

Emerging leaders: An alpha hotspot for compound returns

Research & Insights

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Mid-cap equities can be a hotspot for compound returns as they comprise some of the best small caps that have emerged into larger companies on their journey to becoming large caps. David Lloyd, Portfolio Manager of the Ausbil Australian Emerging Leaders Fund and Co-Head of Emerging Companies, discusses the dynamic mid-cap sector and the opportunities for investors.

10 minute read

Key points

- Mid-cap equities can offer an 'alpha-rich' sweet spot of opportunity as companies emerge as leaders in their sectors.
- In many cases, the 'lion's share' of alpha is made from companies that emerge from small-cap status and eventually become large caps.
- Ausbil has negotiated significant periods of market turmoil, producing alpha from the active Emerging Leaders strategy.
- Some mid-cap equities offer a balance of dividend and growth opportunities. A catalyst-rich environment adds to earnings growth potential, such as M&A opportunities in the mid-cap space and index rebalancing as companies grow.
- Potential for earnings and growth momentum in mid-caps is usually well above that of larger peers.



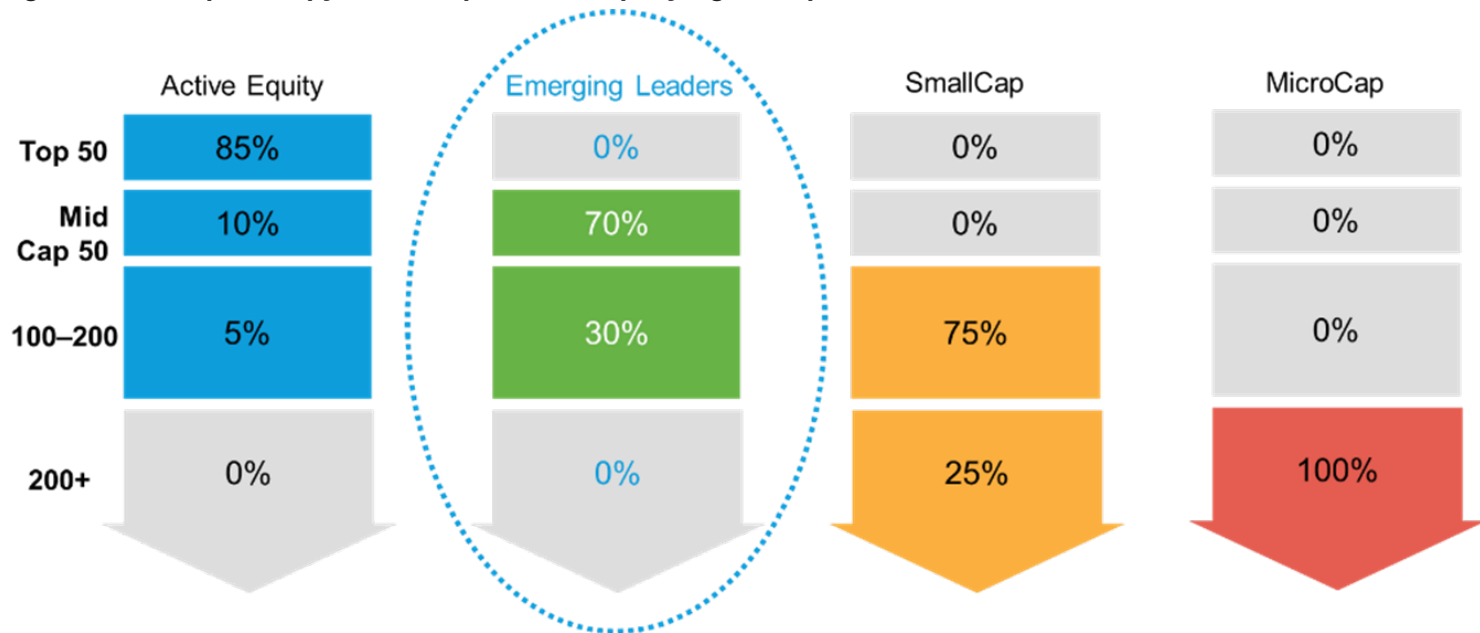
David Lloyd

Co-Head of Emerging
Companies and Portfolio
Manager

Q: What makes mid-cap investing so compelling?

