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Active large-cap equity investing – generating alpha from the biggest companies in the market

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Research & Insights

June 2023

Ausbil has established a track record in equities for over a quarter-of-a-century. In the process, we have demonstrated the capacity to outperform the market on a long, compounding basis. Paul Xiradis (PX), Co-Founder, Executive Chairman, Chief Investment Officer and Portfolio Manager for the large-cap Ausbil Australian Active Equities Fund shares how he looks at large caps, what makes a good investment, and how large caps can deliver long-term compound outperformance.

5-minute read

Key points

- Great large-cap equities are capable of generating earnings growth year-on-year, with businesses that also reward capital investment in upgraded and new capacity.
- Ausbil's investment approach seeks the best companies where all elements are working towards generating earnings and earnings growth, and preferably finding these companies ahead of consensus rerating.
- Ausbil's 25-year track record of long-term active alpha outperformance has successfully negotiated some of the biggest market tail events in history, including the tech boom and bust, the Global Financial Crisis, the COVID pandemic and the energy crisis of 2022/23.
- The reward for Ausbil's active approach to investing has been an information ratio of 1.0 since inception in 1997 to 30 April 2023 on an annualised basis, a significant reward for taking active risk relative to the market.
- Large-cap equities offer investors the ability to invest in the success of Australia's and the global economy, with benefits such as long-term compounding, market strength and dividend income streams that can contribute to both building wealth and generating income.

Q: From your experience, can you describe what a good large-cap company looks like?

PX: Having managed an active large-cap investment strategy for over a quarter of a century, you could say I have become quite familiar with their idiosyncratic nature, what is good in large caps, and also what does not work in large caps.

Over the years I have observed many elements of a successful large cap. The first is a strong business model that is capable of generating earnings growth year-on-year, and also has the potential to invest cashflows into capital expansion and business development at returns that are more attractive than the alternative, capital management and dividend payouts. This sounds simple, but so many businesses just cannot achieve these two things, let alone compete with peers in a global and competitive marketplace.

Beyond the quality of the core business model, in very simple terms, a good large company should have a strong balance sheet, manageable levels of debt, a supportive and stable ownership structure, strong corporate governance, strong and improving ESG credentials, and a strong and experienced management team. A good large company should have a healthy brand, a strong reputation that is guarded, a unique position or proposition that demarcates it from competitors, and potentially an element of protection or barriers to entry that inhibit competitors and enhances the value of its business.

Paul Xiradis
**Executive Chairman,
Chief Investment Officer
Head of Equities**

Paul co-founded Ausbil in 1997 as an Australian equities house, building Ausbil into one of Australia's leading investment managers offering Australian and global equity funds.

Paul holds the position of Executive Chairman of Ausbil, Chief Investment Officer and Head of Equities. Paul has been instrumental in building Ausbil into a multi-billion dollar investment manager. Paul's role includes investment strategy, portfolio construction, Portfolio Management of Ausbil's flagship active large-cap Australia equities funds, and input into the investment management of Ausbil's funds. Paul is a member and Chairman of Ausbil's Portfolio Construction Committee.

He has been in investments since 1979, gaining experience with companies such as Westpac Banking Corporation's Investment Management Division, Mercantile & General and Legal & General Asset Management. Paul's career has included senior roles in management, investment and portfolio management in the funds management industry. Paul is an AAIBF Fellow, ASIA, FAICD, MNIA.

Q: What do you like about large caps from an investment perspective?

PX: Large caps have always been of interest to me perhaps given the complexity they show, and the potential to find gems in this complexity if you take the time to analyse and know a company. Owning a share of Australia's largest and most successful companies is an exciting prospect for investors, and with a careful active approach, it can also be rewarding.

Of course, you do not invest in large companies just because they are large. There can be both good and bad reasons behind a company that has become a large cap. It is not always apparent, but understanding the reasons can help focus on what matters when finding large-cap stocks. Figure 1 illustrates some of the typical characteristics of large caps compared to small caps.

