Investing outside the top 20

by Paul Rickard

Key points

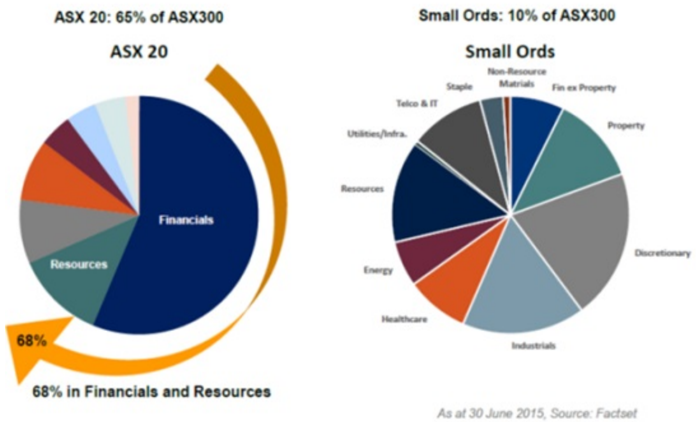
- *Investing in the top 20 stocks has been a pretty good strategy over the last few years. However, in 2015, the top stocks have come under pressure.*
- *One way to diversify outside of the top 20 is through a managed fund like Investors Mutual's Future Leaders Fund. Compared to its benchmark, it has outperformed over most periods.*
- *Other fund managers in this space include Eley Griffiths, K2, Pengana Capital and Perpetual*.

The August reporting season highlighted a key challenge facing our top companies – flat or low top line sales growth. There is only so much "squeezing of the lemon" that can be done on the cost side, and if sales aren't growing, bottom line growth stagnates.

With our top 20 companies, this is even more of a challenge because they are dominated by banks and resource companies. The latter are doing it tough due to falling commodity prices and top line growth is negative, while the banks are struggling to grow earnings per share as they increase their capital ratios.

Investing in the top 20 stocks has been a pretty good strategy over the last few years. In the five years to 31 August, the top 20 index returned 8.81% per annum, compared to 7.91% per annum for the S&P/ASX 300. However, this has turned down in 2015 as the top stocks have come under pressure. For the first eight months of the year, the top 20 lost 3.09% compared to the broader market's loss of 0.67%.

Sector Weightings – Top 20 vs Small Ordinaries (stocks ranked 101 to 300)



The smaller end of the market, represented by the Small Ordinaries Index, which covers stocks ranked 101 to 300 by market capitalization, has a very different sector composition to the top 20 (see chart above) and is much less concentrated. With the lower Australian dollar expected to be of assistance to some companies in the industrial and consumer discretionary sectors, there has arguably never been a better time for investors to consider diversifying outside the top 20.

One way to do this is to through a managed fund, such as Investor Mutuals Future Leaders Fund.

Investors Mutual Future Leaders Fund

The Future Leaders Fund invests in a diversified portfolio of quality companies outside the Top 50 shares listed on the ASX. Investors Mutual is a "bottom up", active manager, and considers companies that are reasonably priced and that have four clear, quality characteristics:

- Competitive advantage
- Recurring earnings
- Capable management
- The ability to grow over time

The Future Leaders Fund invests 80% to 100% in Australian equities (cash is 0% to 20%), and typically holds around 50 securities. The top 10 holdings as at 31 August were as follows:

- Energy Developments
- GWA Group
- Pact Group
- Amalgamated Holdings
- Ansell
- Bank of Queensland
- Steadfast
- AusNet Services
- Amaysim
- Fletcher Building

The performance of the $330 million Future Leaders Fund has been consistently strong. Compared to its benchmark of the S&P 300 excluding the Top 50 stocks and excluding Listed Property Trusts, it has outperformed over most periods as the following chart shows.

Performance to 31 August 2015

	IML Future Leaders	ASX300 Ex 50 Ex LPT	Outperformance
1 month	-2.91%	-4.71%	+1.80%
3 months	-4.31%	-9.59%	+5.28%
1 year	+15.92%	-2.28%	+18.20%
3 Years p.a.	+16.55%	+7.61%	+8.94%
5 Years p.a.	+13.28%	+3.11%	+10.16%
Since Inception p.a.	+11.39%	+7.69%	+3.70%
Inception Date		30-Apr-02	

The manager also says that fund has been more resilient in falling markets, and that the risk of the fund (as measured by the volatility of the returns) is lower (standard deviation of 11.6 for the fund versus benchmark of 16.6). Higher returns at lower risk!

The manager

Investors Mutual Limited (IML) is a specialist Australian equities fund manager, established in 1998 by Anton Tagliaferro. With circa $6 billion under management, IML is a highly-awarded fund manager. It is owned by its key investment staff and the ASX-listed company, Treasury Group Limited (TRG).

Simon Conn manages the Future Leaders Fund.

IML charges a management fee of 0.993% pa (including GST), and is also entitled to a performance fee of 15.375% (including GST) of the performance in excess of the benchmark (S&P/ASX 300 Accumulation Index excluding S&P/ASX 50 and Listed Property Trusts).