Global Mid Cap Equity

Why a dedicated active exposure should improve investment outcomes

This is for investment professionals only and should not be relied upon by private investors

Contents

The authors and contributors of this paper have been as follows:

James Abela, Portfolio Manager
Maroun Younes, Portfolio Manager
Himalee Bahl, Investment Director
Richard Dinham, Head of Client Solutions and Retirement
Daniela Jaramillo, Head of Sustainable Investing, Australia
Ashish Jain, Group Head – Investment Research
Shivam Aggarwal, Senior Associate – Investment Research
Sumit Sayal, Senior Lead – Investment Research
Archit Singhal, Senior Manager – Data Analysis
Kaushik Kumar, Lead – Data Analysis

Executive summary

This paper sets out a detailed rationale for investing in global mid-cap equity. We believe that this asset class has been under-appreciated in the past, but offers some excellent opportunities for investors looking for exposure to global equity markets.

Global mid-cap equity offers exposure to the broad global equity asset class, but also offers the opportunity for superior returns, and superior risk adjusted returns, compared to global large cap equity. And despite some misconceptions about their risk profile, they are, on average, larger, more liquid, with lower trading costs than the Australian large-cap universe.

The global large cap investing universe is heavily influenced by a small number of mega-cap names, many of them in the Tech sector, who have driven performance of the market index for a number of years. By contrast the global mid cap universe of stocks is far more diverse at stock level with no single names, or groups of names, driving performance on the market. This diversity of opportunity is a far more desirable investment characteristic than a top-heavy concentrated market where the risk of getting the key names wrong can have an undue bearing on performance success in global large caps. With significantly lower analyst coverage of stocks in the mid-cap universe compared to large caps there are excellent opportunities to add value by rigorous bottom-up research and active management in this asset class.

One argument often advanced for not using a separate mid-cap manager is that many large cap global equity managers already have a mid-cap exposure; whilst this is generally true, we have established that large cap managers have on average detracted value from their portfolio performance with their mid-cap exposure – attribution analysis has shown that, on average, large cap managers have subtracted relative value with their exposure to global mid-caps. This is not surprising, as most global large cap equity managers will focus the majority of their effort on their large cap names rather than their mid-cap exposures.

There is also a significant case from a portfolio construction perspective that global mid-caps offer an excellent complementary exposure to a global large cap equity portfolio. In particular, the diversifying sector and size characteristics of global mid-cap equity give the opportunity for superior performance and risk outcomes at a portfolio level.

Fidelity's Global Future Leaders Fund offers a compelling opportunity for exposure to the global mid-cap equity asset class. Since its creation in September 2020, this Fund is leading peers in the global mid cap equity space from performance and risk-adjusted performance perspectives.

Of the peers available in Australia, Fidelity is fortunate in being able to utilise a truly global research platform, with a very deep pool of equity analysts and ESG insights. Combined with skilled and experienced portfolio managers, the Fidelity Global Future Leaders Fund is able to offer exposure to this asset class.

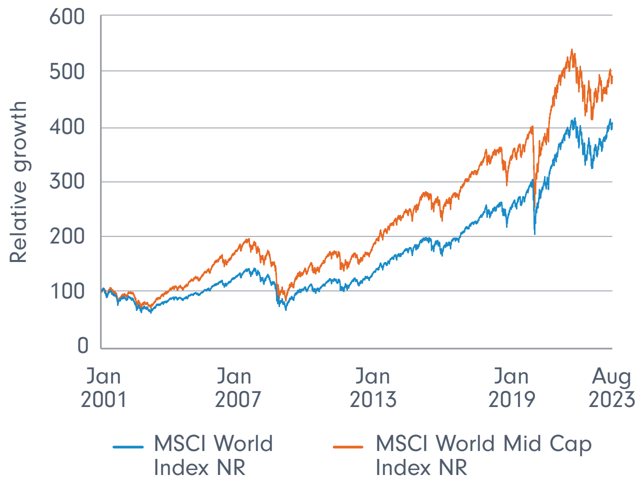
Environmental, social and governance factors are increasingly important in the management of portfolios. Fidelity has considerable expertise in these areas and the investment process has deeply embedded these considerations in the management of the portfolio.

Allocating to global mid cap equity – what is the broad rationale for this asset class?

There is a strong investment rationale for considering the addition of a global mid cap equity allocation to a broader portfolio of equity assets. This section looks at some of the arguments why this makes sense.

Firstly, let's look at the performance of the global mid-cap equity market in comparison to global large cap equity - see Figure 1 below.

Figure 1. Market performance history: Returns since 1 January 2001



Source: FactSet, data to 31 August 2023

This chart shows the longer-term performance of global large cap equity, as measured by MSCI World, and global mid cap equity since 2001. We can draw the following conclusions:

Global mid-cap equity has performed ahead of MSCI World, which represents the large cap equity universe, over the longer term. Whilst there have been shorter term periods when large cap equity has outperformed mid-cap equity, the longer term return premium available from global mid-caps is clear.

We have considered return outcomes over the longer term as it is usually wise to consider longer term outcomes - timing shorter term effects is often difficult and unreliable.

If we now consider both risk and return, we can look at Figure 2 below:

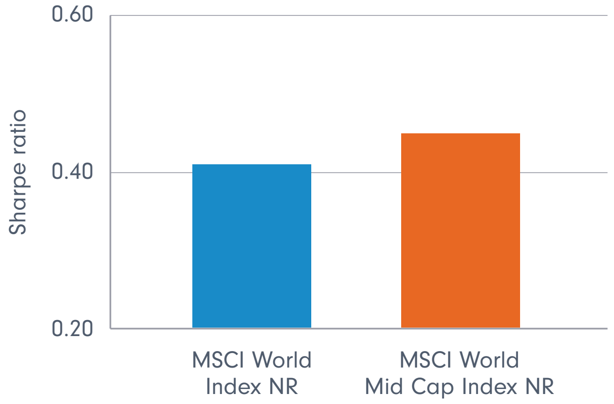
Figure 2. Risk and return since 1 January 2001

Source: FactSet, data to 31 August 2023

Figure 2 shows that while returns on mid cap equity are higher (vertical axis), this does come at the price of slightly higher volatility of returns (a common measure of risk – the horizontal axis). This would be expected and reflects the **risk premium** of global mid-cap stocks versus large cap stocks.