Figure 1: Typical characteristic comparison for large-cap stock v small-cap

Characteristics	Typical large-cap equities	Typical small-cap equities
Revenues	More diversified	More concentrated
Earnings	More diversified, less volatile	Less diversified, more volatile
Earnings growth	Potential for high growth, but typically more mature mid-range growth levels	Potential for high growth, but with higher volatility in earnings
Dividends	Significant free cash flow supports dividends	Often pre-dividend and little free cash flow
Liquidity	High liquidity, tight bid-offer spreads	Sometimes low to negligible liquidity, wider bid-offer spreads
Volatility	Should tend towards lower volatility	Higher volatility comes with less mature companies
Compounding	Good companies have significant cash and capital compounding potential	Most small-cap compounding comes from growth rather than dividends which makes them riskier than large caps

Source: Ausbil.

The relativity between size and earnings is what really matters for the allocation of risk capital. Investors who are serious about generating compound returns on equity look at the interrelationship between earnings and earnings growth, and what it means for value so that assets are acquired for a return on capital that offers the potential for outperformance.

To illustrate this with a contrasting example, in market-cap weighted ETFs (exchange traded funds), the larger the market cap of a company, the more investment capital it attracts, regardless of its earnings profile, growth outlook or whether the business is growing or shrinking. Hence, sentiment-pumped market caps are rewarded for being big, rather than being profitable or having a future earnings growth profile.

Q: What risks are unique to large-cap equities?

PX: There are a number of risks that come with larger companies. Firstly, there is the challenge of complexity. We have a team of equity analysts and portfolio managers who study the same companies every day, 365 days a year, watching every notice, every change and revaluing these companies on an ongoing basis. They are still complicated. However, we believe this complication also offers significant opportunities for outperformance.

Who owns the company and how management are incentivised makes a big difference to how they make decisions. Large caps where management and staff are aligned not just to the interests of customers but also the interest of equity holders can make a huge difference to how a large cap performs. The flipside to this is that poor alignment and bad management can destroy a large cap.

Other risks, of which we avoid through our research and knowledge of companies, can include transparency problems, specific ESG issues or exposures (including negative momentum sustainability scores), and any other element of a company or the market in which it operates that screens as a risk to earnings. We are vigilant on anything that is a risk to our view on earnings growth, and our process is clinical in allocating away from anything we think is adverse to a company growing its earnings and dividends.

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 30 April 2023, Ausbil manage over $15.8 billion in funds under management.

Q: What do you think differentiates Ausbil's Australian Active Equity strategy?

PX: Ausbil has a number of significant points of differentiation that together, we believe, sets us apart from our competitors. Firstly, the application of macro that guides our top-down positioning, combined with a bottom-up fundamental focus on finding companies with a strong outlook for earnings and earnings revisions.

Secondly, the integration of ESG in our large-cap strategy helps reduce risk in the portfolio, and in gaining a deeper fundamental understanding of companies.

Thirdly, Ausbil's investment process can be broadly described as 'core'. We classify ourselves as 'style indifferent'. At certain stages of the cycle, the portfolio may have a value or growth tilt, or no material tilt of one over the other as markets provide opportunities for particular types of stocks to benefit from earnings growth. This means that we can allocate to the most promising earnings growth available in the market.

Finally, I would say our team at Ausbil is one of our advantages. We have a relatively stable team, many of us have been here for one or two decades, following the same process. At the same time, we also balance bringing in external analysts and experts with impressive credentials, with developing younger investment professionals in our process. We have been through multiple macro and geopolitical events and maintained our rolling outperformance which we believe is attributable to our people and our process working together.

Q: What kind of themes are you seeking to capture in your portfolio?

PX: We remain focused on the key thematics that are driving long-term earnings growth, particularly where imbalances see demand exceeding supply on a fundamental basis for some time.

We like critical metals and commodities for the long rotation from fossil fuels to renewables in the great decarbonisation, and the electrification-of-things, with the steady switch from combustion and fossil fuel power to renewable electricity generation. Service companies associated with the cap-ex investment needed for this energy transition are also attractive. With China re-emerging from its intense COVID issues, we see upside in commodity prices as demand returns across calendar 2023.

