ASX ex-20 stocks: the sweet spot for earnings power

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The investment management industry tends to present issues in zero-sum ways. Active versus passive, large cap stocks versus small cap stocks, liquid assets versus illiquid assets, and on it goes.

The truth, however, is different to black and white portrayals.

Well diversified portfolios will likely have exposure to a wide range of assets, investment approaches and styles. Each piece of the investment puzzle adds up to creating stronger total portfolios with potentially better risk-adjusted returns than those based on a single thematic.

This informs our case for investing in stocks outside the S&P/ASX 20 (ASX 20).

ASX 20 stocks form the core of many investors' Australian equity exposure – whether as individual shareholdings or as part of managed funds. Many investment managers benchmark their performance against Australia's leading share market index, the S&P/ASX 200 (ASX 200). Because it is a capitalisation weighted index, it means these managers will naturally have a large exposure 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.

The argument for investing outside the ASX 20 (i.e. ASX ex-20) isn't built on knocking large cap investing. Rather, it's an argument for complementary investing as mid-cap stocks offer different attributes to their large cap counterparts.

There are three broad arguments for ASX 20 investing:

- accessing even more earnings power capable of driving potentially greater total returns;
- a more even spread of sector weights providing greater diversification than the financials, and resources heavy ASX top 20; and
- and wider dispersion of returns, which provides active managers greater scope for adding value through stock selection.

We address each in turn.

The earnings trajectory test

Earnings Per Share (EPS) growth is the fuel that propels total returns. There is powerful evidence that mid-cap stocks, represented by the ASX ex-20 universe, occupy the long-term EPS sweet spot **(Chart 1)**. In turn, superior long-term EPS growth from the ASX ex-20 cohort has translated to higher total returns (**Chart 2)**.

ASX ex-20 stocks: the sweet spot for earnings power

Chart 1: Mid cap stocks* have exhibited strong long-term EPS growth…

EPS growth	1 year (%)	5 years (% pa)	10 years (% pa)	14 years (% pa)
Large Caps (S&P/ASX 20)	-1.8	-1.4	2.6	1.2
Mid Caps*	-12.4	5.0	3.7	2.1
Small Caps (S&P/ASX Small Ordinaries)	0.6	3.7	-1.3	-1.4
S&P/ASX 200	-0.3	1.2	3.2	1.6

* We define mid cap stocks as those in the ASX 200, excluding the ASX 20.
Returns shown are for 1, 5, 10 and 14 years to 30 September 2019.
Source: Bloomberg, Antares

The phenomena of mid-cap stocks exhibiting especially good EPS growth is not an ASX ex-20 only story. We've noted similar trends in other developed country share markets, such as the US and UK markets.

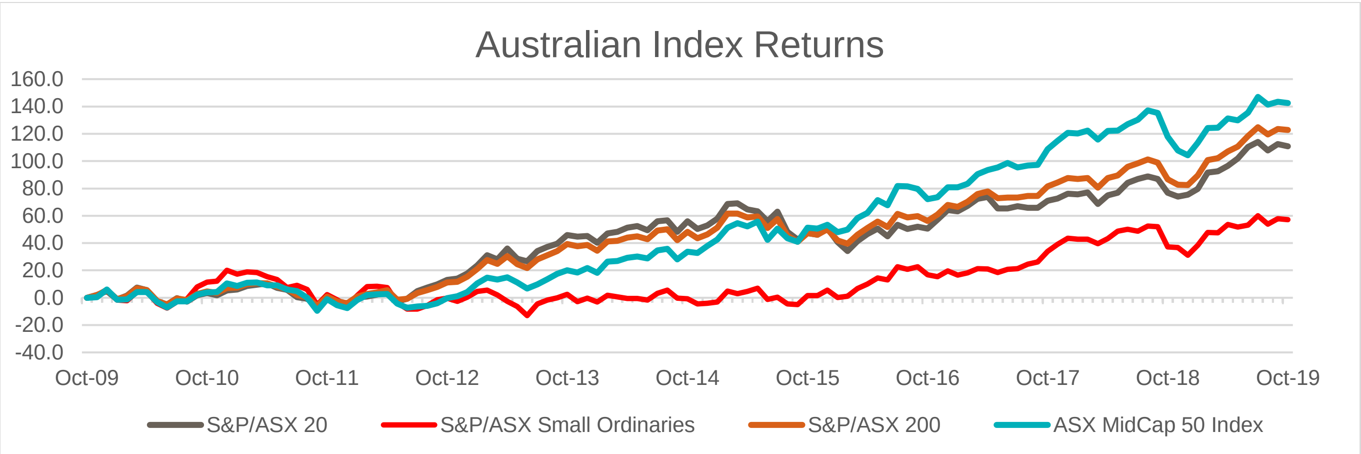
We think this stems from the mid-cap segment of share markets being rich with companies that have established themselves, but which have not yet become mature companies. Moreover, mid-cap stocks often enjoy strong organic growth prospects that can be funded from earnings rather than needing additional equity capital from shareholders.