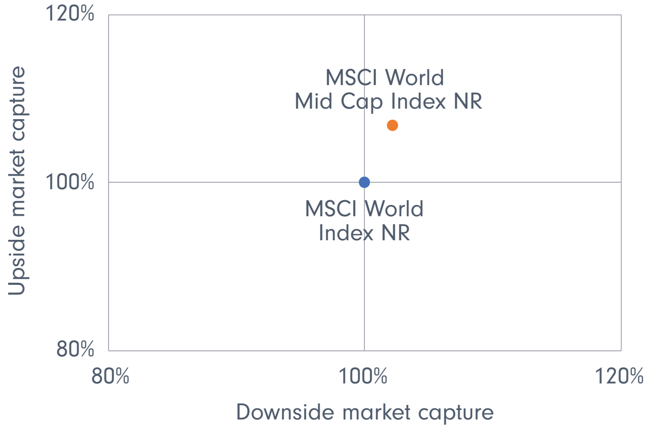
So, whilst there is some additional risk with mid-cap stocks, as measured by volatility, we saw previously that mid cap stocks also have produced additional returns versus large cap stocks over the longer term. So, it is then useful to consider a risk-adjusted return measure – how much does this additional return 'cost' in terms of additional risk? One useful measure for this is the Sharpe Ratio (the return above a risk-free rate per unit of risk, where risk here is measured as the volatility, or standard deviation, of monthly returns). Figure 3 shows the result here.

Figure 3. Risk adjusted return – Sharpe ratio since 1 January 2001



Source: FactSet, data to 31 August 2023

Figure 4. Upside/downside capture



Source: FactSet, data to 31 August 2023

The Sharpe ratio for mid-cap equity at the index level compares favourably over the longer term to the large cap global equity market. So, it is arguable that the extra returns achieved with mid-caps has not come at the price of excessive risk, relative to the broader market. Indeed, we can conclude that global mid-caps may provide an attractive risk-adjusted outcome for investors.

Another useful characteristic for an equity investment is to consider the 'upside/downside' capture behaviour. This is a useful measure to consider the relative volatility of mid-caps as an asset class compared to the broad market when markets are moving up or down. Figure 4 shows up-market and down-market moves relative to the broad market index.

Essentially, it shows that mid-caps move slightly more in both down-markets and in up-markets versus the broader market. This can be described as having a slightly higher **beta** relative to the broad market. When markets are up, the mid-cap index is also up on average by a slightly greater amount. And when markets fall, the chart indicates that on average the mid-cap stocks fall by slightly more than the market. However, as we noted from Figure 3, the Sharpe ratio is slightly better for the mid-cap index over the longer term. Which helps us conclude that the mid-cap index, whilst being slightly more volatile than the large cap index, is delivering a slightly better outcome when considering the modest extent of additional volatility.

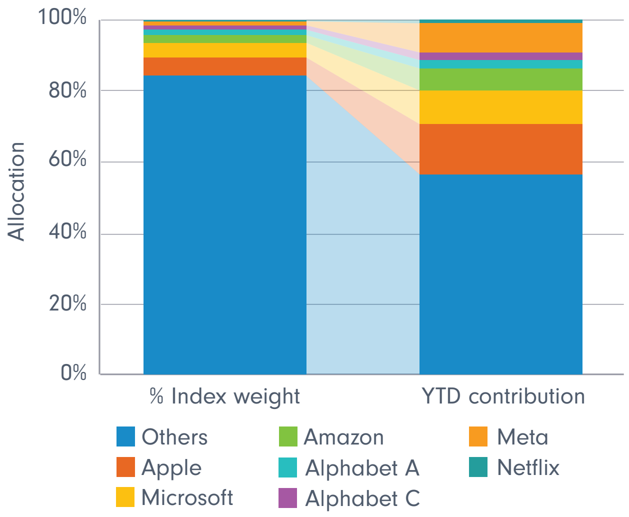
Market concentration issues with the large cap global equity universe

Many investors will be aware that the large cap US equity and global equity markets have been driven to a large extent over recent years by a small number of mega cap technology stocks. These stocks have come to be known as the MANAMA stocks (i.e. Microsoft, Apple, Netflix, Amazon, Meta, Alphabet). The growth of these tech-related names has been so strong in recent years that they have made an outsize contribution to performance of the World index overall.

Figure 5 below shows the extent to which the MANAMA stocks have driven performance of the overall market indices since the start of the year – it is quite extraordinary to observe the extent to which these stocks have driven the overall performance of the market.

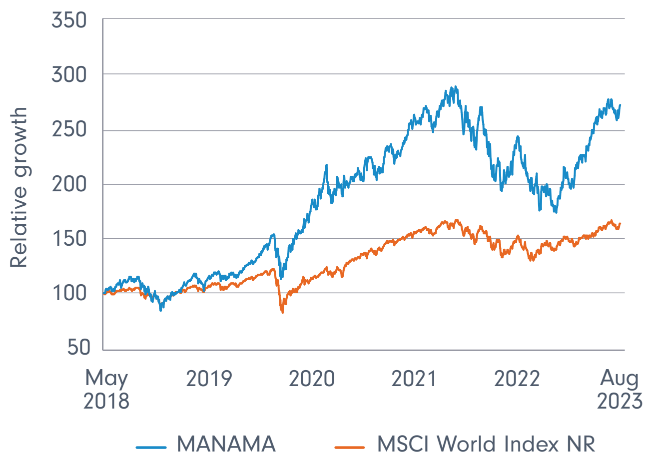
In fact, when we consider longer time periods, we observe that these MANAMA stocks have been drivers of index performance for longer periods also, see Figures 6 and 7.

Figure 5. Market weight vs contribution to MSCI World index performance, 1 January 2023 to 31 August June 2023



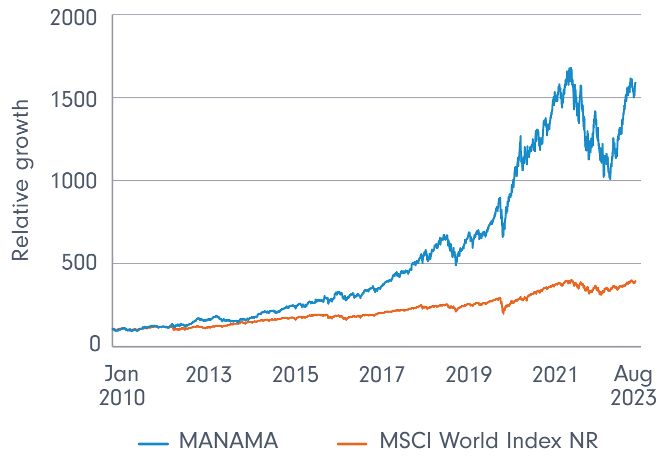
Source: FactSet, data to 31 August 2023

Figure 6. Relative performance of MANAMA stocks vs MSCI World (5 years)



Source: FactSet, data to 31 August 2023

Figure 7. Relative performance of MANAMA stocks vs MSCI World (since 2010)



Source: FactSet, data to 31 August 2023

It is difficult to argue that the performance of a handful of stocks that drive a large proportion of the overall market performance is a sustainable or desirable characteristic for the market over the longer term.

