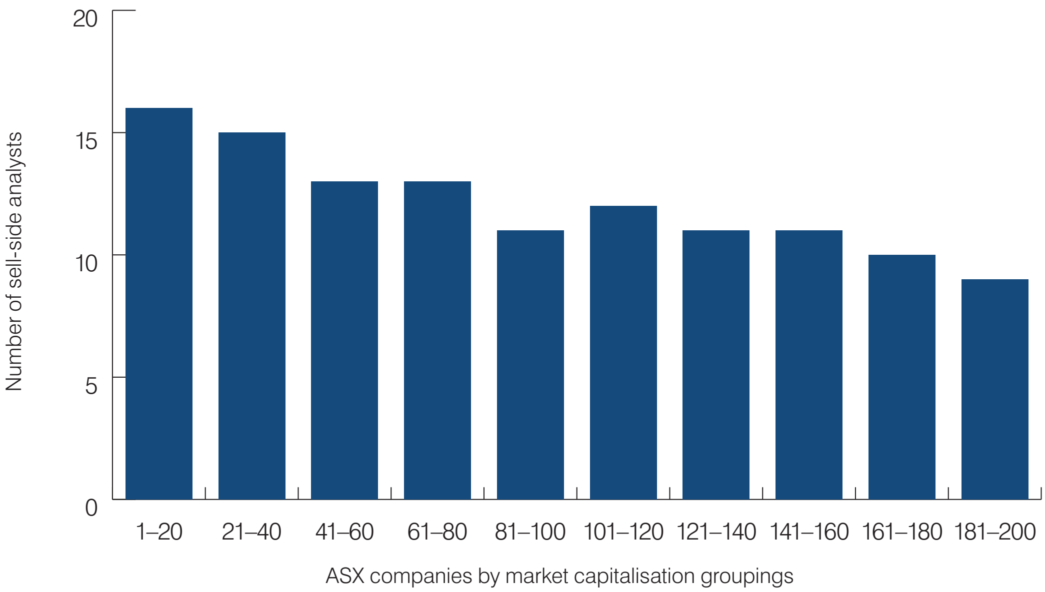
By contrast, return differences between the best and worst performing stocks in the ASX 20 were far narrower over the same periods. In other words, picking the best performing stocks in the ASX 200 ex-20 universe provides potentially greater rewards than stock picking in the ASX 20. This is because when investing with an active manager, the best chance for returns which are materially different to those of the benchmark arises when the investment universe generates highly heterogeneous returns, as with ASX 200 ex-20 stocks.

This is unsurprising as there is outsized sell-side analysts' coverage of the ASX 20 compared to ASX 200 ex-20 companies (Chart 6). It's difficult for investors to gain information advantages on companies already receiving saturation coverage, which is the case with the ASX 20.

On the other hand, owing to lesser coverage, ASX 200 ex-20 investors have far greater scope for stock picking on the back of in-depth, quality research.

Chart 6: Lesser broker coverage creates greater scope for stock picking in ASX 200 ex-20 universe

Average number of broker recommendations by market capitalisation rank



As of 30 April 2024
Source: Bloomberg, Antares Equities

We end in the spirit exhibited early in this note. We are strong advocates of complementary investing, not zero-sum investing.

Serving investors well is more likely to be achieved by helping them to build well diversified portfolios with exposure to a wide group of assets, investment approaches and styles. It's not about pitting one asset class against another, or one investment approach against another.

It certainly doesn't involve knocking investing in ASX 20 stocks versus other parts of the local share market, including the ASX 200 ex-20 universe.

There are strong arguments for investing in both. As we see it, the long-term earnings power of companies in the ASX 200 ex-20 universe, diversification attributes, and greater opportunity for stock selection makes it worthy of investors' consideration.

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