Mid-cap companies, as a group, still have attractive revenue growth runways ahead of them. Disruptors able to grow both earnings and market share by remaking existing industries feature in the mid-cap market.

Think of *Seek* that has leveraged new technology to dominate the job ad market; *Afterpay* that has transformed the buy now pay later market; and *Xero* that has developed accounting software that has become a must-have for many small businesses. These businesses are representative of other industry disruptors across the mid-cap terrain.

Chart 2:...which has ultimately resulted in higher total returns

Australian index returns



The return lines above show cumulative returns for each of the four indices mentioned from September 2009 to 30 September 2019 and includes reinvestment of income. The S&P/ASX MidCap 50 is representative of the mid-cap universe and comprises the largest 100 companies but excludes the largest 50 of these (ie S&P/ASX 100 excluding the S&P/ASX 50).
Source: Morningstar, Antares

Contrast that with Australia's large cap stocks. From a business lifecycle perspective, the large companies dominating share markets might not present the most rewarding investment opportunities.

As a group, they tend to be mature businesses that generate more cash than they can spend on future growth opportunities. When a company's market share is already very large, the limit to growth is no longer just a theoretical concept.

Consequently, their earnings growth trajectory is often a little lower, as **Chart 1** shows, and over the long-term results in good, but not necessarily, market leading total investment returns as **Chart 2** notes.

Small cap stocks — those outside the S&P/ASX 200 Index — are typically placed on the high risk/high return spectrum of the Australian stock market.

Immature companies are higher risk than larger companies, as they're still in the formative stages of establishing durable business models. They also tend to be capital intensive with shareholders often having to endure EPS diluting equity raisings. Higher risk is not always rewarded, but equity raisings are always negative from a short-term EPS perspective.

This helps to explain why, despite their higher risk, small cap stocks, can, as a group, underperform over the long-term as **Chart 2** shows.

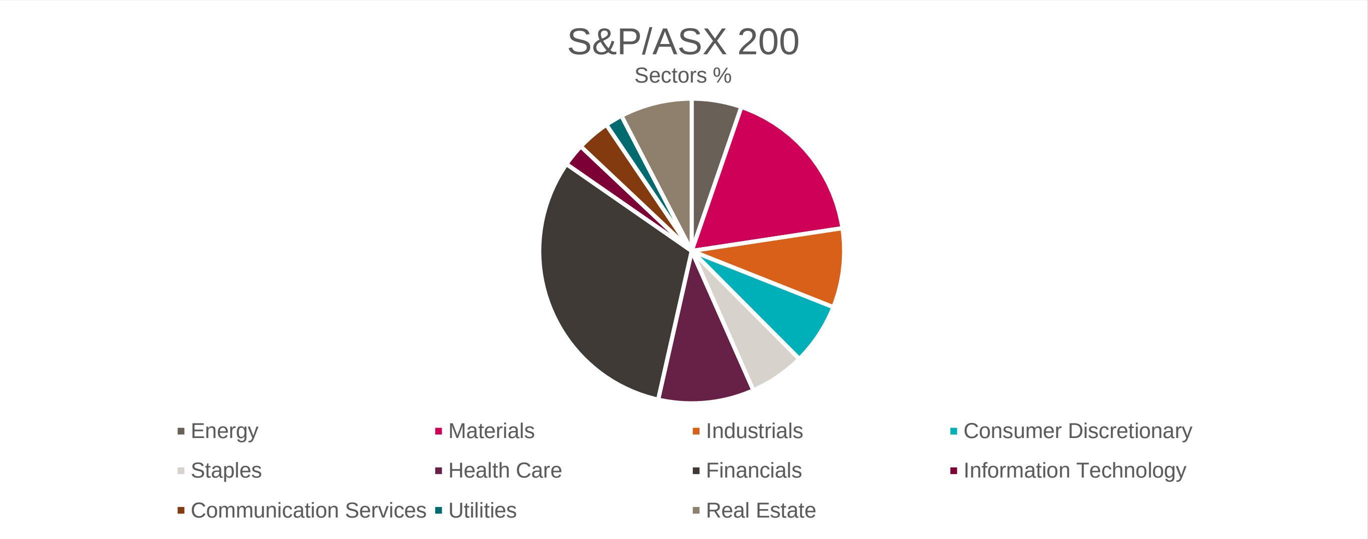
A key message from these observations is that an Australian equity investment program built predominantly around large cap stocks can benefit from extending the opportunity set to cover the ASX ex-20 mid-cap domain.