Yet this is the experience of the MSCI World index over the last several years. It is arguable that this exposes the index to a high level of risk if any one or more of these stocks were to perform poorly in the future. It also makes it hard for large cap global equity managers to sustainably perform well against a market index with these characteristics.

One benefit of the mid-cap stock universe is that it is far more diversified than the large-cap MSCI World index. There are no single stocks, or groups of stocks, dominating this market and no stocks that are more than a small percentage of the overall market. The market is also more diverse on a sector level, with a much lower concentration in the tech sector, this sector having dominated MSCI World performance for some years – see Table 1 below.

Sector weightings in the large cap MSCI World index and mid cap sectors are also quite different. In particular, the table below shows that the weighting to IT is much lower in the mid cap market. Outside of the IT sector, whilst the differences between the indices are not dramatic, the sector distribution is a little more evenly distributed with the mid cap index – see Table 2 below.

Further, by virtue of having a much lower weighting to IT, a mid-cap exposure offers, at a sector level, an excellent complementary exposure for a portfolio with large cap exposure. This is an important portfolio construction consideration.

Table 1. Top 10 stocks by index weights – comparison of market indices

MSCI World Index	% of index	MSCI World Mid Cap Index	% of index
Apple Inc.	5.2	ON Semiconductor Corp	0.5
Microsoft Corporation	4.1	Copart Inc.	0.5
Amazon.com, Inc.	2.2	DR Horton Inc.	0.4
NVIDIA Corporation	2.1	AMETEK Inc.	0.4
Alphabet Inc. Class A	1.4	Baker Hughes Company Class A	0.4
Alphabet Inc. Class C	1.3	Trade Desk Inc. Class A	0.4
Tesla, Inc.	1.3	Constellation Energy Corp	0.4
Meta Platforms Inc. Class A	1.3	CoStar Group Inc.	0.4
Berkshire Hathaway Inc. Class B	0.8	Ferguson Plc	0.4
Exxon Mobil Corporation	0.8	United Rentals Inc.	0.4
Top 10	**20.4%**	**Top 10**	**4.3%**

Source: FactSet, 31 August 2023.

Table 2. Sector weightings – MSCI World & Mid Cap Indices

MSCI World sector	% index weight	Mid cap sector	% index weight
IT	22.2	Industrials	19.8
Financials	14.7	Financials	13.6
Health Care	12.7	IT	13.0
Consumer Discretionary	11.0	Consumer Discretionary	10.3
Industrials	10.9	Materials	8.7
Communication Services	7.3	Health Care	8.1
Consumer Staples	7.3	Real Estate	7.0
Energy	4.9	Utilities	6.1
Materials	4.1	Communication Services	4.8
Utilities	2.7	Consumer Staples	4.4
Real Estate	2.4	Energy	4.2

Source: FactSet, 31 August 2023.

Breadth of opportunity in global mid-cap equity

The **Fundamental Law of Active Management** is a well-regarded approach to portfolio management theory. Essentially the law states that, when investing in a particular market, superior investment outcomes can be more readily achieved when there are two key elements in place:

1	An investment manager has **superior insight** into the market in question (we will come back to this later).
2	There is a significant **breadth of opportunity** in the market.

Focusing on the second element here, the breadth of opportunity in large cap equity is drastically reduced by the dominant behaviour of a few large cap stocks that are driving a majority of the performance. It becomes much harder to 'pick the winners' in a market with a much narrower set of drivers. Many active managers, unsure of what to do with these stocks, elect to hold weightings that are close to index weight to mitigate the risk to their overall performance from these few stocks. In contrast, the mid-cap universe of stocks is far more diverse as we have seen above. Consequently, this type of 'index-hugging' behaviour is not generally observed in mid-cap portfolios and is not needed to mitigate index-relative risk. For these reasons, we can argue that active management is much better placed to add value relative to the market index in mid-cap stocks.

Trading costs

One misconception with investing in global mid-cap stocks is that the trading costs would be expected to be much higher. Whilst average trading costs are a little higher than for the large cap universe, the extra cost is not significant. See Table 3.

Table 3. Comparative trading costs across markets

Index	Average trading cost
MSCI World Mid Cap Index	0.13%
MSCI World Index	0.08%

Source: FactSet, 31 May 2023

Market size

There are some potential misconceptions about the size of stocks in the mid-cap universe. If we compare the range and average of stock size capitalisation in the ASX 300, MSCI World and MSCI World Mid-Cap indices, this will help comprehend the relative scale of the opportunities available.

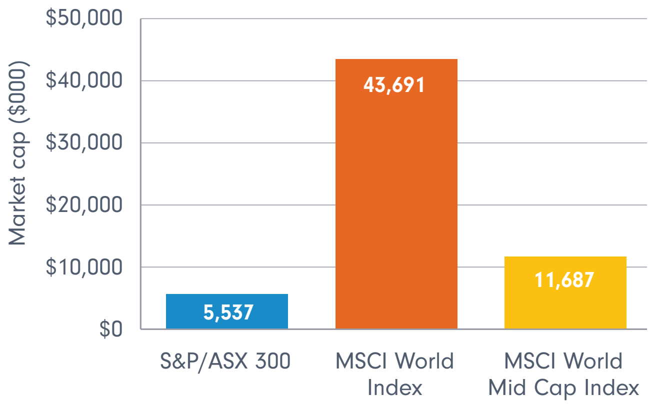
The MSCI World Mid Cap Index consists of around 900 listed companies, with a market cap range for those companies of around US$1 billion to US$40 billion. This index is a sample of the available opportunity set with there being a further approximately 3,000 listed mid-cap companies in the investing universe that are not included in the MSCI Mid Cap index.

In the MSCI World Index, there are around 1,600 listed company constituents with a market cap range of US$1 billion to US$2,900 billion. This compares to the ASX 300 index, which consists of companies in the market cap range US$90 million to US$150 billion.

The total market size of the global mid-cap investing universe as defined by the MSCI Mid Cap Index is approximately US$8.3 trillion, which is around **six times larger** than the Australian stock market capitalisation (ASX 300) of AUD$2.1 trillion, based on current exchange rates.

Figure 8 below shows the average market cap range of the various indices. It shows that the global mid cap index has a larger average market cap than the ASX 300. So, whilst the largest companies in the ASX 300 are larger than the largest companies in the mid cap index, the global mid cap index is significantly larger on average than companies in the ASX 300. This should allay any concern that by holding an allocation to global mid-caps that investors are investing in small, illiquid names that are difficult to trade.