DL: Mid-cap equities occupy the 'sweet spot' between small caps and their high-growth potential, and large caps, with their balance sheet strength. Companies that enter the mid-cap sector are usually seeing a long runway of growth driven by product innovation, growing market share and/or global expansion. We look for those companies accelerating out of the small-cap space on consistently superior earnings growth, where an excellent business model, quality management and execution, rising free cash flow and some pricing power underpin their valuations. The beauty of mid-cap investing is that a lot of the growth path remains, but we have the advantage of knowing how these companies performed when they were small and micro-caps (Figure 1).

Figure 1: Mid-caps occupy a sweet spot in a company's growth path



Source: Ausbil, 31 May 2025. The percentage allocations referenced are indicative only and are provided for illustrative purposes. Actual portfolio holdings may vary from these indicative ranges due to market movements, investment decisions, liquidity considerations, or other portfolio management factors. The portfolio may include securities that fall outside of the stated ranges at any time.

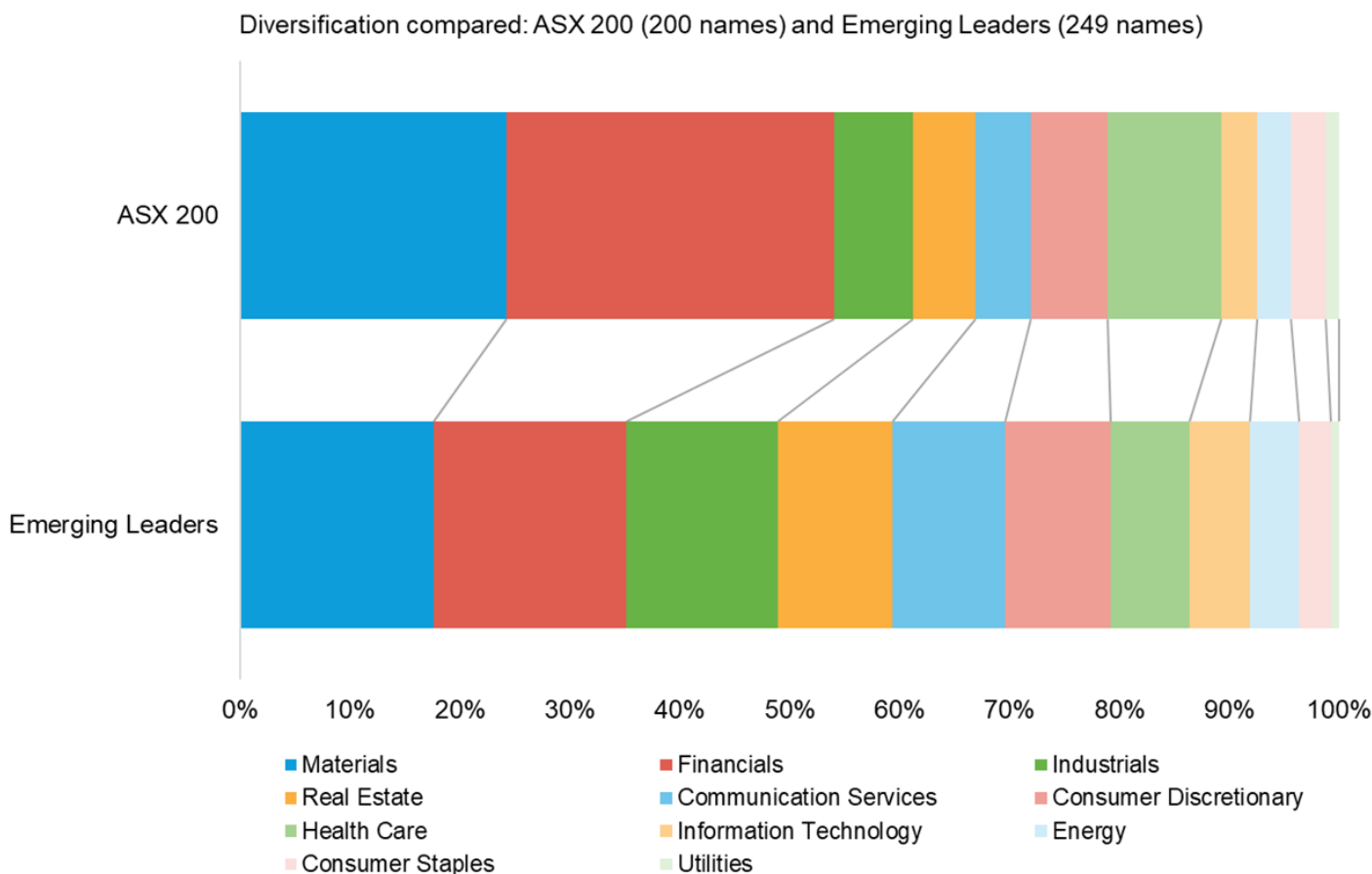
Mid-cap equities are a dynamic space. The sector can generate long compounding returns and also benefit from smaller, fast-growing companies. Afterpay, now part of Square (Block), is an example of a fast-growing company, rising through the micro and small cap sectors, becoming a mid-cap and then graduating 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: The mid-cap sector overlaps part of the ASX 200. How are they different?

