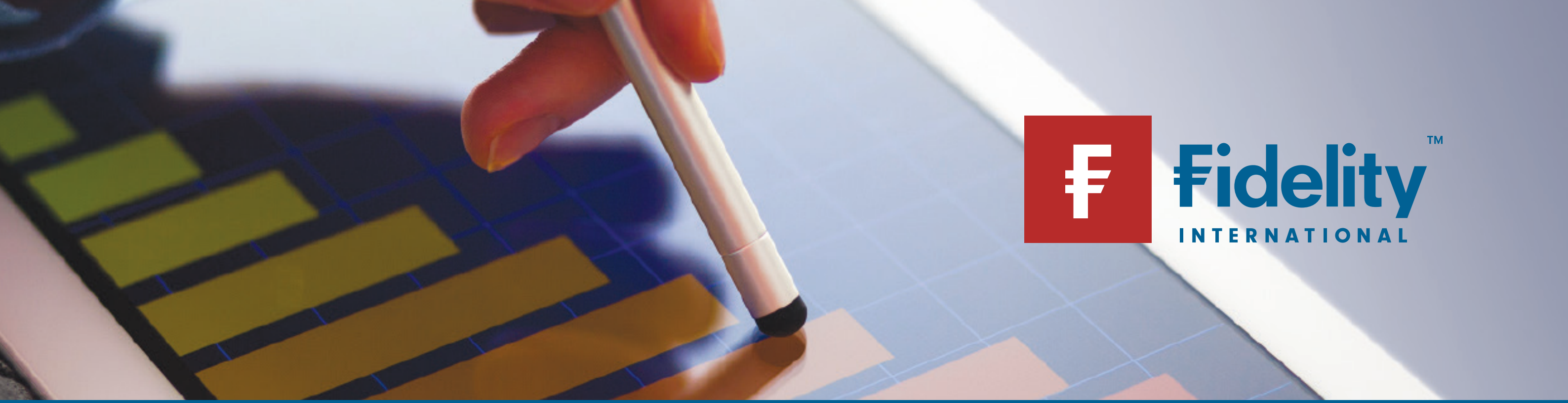

Why Australian mid- and small caps?

If you researched Australia's largest listed companies by market capitalisation, you'd discover that some of them were much smaller stocks not that long ago. Such stocks would include the blood refiner CSL, toll-road operator Transurban, Ramsay Health Care and PNG-focused Oil Search.

These companies grew into Australia's biggest companies by market cap by implementing business models that allowed for sustainable excess returns year after year. Their shareholders were enriched accordingly.

The case for investing in mid- and small-cap stocks is built around finding these future leaders. But there's more to it than that. Investing in mid- and small caps offers diversification benefits to investors that are worthy of consideration, even after allowing for the extra risk in investing in the smaller stocks on the ASX.

What is a mid- or small cap?

A mid-cap is generally classed as a stock that for most of the time sits from 51 to 100 on the list of Australian stocks by market cap (the number of shares on issue multiplied by the price of those shares). At the end of last year, these companies had market caps ranging from $5.7 billion down to $1.6 billion.

These mid-cap stocks included ear-implant maker Cochlear (53), internet-job site owner Seek (55), Domino's (66) and carsales.com (82). It included older household names that used to be bigger, such as BlueScope Steel (80) and Fairfax Media (89).

Small caps are those that number 101 and below when measured by market cap. Some small caps have familiar names – Nine Entertainment (119), Bega Cheese (128) and Myer (140). Most of them, though, are yet to rise to prominence.

A common benchmark for smaller stocks on the ASX is the S&P/ASX Mid Small Index, which tracks the top 300 stocks by market cap minus the top 50. (A common benchmark for the broader market is the S&P/ASX 200 Accumulation Index.)

Why invest in smaller stocks?

So why should investors consider placing their money in a managed fund that invests in a bunch of companies they have mostly never heard of? There are four main reasons to do so.

1. Smaller companies offer potential excess returns because their earnings growth is at its highest

Investing is about risk versus reward. Smaller stocks have the potential to offer bumper returns, especially in a low-return world, because small stocks that become big stocks make a lot of money for their shareholders along the way.

Companies are trying to seek a return on their investments to stay in business. The point in the life of a company when it is making the highest return on invested capital – or is at its most profitable – is often when it is a rising small- or mid-cap stock. It's at this point when its revenue and earnings are expanding at their fastest rates. Often it's at this time its share price is taking its biggest leaps.

Take retailers, for example. The most successful ones use their profits to roll out the same types of stores across the country. Their profitability (as distinct from their profits) probably peaks in the midst of this expansion. Once they have stores everywhere they are more mature businesses with limited expansion potential (unless they take the risky decision to head overseas). When their growth is exhausted, they can still be highly profitable businesses but their profit growth rates might be limited and their share price might languish accordingly.

2. Smaller stocks help diversify a portfolio of Australian equities

If you invest in a standard Australian share fund that is benchmarked against the S&P/ASX 200 you are investing in a fund that, due to the composition of the index, is skewed towards Banks, Telstra and BHP Billiton. As at 31 December 2015, for instance, the four biggest stocks on the ASX were the four big banks. Add in Telstra and BHP Billiton and you're at 39.4% of the benchmark. The top-10 stocks on that day were 51% of the index. That's poor diversification. If the banks hit trouble or one or two of those other big stocks struggle – as BHP Billiton has recently due to the tumble in commodity prices – then the S&P/ASX 200 Index will offer lean returns.