Figure 8. Average market cap of different equity indices



Source: FactSet, 31 August 2023

Broker coverage

One appealing element of the global mid-cap investment universe of stocks is that it is less well covered from an investment broker research perspective than the global large cap universe. This lower level of coverage, together with a large number of individual stocks– around 900 in the index and a further 3,000 in the universe of investible stocks – creates a ripe opportunity set from which to add value relative to the index.

Table 4. Broker coverage comparison between markets

Index	Average number of brokers covering each stock
MSCI World Index	19
MSCI World Mid Cap Index	13

Source: FactSet, 31 August 2023

Why should investors consider an allocation to global mid-caps?

Mid-caps sit in what might be called the 'sweet spot' between large cap and small cap stocks. They can offer more growth than large-caps with less risk and volatility than small and micro-caps. Indeed, if we look back over the past quarter of a century or so, global mid-caps have generated higher returns than large caps.

The mid-cap universe is home to many potential 'multi-baggers' – companies that have the potential to grow many multiples of their current value. The segment is under-researched compared to their large-cap brethren as we saw from Table 4 on the previous page.

Fewer investors researching these names increases the likelihood of high-quality business flying under the radar, allowing for mispriced opportunities. Investors can also quite often 'miss the forest for the trees', not realising that there are well-established businesses with strong track records alongside the more obvious listings of newer companies and business models.

Many of these businesses are also founder-led. This increases the likelihood that management teams are innovative, agile, and their interests are strongly aligned with outside shareholders. In Fidelity's experience, the best ideas or 'future leaders' in the global mid and small-cap universe are typically business models that are either structural winners, technology disruptors, innovators, category killers and/or brand leaders.

Sometimes these businesses are unique niche operators or specialists who dominate their field. At other times they are part of a large global theme. Sectors such as technology, health care, globally focused consumer, and industrials have more recently been home to such business models.

Why does a dedicated exposure make sense?

One argument investors may have against a dedicated exposure to global mid-caps is that exposure to this sector is already being achieved with their large cap global equity managers – because these managers will typically hold some stocks from mid-caps.

Data from eVestment shows that the median large cap global equity manager typically holds 20% to 25% of their portfolio in mid-cap stocks. So the argument that some investors make is that exposure to mid-caps is already being achieved, so why should an investor also hire a mid-cap manager?

So, to answer to this question, we should consider whether large cap managers possess the skills to invest in mid-caps. Large cap managers will generally spend most of their time analysing the biggest stocks in their portfolio – as these are the stocks that drive most of their performance and these are the stocks that will determine how they fare relative to the benchmark large cap index. So, what we need to consider is whether large cap managers have been able to add any value holding mid-cap stocks. An insight into this can be gained by looking at attribution analysis – consider Table 5.

Table 5, sourced from the median performance of 305 global large cap equity managers available to investors in Australia in the eVestment database, shows that over all periods over the last five years, the mid-cap element of the median active global equity manager has significantly underperformed relative to the benchmark index for those managers. So, we can conclude that large cap global equity managers have not, on average, been able to add value relative to their benchmarks through having an allocation to mid-caps.

This result is not unexpected as large cap managers are not necessarily experts in global mid-cap stocks, given that they will generally be less significant stocks in their portfolio, and because large cap managers tend to spend most of their time and effort focusing on the largest stocks in their portfolios.

In addition, as we saw earlier in this report, the global large cap equity market is heavily influenced by the performance of a few mega cap technology names. Global mid-caps offer the opportunity for an excellent diversifying exposure with a greater probability of above-index performance over medium and longer time periods.

Table 5. Median performance of mid-cap element of global large cap equity managers vs index

Index	1 year (%)	2 year s (% p.a.)	3 years (% p.a.)	4 years (% p.a.)	5 years (% p.a.)
MSCI World Index	22.43	7.00	13.44	11.22	11.37
Mid cap element of median large cap manager	18.69	4.48	12.44	8.82	8.96

Source: eVestment, periods to 30 June 2023, 305 large cap global equity products

Why is Fidelity well placed to offer a global mid cap equity fund?

There are a growing number of global mid cap equity managers available to investors in Australia. However, we believe that Fidelity is able to offer an exceptionally strong and capable strategy in this area and is able to differentiate its offering, the Fidelity Global Future Leaders Fund, in a number of ways as follows:

Global research platform

Fidelity has a truly enviable global research platform, with 140 global equity research analysts dedicated to equity research located on the ground across the world. This research platform is one of the largest in the industry and we believe is essential to gain the insights necessary to run portfolios such as these effectively. This also includes a team of analysts dedicated to small-mid cap research across geographies. This is supplemented by our integrated bottom-up, cross-asset research, where our portfolio managers can also access research produced by our fixed income analysts and industry level insight generated by our dedicated sustainable investing team. We believe this depth of substantial, real-time information is outstanding in the Australian marketplace.

Truly diversified global offering

It is critical for a global mid cap offering to be properly diversified and not be focused on a few sectors or countries. Fidelity has extensive global reach and so can offer a fund that is properly diversified by sector and country, with no significant areas of the market excluded due to lack of coverage.

Skills and experience of portfolio managers

The Fidelity Global Future Leaders Fund is jointly managed by two of our experienced investment professionals James Abela and Maroun Younes.

James Abela has over 25 years' investment experience. He started his journey at Fidelity as an investment analyst in 2004 and was subsequently promoted to a portfolio manager in 2013. James' talent managing small to mid-caps domestically is well recognised, with consecutive-year wins in 2018, 2019 and 2020 in the Morningstar Fund Manager of the Year awards, in the Domestic Equities Small Cap Category. James was also awarded Money Management Fund Manager of the Year – Australian Small/Mid Cap Equities – Highly Commended – 2020 and was Category winner: Australian equities – Small Cap in the 2019 Zenith Fund Awards.

Maroun Younes joined Fidelity in 2012 as an investment analyst and has 15 years' investment experience in sectors covering telecommunications, media and technology.

Together, James and Maroun bring a wealth of knowledge of both the Australian and global markets and over a range of sectors. They are both based in our Sydney office, where they collaborate extensively to select stocks and construct the portfolio as they jointly have the ultimate investment responsibility for this product.

Disciplined investment process

The strategy recognises that markets are semi-efficient and share prices do not always reflect inherent worth. To uncover the best opportunities for outperformance, the portfolio managers draw on Fidelity's in-house, bottom-up fundamental research resources detailed in the preceding to build the portfolio. The strategy pivots on a viability-sustainability-credibility (VSC) driven approach, where each investment opportunity is evaluated on multiple dimensions to assess the returns potential as well as the longevity and reliability of the returns' potential.