A more even spread of sector weights in ASX ex-20

A quick glance at the ASX 200's sector composition confirms what generations of investors have known — the Australian share market is very financials and materials (resources companies) dominated **(Chart 3)**. It's estimated that the two sectors combined represent around 50% of the broad Australian share market (as measured by the ASX 200) by market capitalisation.[1]

The ASX 200's financials and materials concentration has remained remarkably consistent over the past century. That's not surprising given that BHP and Rio Tinto were founded in the 19th century, and banks such as Westpac, ANZ and NAB also have histories dating back nearly two centuries.

Chart 3: ASX 200 dominated by Financials and Materials sectors



As of 31 October, 2019
Source: IRESS, Antares

[1] Iress data as of 31 October 2019

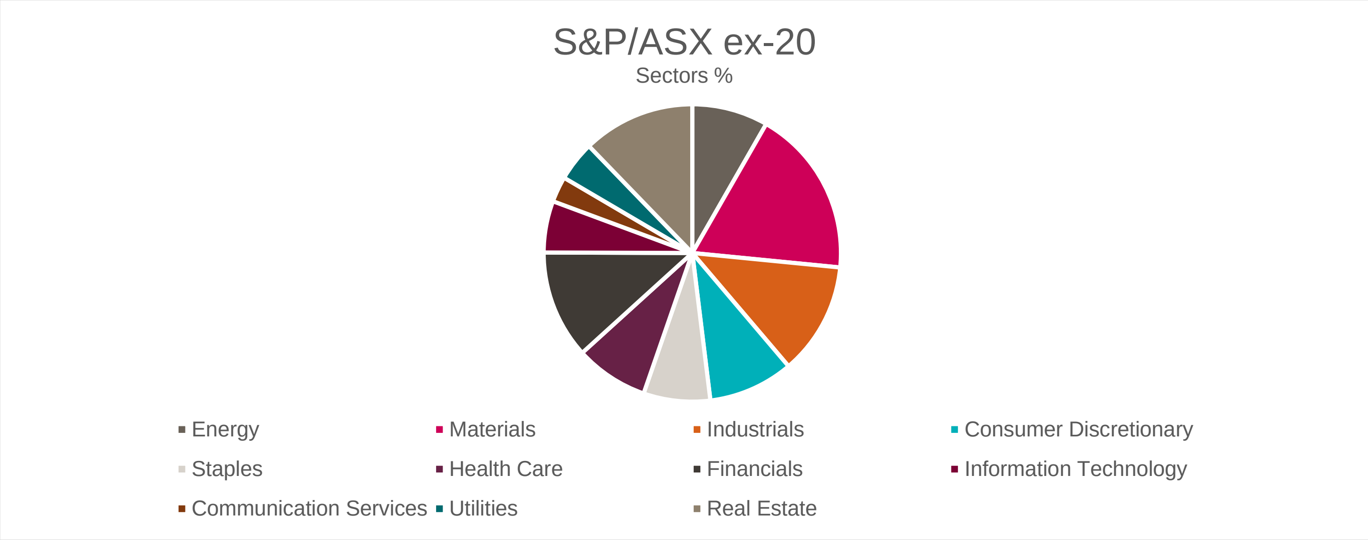
What all this distils down to is that many equity investors' financial well-being is effectively tied to two factors — the housing cycle, in the case of financials, and commodity price cycles, in the case of materials.