By comparison on the same day, the top-10 stocks for the S&P/ASX Mid Small Index were just 20.6% of this index. These stocks include health stocks such as sleep-apnoea company ResMed, ear-implant maker Cochlear, and Tatts.

S&P/ASX Mid Small Index: top-10 holdings are 20.6% of the index

Qantas Airways	3.0
Tatts	2.3
Aristocrat Leisure	2.3
Treasury Wine Estates	2.1
ResMed	2.0
Cochlear	1.9
Bendigo and Adelaide Bank	1.9
Bank of Queensland	1.8
Challenger	1.7
Healthscope	1.6

Source: Fidelity as at 31 December 2015

The top-20 stocks in the Mid Small Index only amount to 33.9% of this benchmark. These stocks include Healthscope, Star Entertainment and Tabcorp.

The diversification is better on an industry basis too. Financials were only 21% of the benchmark for smaller stocks on 31 December 2015, not 49% as they were in the broader index. On the same day, consumer, industrial and healthcare stocks were 29%, 12% and 11% of the Mid Small Index compared with 12%, 8% and 7% for the broader index.

3. Interests are often more aligned

When you invest in a company you want to make sure that you invest in a company where management are focused on generating superior returns and are committed to acting in the interests of all shareholders.

With smaller stocks, it's common to find that management still own a chunk of the company, whereas CEOs of large companies might only own a tiny part of the conglomerates they run. Thus management at smaller companies are more likely to act with shareholders in mind because they are big shareholders. There's less chance, for example, of decisions being taken that prioritise empire building over profitability.

4. Smaller stocks are undercovered

Smaller stocks are less well known and analysed compared with larger companies. This means a skilled active investor with proper resources has more potential to find good stocks that are underappreciated and under-priced. Over time, other investors are bound to recognise the qualities of such stocks and their share prices will outperform market indices.

Another reason to invest is that smaller stocks tend to be takeover targets. Not only does a takeover offer propel the target's share prices to unexpected heights; as well, the tendency for larger companies to swoop on smaller ones often means that mid- and small caps trade above what they otherwise would.

Smaller stocks can contain turnaround stories too. Some large stocks flounder for a while and become so unloved they slip out of the top 50. Such a drop can inspire a shakeup that revamps a company. Qantas Airways has staged such a turnaround in recent years.

Things to consider

Investing in smaller stocks may offer investors many benefits. But investors need to be aware that there are extra risks too. Management is often inexperienced. The business model is often untested in all economic conditions because the company might not have been around long enough. Smaller stocks are often single businesses, which means that they offer one type of product or service. They are therefore more vulnerable to competition and thus stagnating or failing.

Smaller stocks carry the extra risk at an aggregate level. When investors are concerned about the economic outlook and seek haven securities, asset classes that are perceived as risky (such as mid- and small caps) can be sold down. Even allowing for these risks, however, the potential extra return and diversification benefits of smaller stocks make them worthwhile considerations.

The Fidelity Future Leaders Fund

The Fidelity Future Leaders Fund offers access to the Australian stars of tomorrow. The fund aims to outperform the benchmark over a period of five to seven years. It invests in 40 to 70 mid- and small-cap stocks. Risk is managed by holding a diversified selection of thoroughly researched companies.

Key facts

- The fund aims to outperform the S&P/ASX Mid Small Index (before fees, costs and taxes) over five to seven years.
- James Abela, a highly experienced and well regarded member of Fidelity's Australian equities team, manages the fund.
- The portfolio manager seeks to invest in attractively valued smaller companies that have strong competitive positions and sound management.
- The portfolio manager has access to the research of more than 400 investment professionals* who help him build a global view of Australian companies.
- The fund is a bottom-up, actively managed fund. Portfolio construction is driven by stock selection.
- Sector allocations are a result of stock selection and have a range of ±10% relative to the benchmark. Stock positions can be within ±5% of the benchmark.

For more information on the fund, visit: fidelity.com.au/funds/fidelity-future-leaders-fund

Market cap information comes from DataStream.

www.fidelity.com.au

Fidelity INTERNATIONAL™

Important information

*Investment professional number includes fixed income analysts and equity (including technical and shorting) analysts.

References to specific securities should not be taken as recommendations.

This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL No. 409340 ('Fidelity Australia'). Fidelity Australia is a member of the FIL Limited group of companies commonly known as Fidelity International.

This document is intended for use by advisers and wholesale investors. Retail investors should not rely on any information in this document without first seeking advice from their financial adviser. This document has been prepared without taking into account your objectives, financial situation or needs. You should consider these matters before acting on the information. You should also consider the relevant Product Disclosure Statements ('PDS') for any Fidelity Australia product mentioned in this document before making any decision about whether to acquire the product. The PDS can be obtained by contacting Fidelity Australia on 1800 119 270 or by downloading it from our website at www.fidelity.com.au. This document may include general commentary on market activity, sector trends or other broad-based economic or political conditions that should not be taken as investment advice. Information stated herein about specific securities is subject to change. Any reference to specific securities should not be taken as a recommendation to buy, sell or hold these securities. While the information contained in this document has been prepared with reasonable care, no responsibility or liability is accepted for any errors or omissions or misstatements however caused. This document is intended as general information only. The document may not be reproduced or transmitted without prior written permission of Fidelity Australia. The issuer of Fidelity Australia's managed investment schemes is FIL Responsible Entity (Australia) Limited ABN 33 148 059 009. Reference to ($) are in Australian dollars unless stated otherwise.

FD17145