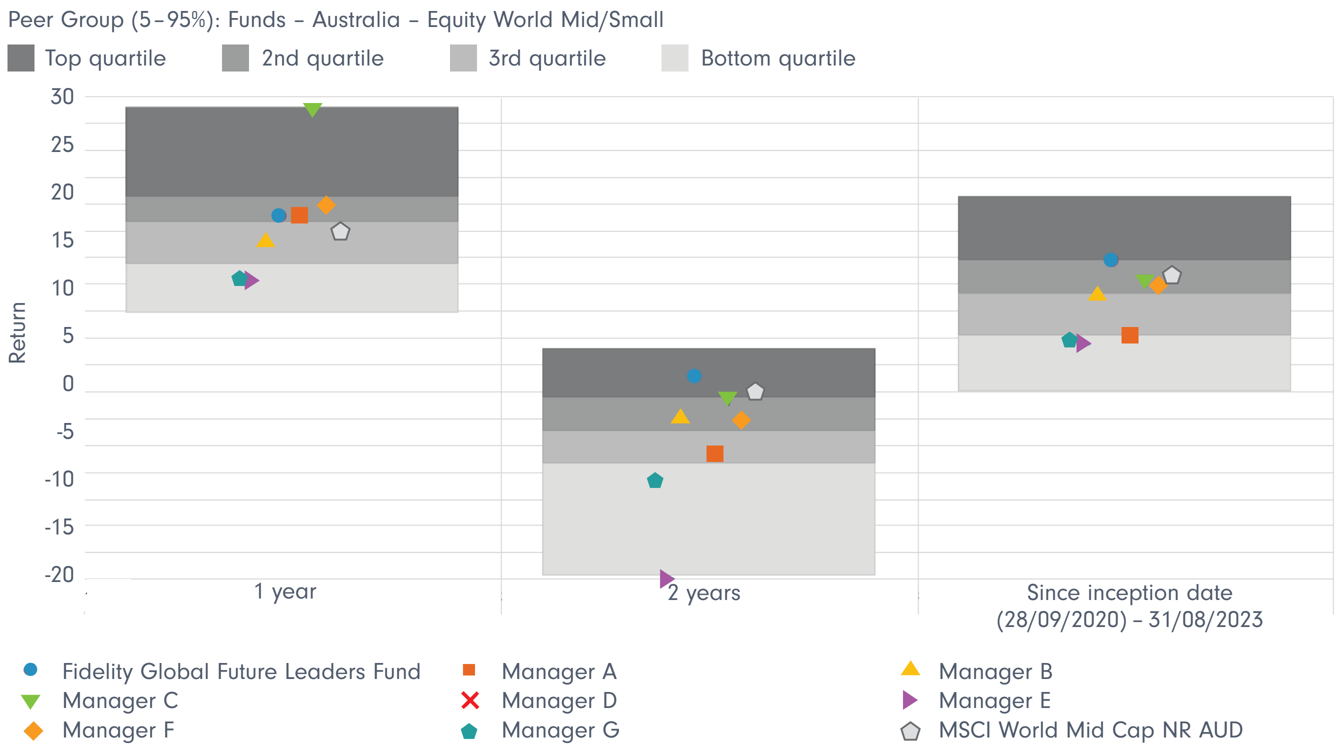
The aim is to find companies that not only grow but also create shareholder value over the long term. The co-managers focus on valuations while constructing the portfolio across Quality, Value, Transition and Momentum (QVTM) categories. Assessing the market across these four segments helps maintain a heightened awareness of opportunities driven by company, sector, industry, and valuation cycles, as well as shifts in market psychology. The managers focus on the sustainability of business practices as an important input in their decision making, as they are of the firm opinion that it is this mindset that aids the delivery of qualitative growth over time.

The final portfolio is typically overweight companies that demonstrate stronger-than-average Viability, Sustainability and Credibility. The portfolio of 40 to 70 stocks is a blend of Quality, Value, Transition and Momentum companies. James and Maroun believe that a balanced portfolio containing stocks across these four segments will deliver more consistent performance through different market cycles compared to a portfolio focused on only one or two of these segments.

If we look at some of the performance and risk characteristics of the Fidelity Global Future Leaders Fund and the range of competitors' funds available (i.e. all global mid cap and small cap equity funds available to investors in Australia, as defined by Morningstar) – see Figure 9 below.

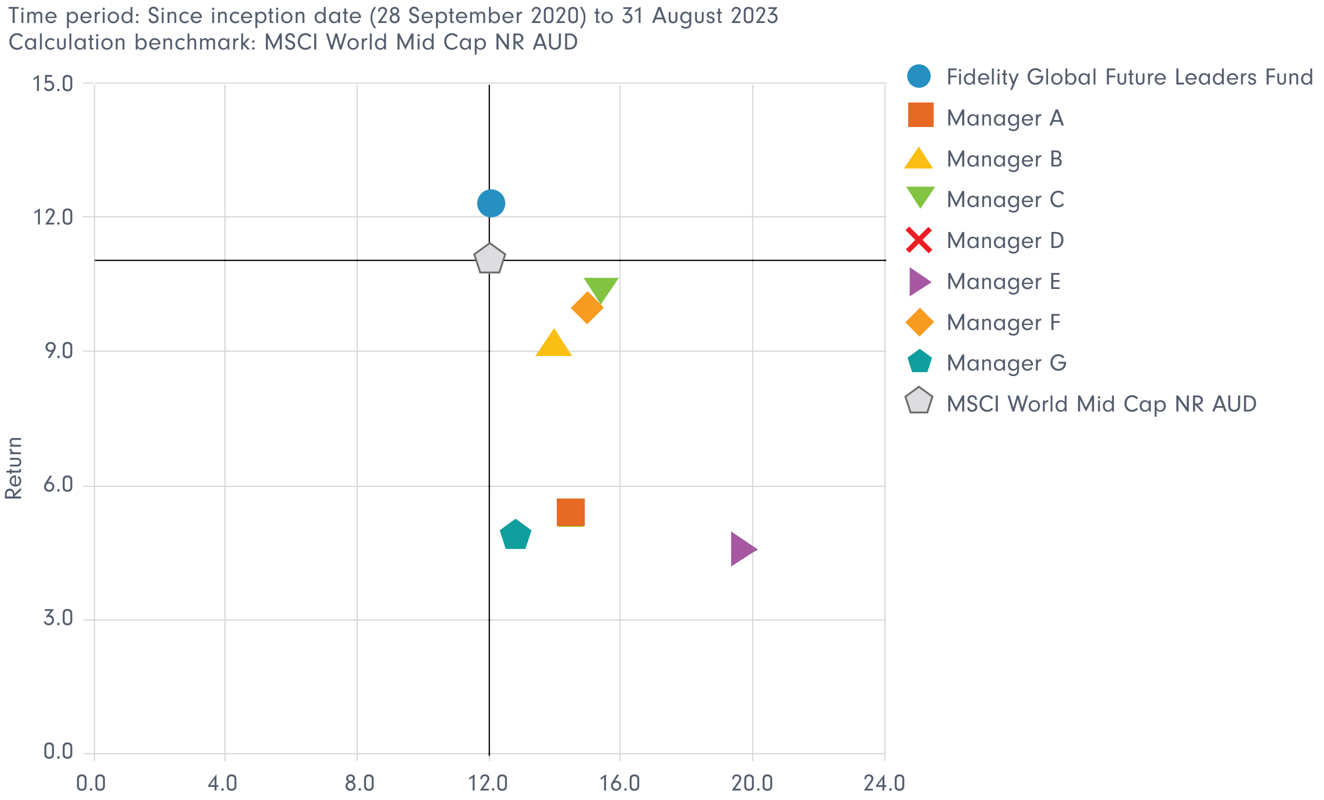
This chart shows that the Fidelity fund has the most consistent performance when compared to the peer group of global mid-cap managers available in Australia and has outperformed all peers since the fund's inception date (28 September 2020).