Additionally, housing cycle exposure embedded within the ASX 200 is magnified by the fact that most Australians' largest asset is residential property. This "doubling-up" means that many investors unwittingly have outsized housing related risks.

We think the edge can be taken off such concentration risk by diversifying into the ASX ex-20 universe **(Chart 4)** where no sector over-dominates.

An absence of sector over-domination in the ASX ex-20 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 such an issue in the ASX 200.

Chart 4: ASX ex-20 universe offers greater sector diversification



As of 31 October, 2019
Source: IRESS, Antares

We think this is good for investors as it puts the onus on the active managers they employ. Stock selection is what professional investment managers should ultimately be judged on, less so on whether they stick close to sector benchmarks.

Wider return dispersion emphasises greater active management opportunity

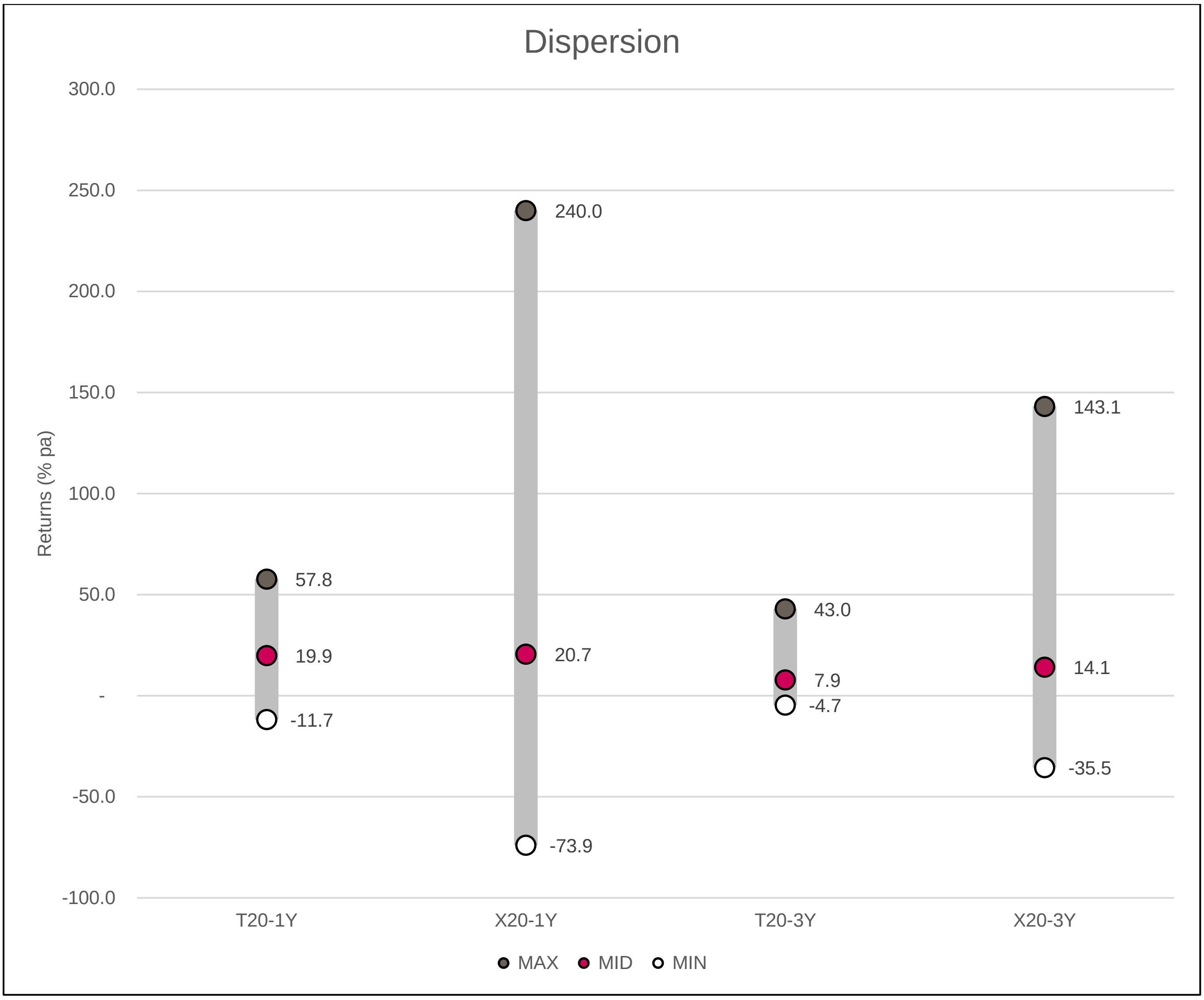
Finally, we believe the active investing case is boosted by the wide dispersion of returns in the ASX ex-20 universe versus the ASX 20 **(Chart 5)** over one year as well as three years.[2]