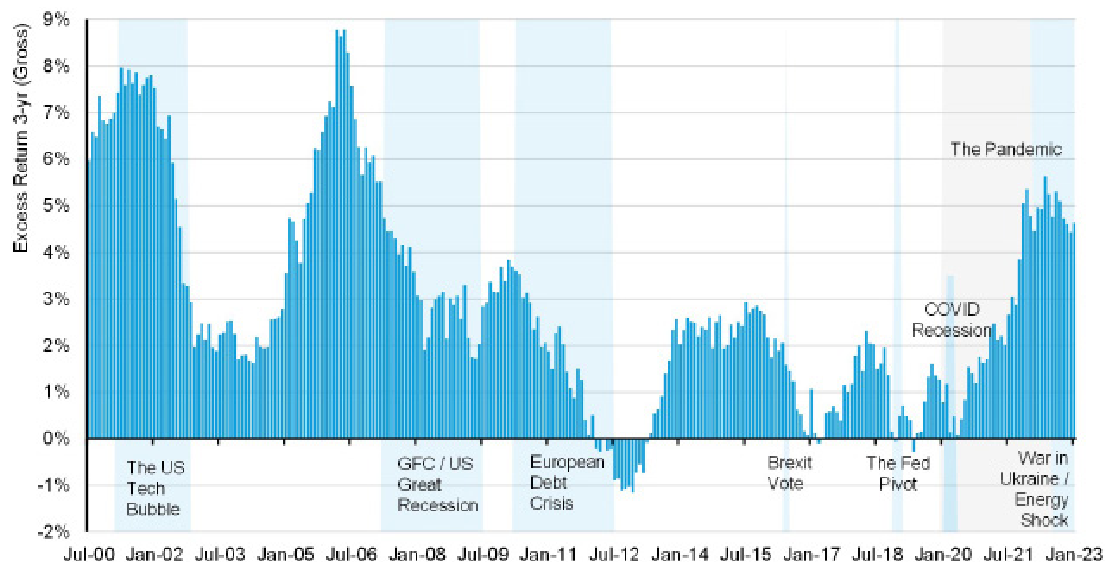
The beneficiaries of elevated inflation are expected to perform in 2023, but the emphasis on those that perform well in a rising rate environment is starting to shift towards those that will benefit with stabilisation and peaking rates. Quality REITs, some quality leaders in technology, and some exposures in building products are helping to bridge the shift from the inflation beneficiaries that outperformed in 2022.

Q: How does the strategy perform across the cycle?

PX: One of the benefits of investing in businesses with high cash-backed earnings that produce a steady EPS growth profile is the potential that comes not from a few years of high returns, but from steady outperformance over time. Such stocks can produce a compounding effect in the returns generated from these balance sheets over time. The beauty of the mathematics behind compounding is that a small, repeatable outperformance advantage, replicated over time, can create a very large advantage.

For investors, the Australian market offers alpha generating opportunities over the long term, and across the cycle. This is evidenced in Ausbil's track record since inception, now in its 26th year, which has been able to source consistent alpha (outperformance over the benchmark) across the cycle, as illustrated in Chart 1.

Chart 1: Ausbil Australian Active Equity - excess returns generated across the cycle



Source: Ausbil, May 2023.

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. This has generated the rolling three-year excess returns illustrated in Chart 1. The Ausbil Active Equity 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, and the rapid normalisation of interest rates across 2022 and 2023. 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.

Ausbil's dynamic approach to earnings and earnings revisions has helped add quality earnings and earnings growth, but also helped to reduce the downside risks through underweighting or avoiding sectors and stocks that have entered periods of earnings de-rating. This comes from both macro top-down and fundamental bottom-up intelligence on stocks and sectors, and from the additional risk benefits the integration of ESG offers our portfolios. The success of our active approach to investing is highlighted by the reward Ausbil has been able to generate for investors compared to the benchmark, adjusted by how volatile this reward has been. In other words, the information ratio shows how much an active strategy is being rewarded relative to a simple passive market exposure.

Ausbil has achieved an information ratio of 1.0 since inception in 1997 to 30 April 2023 on an annualised basis, representing the proportion active management has added relative to the tracking error (variability in that outperformance). According to researchers, an information ratio of 0.6 is very good, while an information ratio of 1.0 or above is considered rare (Goodwin, 1998). In assessing the long-term performance of Ausbil's Australian Active Equity strategy, the excess returns demonstrated in Chart 1 show that the strategy has been able to generate consistent outperformance across the cycle.

Q: How do you apply ESG to your investment approach?

PX: Ausbil is a signatory to the United Nations Principles for Responsible Investment (UN PRI) and has a dedicated environmental, social and governance (ESG) research team who provide proprietary in-house research and scoring across the group. ESG research, company, sector and momentum scores are incorporated in Ausbil's investment decision making process. Ausbil believes that consideration of ESG issues, founded in excellent ESG research, and informed by active and regular engagement with the leaders and boards of companies can help identify mispriced stocks, assess a company's earnings sustainability, and improve our risk-adjusted performance. Similarly, engagement on ESG issues can drive long-term value and reduce the risk of value destruction as it considers a far broader range of risk outcomes.