Figure 9. Global mid and small cap manager universe* – peer relative trailing performance



*All global mid cap and small cap equity funds available to investors in Australia, as defined by Morningstar.
Source: Morningstar Direct, 31 August 2023

Figure 10. Return and risk comparison across peer group



Source: Morningstar Direct, 31 August 2023

Figure 10 shows that the Fidelity fund has both the best performance since inception date (28 September 2020) and has also been taking the least amount of risk, as measured by standard deviation of monthly returns, when compared to all peers. Indeed, the risk level on this basis is virtually the same as for the benchmark index, where the index has around 900 stocks; the Global Future Leaders Fund has a much smaller number of stocks (normally in the range of 40 to 70). This is a very strong outcome.

If we consider risk from a number of other perspectives, we can consider Table 6, following.

Table 6. Risk and return statistics since inception date

Time period: Since inception date (28 September 2020) to 31 August 2023
Calculation benchmark: MSCI World Mid Cap NR AUD

Index	Annualised return	Std Dev	Sharpe ratio	Information ratio (arith)	Beta	Tracking Error	Max Drawdown
Fidelity Global Future Leaders Fund	12.30	12.05	0.35	0.29	0.94	4.40	-19.12
Manager A	5.38	14.49	0.01	-0.69	0.97	8.22	-28.77
Manager B	9.21	13.98	0.19	-0.29	0.99	6.23	-21.66
Manager C	10.35	15.36	0.24	-0.08	1.03	8.08	-27.43
Manager D	–	–	–	–	–	–	–
Manager E	4.57	19.77	0.02	-0.44	1.06	14.57	-43.30
Manager F	10.02	14.99	0.21	-0.16	1.13	6.38	-23.69
Manager G	4.88	12.83	-0.02	-0.85	1.00	7.26	-29.04
MSCI World Mid Cap NR AUD	11.03	12.01	0.28	–	1.00	0.00	-18.18

Source: eMorningstar Direct, 31 August 2023

This table shows a number of useful risk measures, as follows:

Std Dev Standard deviation of absolute returns. A measure of volatility of the portfolio in absolute terms.

Sharpe ratio A measure of the excess return above a risk-free rate per unit of risk, where risk in this case is measured as the standard deviation of returns

Information ratio A measure of the excess returns above the benchmark returns per unit of risk, where risk is measured as tracking error i.e. the standard deviation of relative returns compared to the benchmark index.

Beta A measure of the proportionate extent to which a portfolio moves relative to the market index.

Tracking error A measure of risk relative to a benchmark index – the standard deviation of returns relative to the index over each measurement period (usually monthly)

Max drawdown The largest negative return, peak to trough, over the period in question.

Note: in the calculation of these risk metrics, it is usual to use monthly data.

The table above shows a range of excellent outcomes compared to the index and compared to peers across a number of different, performance, risk adjusted performance and risk measures over the period since the Fidelity Fund was launched.

Another feature of the Fidelity Global Future Leaders Fund is that it is well diversified by sector. If we consider sector weightings across the range of global mid-cap managers available in Australia, see Figure 11 below.

This chart shows that some of the competitor global mid-cap equity funds have quite a narrow sector focus. This is due to some competitors' lack of truly global research coverage, with some of them having to rely on a relatively small, locally based research team. By contrast, Fidelity has one of the most extensive research teams of any global investment manager, with on-the-ground research analysts in many corners of the globe uncovering insights not available to small Australia-based research teams. The chart demonstrates that the Fidelity portfolio is well-diversified across sectors reflecting the broad and deep global research coverage, helping to maximise the opportunity to add value through proprietary insights.

These diversification benefits of the Fidelity Global Future Leaders Fund show through in the lower levels of risk observed in Figure 10 and Table 6 on the previous page.

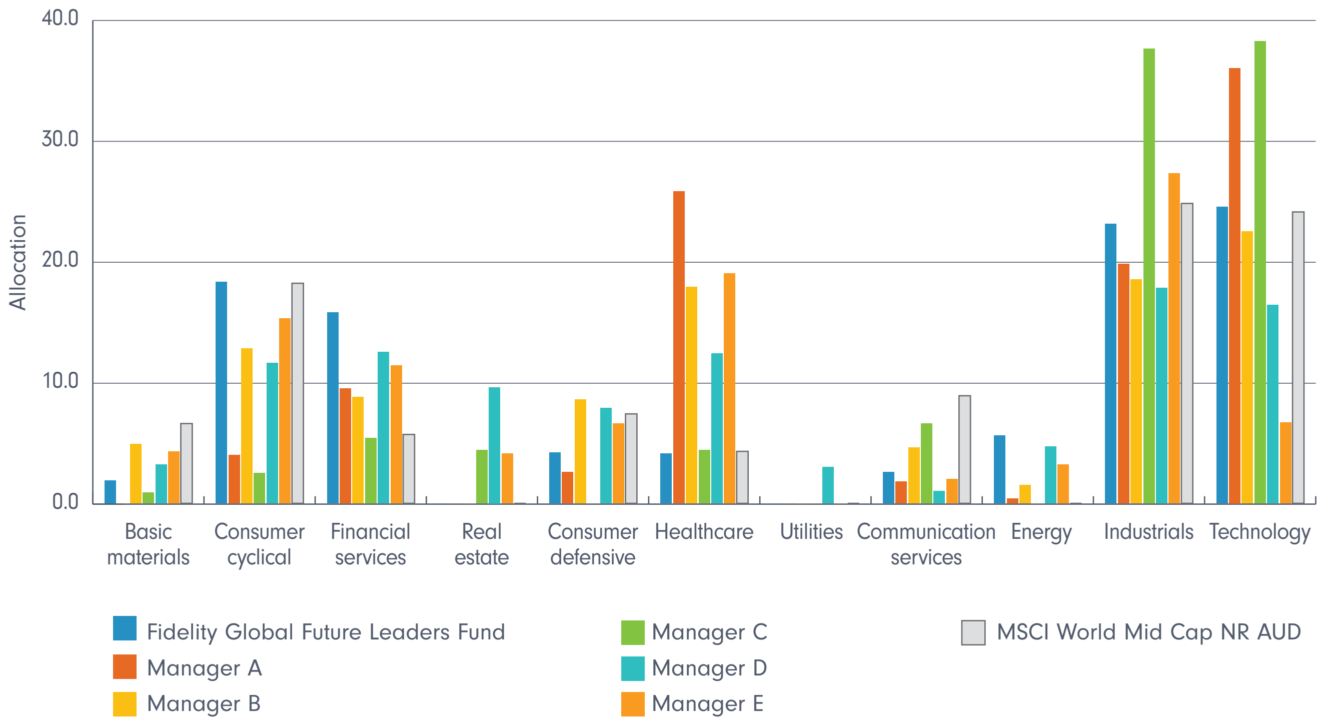
Environment, social and governance considerations

