



Outlook 2025



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Key points

- The Australian small-mid cap universe continues to provide access to both technology-led innovation and cyclical recovery across a range of industries.
- Valuation consciousness is critical as market is less sensitive to risk and leaning towards euphoria.
- The Fund continues to judiciously deploy the quality, momentum, transition and value (QMTV) approach to find what we believe to be the best opportunities capable of delivering consistent alpha.

What is your outlook for Australian small-mid caps?

The Australia small-mid cap universe provides exposure to economic cyclical recovery, technology innovation, consumer improvements and companies with steady earnings growth, and continues to attract investor interest. Over 2024, the Fund has been dominated by technology leaders across many industries such as software, consumer technology platforms as well as financial services technology platforms. Select stocks across industrial and consumer-led segments that have seen either earnings expectations improve or where investors have become more comfortable about their growth outlook have also been performing well. These types of companies continue to deliver structural and cyclical growth, which supports their growth outlook into 2025. It is difficult to see the underlying market dynamics that could change the positive earnings trends.

Valuation multiples have expanded considerably and consequently, the Australian Mid Small Index (ASX300 ex-50) is valued at 20 times Price/Earnings (P/E) for 2025 earnings per share (EPS) as at 31 October 2024. This is a high level relative to history; this reflects strong growth as well as high expectations that the growth trajectory will continue, with expectations of 12 per cent EPS growth at the index level for 2025. The multiple of growth stocks' have risen strongly during 2024, thus it is pragmatic to be concerned about those stocks that trade on P/E multiples over 40 times; here investors mindset is close to "euphoric", and amid such strong sentiment, there should not be any complacency towards the risks associated with the individual thesis. Currently, there is also close to 40 stocks which are reporting losses, adding to the concern that markets are very risk tolerant at the moment.

How are you looking to position your portfolio against this backdrop?

2024 has been a very strong 12-month period for the Fund with a 39 per cent return to the end of October 2024. This has been delivered by rewarding stock picking and favourable exposure to quality and momentum styles as well as an underweight in value. We are conscious of this high return and the focus over the next few months will be managing this risk to ensure the style of the portfolio is kept within a range that historically has aided in reducing draw down risk in

the event of a market decline.

“If you can follow only one bit of data, follow the earnings” - Peter Lynch, Fidelity Investments

This quote is highly relevant in prevailing market sentiment where the Australian Mid Small Index is now trading at over 20 times P/E ratio and sentiment remains very buoyant. Valuation discipline is particularly important in this point of the market cycle as the Australian mid and small cap universe is developing some extreme levels in pockets of strong earnings growth and high confidence. As multiple expansions have been significant, this is pushing expectations higher and for a longer duration.

Quality and Momentum stocks are under review for valuation risk and potential changes in growth outlooks. Should there be any disappointments, we think these stocks will likely fall sharply as multiples compress back to index levels on this sentiment shift. As we exercise caution towards Quality and Momentum stocks and adjust these positions, we are also looking for opportunities in Transition names where we are likely to see a positive earnings trend, solid free cash generation and support from catalysts that could lead to idiosyncratic driven multiple expansion. We believe there are some attractive companies that fit this profile in the resources, healthcare, and industrial sectors.

All information is current as at 6 December 2024 unless otherwise stated.

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