DL: Because the diversity of the ASX 200 is dominated by the market caps of the largest companies, on a sector share basis, the mid-cap sector offers more diversity of opportunity. The main difference is the large banks and mining companies, which dominate almost half of the ASX 200 (Figure 2).

“Mid-cap equities are a dynamic space. The sector can generate long compounding returns and also benefit from smaller, fast-growing companies”

Figure 2: Mid-caps are a diverse universe



Source: Ausbil, Bloomberg as at 30 April 2025. Based on relative market cap of sectors. Emerging Leaders is for the Fund's Composite Benchmark, 70% of the S&P/ASX MidCap 50 Accumulation Index and 30% of the S&P/ASX Small Ordinaries Accumulation Index.

By contrast, smaller materials, banks and financials make way for a diversity of other sector opportunities in mid-caps that can offer greater allocation flexibility across changing macro-economic environments.

Q: How has the strategy negotiated volatile markets?

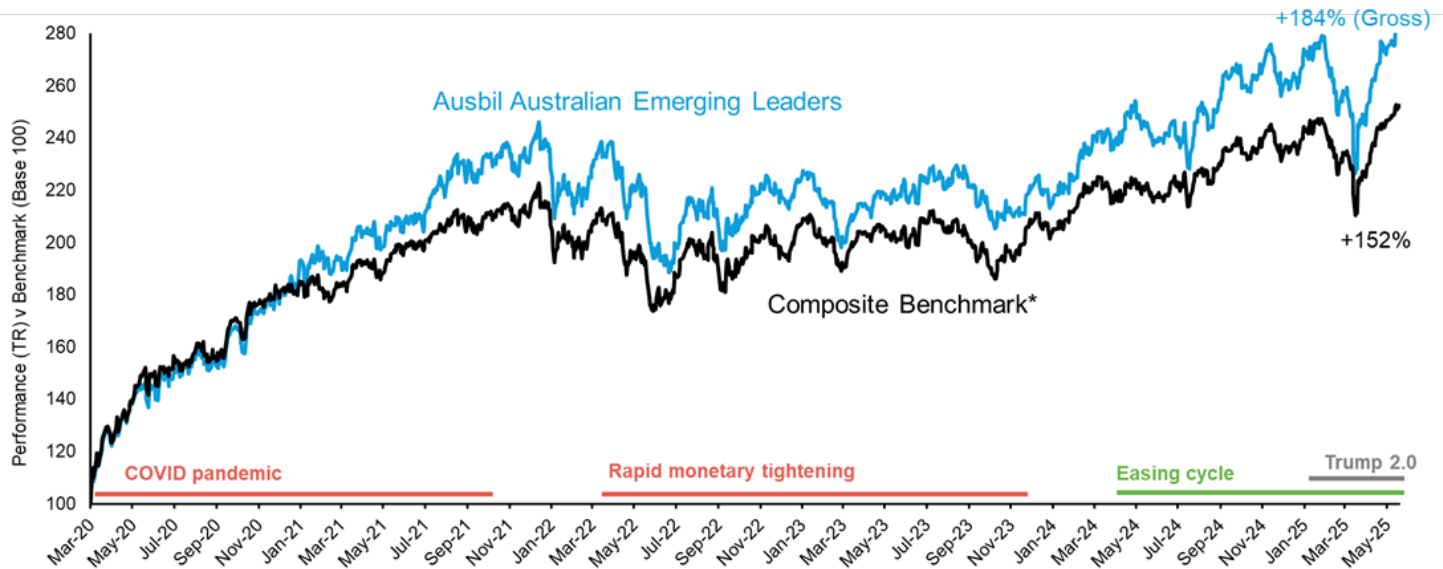
DL: Ausbil has a top-down bottom-up process that melds macro-economic outlook and fundamental analysis in order to generate alpha. This combination has helped significantly in negotiating complex market events like the pandemic with its supply-side shock, the energy shock from the invasion of Ukraine, the rapid monetary tightening of 2022/23 in response to rampant inflation, and more recently, the tariff shock of 2025. The Ausbil Australian Emerging Leaders strategy has been able to manage its portfolio across these complex events and generate alpha (Figure 3).