Environmental, social and governance (ESG) considerations are a vital element of the way that the Fidelity Global Future Leaders Fund is managed. These considerations are not only a potential source of additional returns but are also a source of additional risk if not properly evaluated.

Integration of ESG in the Fidelity Global Future Leaders Fund's portfolio construction

The Fidelity Global Future Leaders Fund integrates ESG factors as an important element within the investment process. The Fund has a three-pillar approach summarised as Viability-Sustainability-Credibility (VSC) and ESG is one of the factors within the Sustainability pillar which looks at a business' ability to maintain the business model in the long term. Typically, the high conviction holdings in the Fund are stocks that score highly on the VSC pillars on an aggregated basis, and a material shift in ESG assessment can impact this score in either direction.

Figure 11. Sector weightings of global mid cap managers



Source: Morningstar Direct, 31 August 2023

The portfolio managers predominantly consider Fidelity's proprietary ESG ratings and the in-depth assessment available from the rigorous underlying research that supports these ratings as material insights in their decision-making process. Whilst most stocks in the portfolio will have a proprietary ESG rating, where a stock is not rated by Fidelity, the portfolio managers will refer to external MSCI ratings as an indicator of sustainability characteristics.

Typically, the portfolio holdings will have good ESG characteristics (i.e. A, B or C rated*) as the managers believe that the longevity of businesses and their potential to graduate from small-mid cap stocks to large cap future leaders will depend to a significant extent on their ability to have positive impact on the environment and society. However, this does not preclude the portfolio managers from investing in strong fundamentals-led opportunities that have a lower initial ESG score. Such opportunities would be subject to our due diligence providing insights on the factors that contribute to the lower ESG rating, and that the managers having conviction that the ESG rating trajectory would subsequently improve and that there is a scope for effectively engaging with the company on the issues of concern. The managers remain strong advocates for analyst-led sustainability engagement with portfolio companies and extend their complete support to issues that our analysts deem as important.

Quarterly sustainability review

Monitoring of ESG characteristics for the Fidelity Global Future Leaders Fund occurs through the Quarterly Sustainability Review (QSR). This process aims to measure and monitor progress of a fund and demonstrate how sustainability is incorporated into fund portfolio construction and how it influences investment decisions. The review process, which sits alongside the Quarterly Financial Review of funds, involves a collaborative effort across various teams and is run by senior management and chief investment officers together with the Sustainable Investing team.

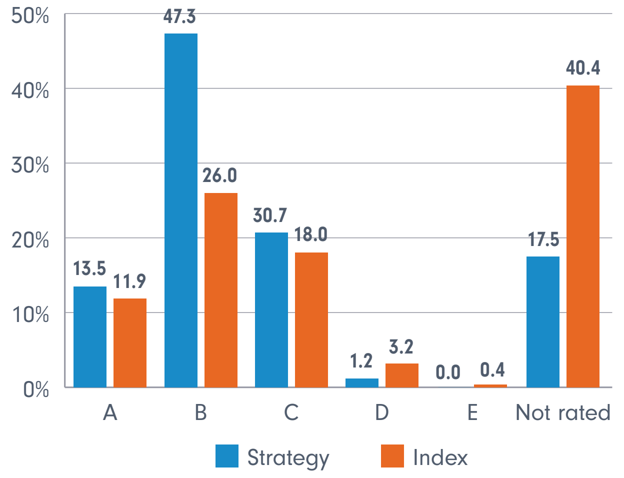
Active ownership

We aim to be active owners with the companies that are held within the Global Future Leaders' strategy. This involves engaging with companies on ESG issues with the aim of improving long-term investment outcomes. Investors play an important role in encouraging companies to improve their ESG practices and have many tools at their disposal to support companies in their transition strategies, ultimately in the long-term interest of clients. Fidelity's scale affords us a significant level of corporate access. We use this to influence corporate behaviours through shareholder dialogue with companies and voting at company annual general meetings (AGMs), and we seek to engage with policy makers and regulators, in instances for example where there are common market barriers to companies progressing towards their sustainability goals.

***About Fidelity's ESG ratings:** Fidelity ESG ratings aim to provide a forward-looking assessment of the extent to which an issuer's performance on material sustainability issues supports or is likely to impair long-term value creation for shareholders. Fidelity's ESG ratings seek to measure how an issuer manages negative ESG externalities and material business risks. The assessment seeks to provide a granular and forward-looking view of an issuer's ESG performance with an overall rating, E/S/G pillar score, together with a trajectory rating (i.e. if the rating is likely to improve or decline in the future). The ratings are used to inform and supplement the portfolio managers' decision to buy, hold or sell a position. They are also used for monitoring a fund's ESG profile to comply with regulations (e.g. reporting principal adverse impacts), prioritising engagement with companies, client communications and reporting.