Q: How has the Fund performed over time?

PX: Ausbil's Australian Active Equity Fund, is 26-years old and has generated a gross long-term outperformance since inception of +11.1% per annum (before fees), and +10.2% per annum (after fees), outperforming the benchmark (S&P/ ASX 300 Accumulation Index). Table 1 illustrates our performance since inception.

Table 1: Fund performance (after fees)

	1 Yr	2 Yrs (pa) *	3 Yrs (pa) *	5 Yrs (pa) *	7 Yrs (pa) *	Since Inception (pa) *
Ausbil Australian Active Equity Fund %	2.25%	7.68%	18.45%	9.60%	10.64%	10.17%
Benchmark^ %	2.13%	6.07%	13.97%	8.23%	9.14%	8.19%
Value Added %	0.12%	1.61%	4.48%	1.36%	1.49%	1.98%

Source: Ausbil, post-fees as at 30 April 2023.
*Annualised return.
Inception date is July 1997.
^S&P/ASX 300 Accumulation Index.

Q: What is the outlook for large cap equities, now and in the future?

PX: Major COVID stimuli in 2020, a resurging post-pandemic economy from late 2020 and into 2022, and an energy shock with the February 2022 invasion of Ukraine all contributed to the recent record inflation experienced across the world.

Central banks have responded with rapid rate rises to pare back inflation. Recent reads suggest inflation may have peaked, and is on the way down now, though we believe it will take some time. We also think that central banks are near the end of this rate rise cycle and will look to hold for some time subject to data. We do not currently subscribe to any immediate rate pivot, but we can see potential for some rate reversals if economies have slowed a little too much, but this is not especially relevant to current positioning.

Although the Australian economy is slowing on contractionary monetary policy, we believe Australia's resource economy is well-placed to outperform other developed markets with below-trend growth, but no recession.

That said, we believe earnings growth will be hard to come by in 2023, however Ausbil expects key sectors to offer strong EPS growth opportunities above consensus, and some quality leaders across the market to demonstrate earnings growth with resilient demand across the economic cycle, and the capacity to pass on higher costs to end-consumers.

With this in mind, we see ongoing support for earnings growth in resources, diversified financials, general insurers and in energy given the shock we have experienced from the invasion of Ukraine. In resources, we are invested extensively across the decarbonisation thematic, in copper, nickel, lithium and rare earths. We are avoiding sectors that are cyclical, over-exposed to slowing economic growth, and whose earnings are adversely impacted by inflationary pressures. This includes construction, retailing and consumer discretionary.

Q: What about Australia's future as an investment destination?

PX: Longer term, Australia is positioned as an economy to offer major investment and growth potential for listed companies Firstly, given the drive to net zero by 2050, the underlying push to decarbonise the world will require a lot of natural resources, particularly base metals, battery materials, bulk materials and energy. Australia is one of the best positioned economies globally to benefit from this fundamental change. Secondly, Australia's trade relationship with Asia, and China in particular, has greatly benefitted the country and will continue to drive demand for our exports in the coming decades. Thirdly, Australia is a young country that is set to grow steadily with migration and in size. There will be a compound growth benefit in how we develop our own export markets in knowledge, services, technology, commodities, agriculture, tourism and expertise, and how this manifests in investment back into local construction, real estate, infrastructure, services and consumer markets. These key themes, we believe, position Australia with significant advantage over our peers from an economic growth perspective. In our view, it makes a lot of sense to invest in Australia's future.

We believe Australia is positioned for a long tailwind of economic growth, and while crises like the pandemic, wars and the recent energy crisis may hinder the economy in the short term, in the long run this tailwind of growth can drive compound returns for patient investors. A critical aspect to this tailwind of growth will be Australia's position as a key natural resources economy, though it will also manifest in Australia's education and health care exports, and in the internal growth of our economy. Australian large-cap stocks offer an ideal vehicle in which to invest in the compounding benefits generated by key thematics, and by the ongoing compounding growth in Australia's population and economy. An active approach with a track record of long-term outperformance can only accelerate the benefits of such an approach.

References

Goodwin, Thomas H. 1998. "The Information Ratio." Financial Analysts Journal 54 (4): 34–43.

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