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Figure 3: The Emerging Leaders strategy has generated alpha across troubled times



Source: *70% of the S&P/ASX MidCap 50 Accumulation Index and 30% of the S&P/ASX Small Ordinaries Accumulation Index. Source: Ausbil, FactSet, returns gross of fees and assume distributions are reinvested from market low at 23 March 2020 to 10 June 2025, and based to 100. Benchmark is the Composite Benchmark. The performance of Ausbil Australian Emerging Leaders is the Ausbil Australian Emerging Leaders Fund (ARSN 089 995 442). Past performance is not a reliable indicator of future performance.

When a lot of other investment managers were pulling back into cash during these various shocks, Ausbil's process helped us identify areas that would benefit, and we set our portfolios accordingly. During COVID, we actively tilted towards beneficiaries of work from home, beneficiaries of the massive stimulus, vaccines, the health care sector, and the acceleration in e-commerce that occurred. From positioning for these themes, we generated significant alpha from names like Charter Hall (on the explosion in logistics and warehousing demand under lockdown), Super Retail Group (on the boom in home spending), and resources names like Lynas Rare Earths and OZ Minerals in copper (on our view that they would benefit from the impact of the huge stimulus on economic growth).

During the rapid monetary tightening in 2022/23, we analysed the impact of rapidly rising rates and realised that the beneficiaries would include banks (like Virgin Money and Bank of Queensland in banking, and AUB Group in writing general insurance), stocks with strong balance sheets, and structural growth features and leverage to higher interest rates (like technology unicorn, Life360, and Webjet).

We have been quite fortunate that our macro has helped drive our allocation decisions, and we have been able to express these in many names that have benefited from our view. Importantly, we have stayed invested during these periods and have benefitted from the strong market recoveries.

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 May 2025, Ausbil manage over \$20.1 billion in funds under management.

Q: What makes the Emerging Leaders' universe an alpha hotspot?

DL: 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 draw-downs on the way, tends to favour the overall growth path of mid-cap and smaller companies.

Q: Does this mean mid-caps are riskier?

DL: Because of the fundamental analysis we undertake on companies on our Portfolio, we do not consider them riskier propositions than larger cap peers. It is easy to make expensive mistakes at any market cap. In theory, smaller companies are riskier and command a higher risk premium to the risk-free rate to entice investors onto their registers. This is why over time, with a higher notional growth component to their returns, that mid and small companies outperform larger companies.

There are some key risks that can make smaller companies riskier but which we mitigate in our process to some extent. The first is profitability. We invest in companies that are profitable and with higher levels of free cash flow than the universe average. We are careful to invest with liquidity in mind so that we do not lose on spreads as we enter, add to and exit positions. Our top-down process helps leverage our macro views into taking careful sector allocation decisions so that we are not fighting the market cycle, even with great companies. Finally, with the integration of ESG in our qualitative assessment of companies, we believe we capture a larger risk set than other investors, helping to mitigate for a wider range of issues.