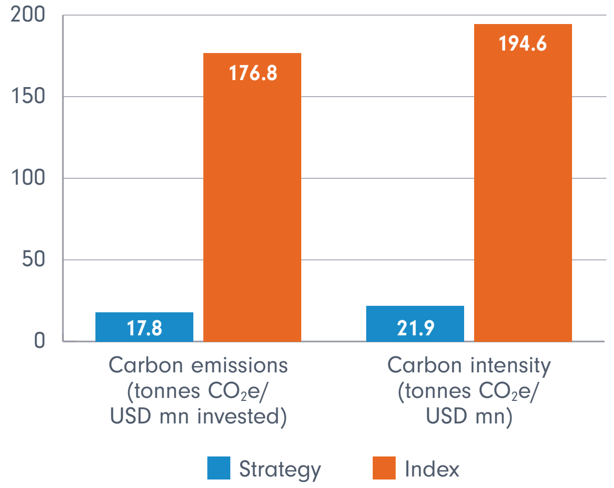
To give some insights on the ESG characteristics of the Fund, the charts below show the proprietary ESG ratings and carbon footprint breakdown of the Fund versus the index.

Figure 12. Fidelity proprietary ESG profile of Fidelity Global Future Leaders Fund (% NAV exposure)



Source: Fidelity International

Figure 13. Carbon footprint of Fidelity Global Future Leaders Fund



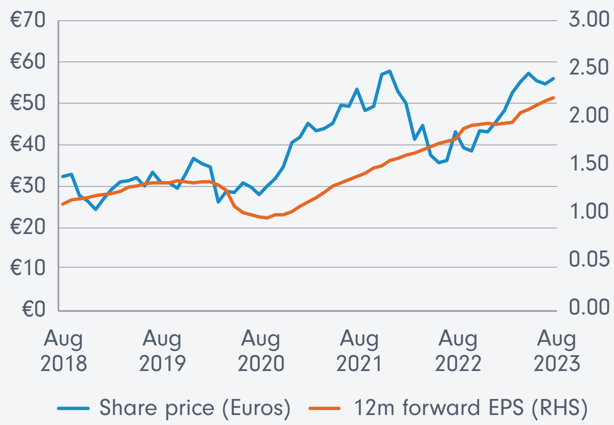
Source: Fidelity International

Stock examples

It is useful to consider some examples of stocks held in the Fidelity Global Future Leaders portfolio. The three stock examples following have been held by the Fund since the fund inception (September 2020) and, as at time of writing (August 2023), are still held in the portfolio.

Moncler owns luxury outwear brands Moncler and Stone Island, and as a global luxury brand penetrating new middle-class led markets, it benefits from middle class consumers, particularly in emerging markets, upgrading their consumption preferences as they lean towards aspirational purchases. On one hand, outwear demand is fragmented and Moncler's strong brand proposition in this segment is attractive, it has also been observed that luxury demand is less impacted by inflation. It is equally important to understand seasonality in demand while assessing financials and valuation. Moncler also scores high on good governance, where its score is vastly superior to peers and particularly strong for a luxury company with a dominant shareholder.

Figure 14. Moncler 5-year share price and EPS

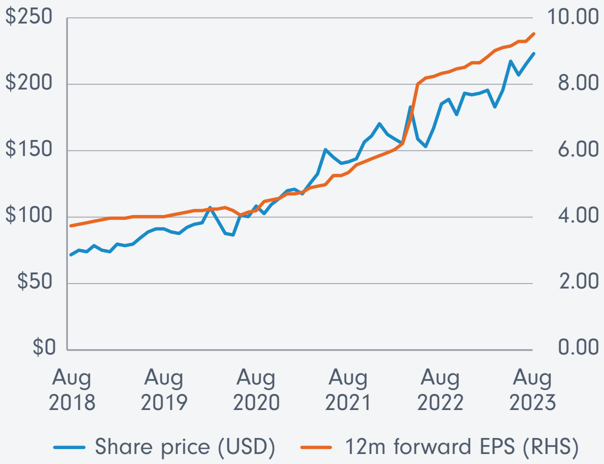


Source: Refinitive

Gallagher

Arthur J Gallagher and Co is an insurance broker and provides risk management services. The company intermediates between a variety of insurers and clients, where it neither assumes risk nor is responsible for claims to be paid. It charges fees as a percentage of premiums that have been rising with inflation. The business is capital light and highly cash generative, which has enabled Arthur J Gallagher to build a good track record of growth through acquisitions. There is an additional tailwind from clean-energy tax credits that it previously earned via green investments that support its cash flows. As a result of its higher exposure to broking (mostly commission based), the company has been able to show good growth through the economic cycle. The backdrop for revenue growth at Arthur J Gallagher remains favourable given an increase in insurance demand and the company's ability to grow its market share.

Figure 15. Arthur J Gallagher 5-year share price and EPS



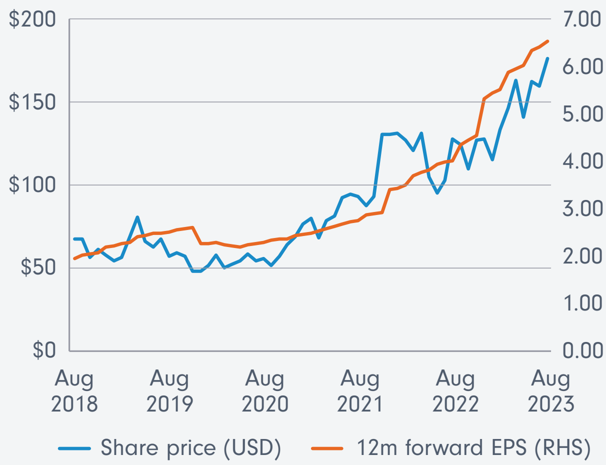
Source: Refinitive

ARISTA

US-based **Arista Networks** provides cloud-based networking software solutions for internet companies, cloud service providers and data centres for enterprise support. It is a long-term compounder with a strong runway for growth both in the cloud and enterprise solutions markets. Arista provides network switches that speed up communications among racks of computer servers. Such switches are essential to hyperscalers – the likes of Google, Microsoft and Meta (Facebook).

One of the important structural growth opportunities underpinning the prospective demand for such switches is Generative AI, which is a type of artificial intelligence technology that can produce various types of content, including text, imagery, audio and synthetic data and thus needs substantial computing capabilities.

Figure 16. Arista Networks 5-year share price and EPS



Source: Refinitive

About Fidelity International

Fidelity International offers investment solutions and services and retirement expertise to more than 2.52 million customers globally. As a privately held, purpose-driven company with a 50-year heritage, we think generationally and invest for the long term. Operating in more than 25 locations, we invest A$572.7 billion globally on behalf of clients in the Asia-Pacific, Europe, the Middle East and South America. We are responsible for **A$235.5 billion** in assets under administration.*

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If you require any assistance please contact us on **1800 119 270** (Adviser Services)

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*Data as at **30 June 2023**. Read more at fidelity.com.au