Over one year to 30 September 2019, there was more than 380% difference between the best and worst performing ASX ex-20 stocks. Over three years to 30 September 2019, there was an almost 190% difference between the best and worst performing ASX ex-20 stocks.

[2] This refers to one and three years to 30 September 2019 returns for the companies listed on the S&P/ASX 200 Index excluding the companies listed on the S&P/ASX 20 Index versus the companies listed on the S&P/ASX 20 Index.

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

Dispersion of returns ASX ex-20 universe versus ASX 20



As of 30 September, 2019

Source: Bloomberg, Antares

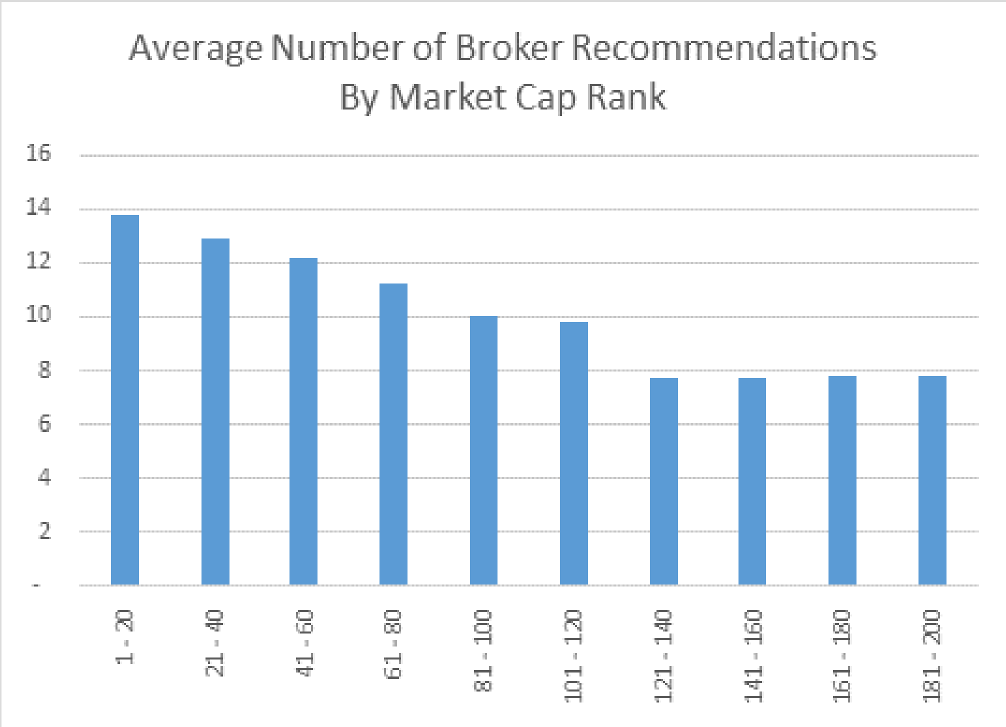
By contrast, return differences between the best and worst performing stocks in the ASX 20 were far narrower over the same periods.

In other words, picking the best performing stocks in the ASX ex-20 universe provides potentially greater reward than stock picking in the ASX 20.

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

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

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



As of 30 September, 2019
Source: Antares, Bloomberg

We end as we started. 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 ex-20 universe.

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