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

DL: Recently, President Trump's tariff announcements shocked the market on 2 April, and led to significant volatility and a flight to safety. We have been analysing these tariff changes from a macro perspective. We determined within days of the tariff announcement that the impact, while sharp, would be temporary. The equity market has since recovered from its 'Liberation Day' sell off, and we have benefited from tilts to information technology, financials and in selective materials exposures. Moreover, across the remainder of calendar 2025, we believe US exposed cyclicals should also perform strongly as tariff uncertainty clears, Trump's deregulation agenda commences, and as the Federal Reserve lowers interest rates. A key beneficiary based on our outlook is likely to be Reece, an Australian and US plumbing supplies business which should benefit from an improving US housing cycle, continued US store roll-out and improve US store economics.

REA Group, well known in Australia for realestate.com.au is also a growing player in the US with realtor.com, and across Asia. REA has been able to deliver double-digit revenue growth over the past 15-years, a trend we see extending as REA retains a dominant home position and builds on its technology leadership in its expanding global ventures.

We are also seeing significant opportunity in the structural growth in technology. Block is one company where we see significant opportunity, now with 57 million Cash App users globally and growing, capturing US\$220bn in point of sale transactions in the US, and processing US\$12.5bn annually in buy-now-pay-later transactions. This has seen Cash App deliver 58% CAGR in gross profit since 2018 as Block displaces other financial intermediaries for the business of everyday customers in the US and Australia.

Another tech name we are excited about is Life360. We have been in this name for some time, and we think that there is a significant growth path ahead based on the comparative experience of similar companies. Life360 now has over 44 million monthly average users, more than Duolingo (29m), close to Reddit (48m), and we believe is growing towards the likes of Uber (59m) and Spotify (65m) because of its relevance to the lives of its users. Life360 offers families and friends a tracking platform for safety, community building, roadside assistance and communi-

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cation. The service has proved incredibly popular and is set to expand further with innovations in pet and asset tracking. We see major opportunity in the rapid adoption of Life360 by users in the potential for both subscriptions and advertising revenue. Life360 currently earns \$0.69 per monthly average user (MAU). Advertising revenue per MAU for Duolingo is around \$0.80, with Reddit at \$3.32, Spotify at \$3.99 and Uber at \$6.16. These structural growth companies are relatively inelastic to changes in the economy, making them exciting additions to our thematic exposures.

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

DL: 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 Australian Emerging Leaders mid-cap strategy?

DL: 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 Team, 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?

DL: 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 +1.4% 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 illustrates our performance since inception.

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Table 1: Fund performance (net of fees)

Performance to 30 June 2025	Emerging Leaders %	Benchmark^ %	Value Added %
1 month	3.14	0.80	2.34
3 months	14.68	9.84	4.84
6 months	9.99	6.98	3.02
1 Year	18.01	15.24	2.77
2 Years*	13.34	11.26	2.08
3 Years*	13.04	12.52	0.52
5 Years*	13.84	11.10	2.74
7 Years*	7.89	8.09	-0.20
10 Years*	10.07	10.50	-0.43
15 Years*	9.51	9.20	0.31
20 Years*	8.65	7.53	1.12
Since Inception* (May 2002)	10.67	9.09	1.58

Source: Ausbil, post-fees as at 30 June 2025.

*Annualised return.

^70% S&P/ASX Midcap 50 Accumulation Index and 30% S&P/ASX Small Ordinaries Accumulation Index. Assumes reinvestment of all dividends for the Benchmark, and all distributions for the investment strategy (Emerging Leaders).

More information

For more information visit www.ausbil.com.au.

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More information

For more information on Ausbil Australian Emerging Leaders Fund visit www.ausbil.com.au.

To access our current investment performance information, please click on the following links:

<https://www.ausbil.com.au/products/australian-equities/ausbil-australian-emerging-leaders-fund>

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