Welcome to the latest episode of Conversations. This year, we're focused on the "The Long View." CEO Damien McIntyre will be joined by investment managers and strategists from across GSFM's partner network to explore the long-term outlook for their respective specialties. While we will continue to monitor and address short-term market noise – recognising its power to shift long-term outcomes – our primary goal is to provide you with a clear, strategic perspective on the enduring trends shaping the future of investment.

Today, Damien is in conversation with Tim Carleton from Auscap Asset Management. In the run up to the reporting season, Tim and Damien discuss the short- and long-term outlook for Australian equities, with particular emphasis on Tim's preferred sector – Aussie mid-caps.

Before I hand over, I need to read this important notice:

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Damo and Tim, the microphone is all yours.

Damien McIntyre

Thank you very much, Tracey. Welcome Tim, how are you?

Tim Carleton

Very good. Thank you, Damo. Nice to be here.

Damien McIntyre

By way of background, Tim is the founder and chief investment officer of Auscap Asset Management, and Auscap is our most recent partner focusing on Australian equities. Today, our conversation is around the Australian mid-cap sector in particular. We really want to delve into why it's such an attractive hunting ground for returns, not just right now, but in the future. So, Tim, if you don't mind, I might just lead with that question.

Tim Carleton

If we think about duration, the total return that any investor receives from investing in equities becomes closer and closer to a function of two things the longer they're invested, and those two things are earnings growth and the dividend yield that they receive.

So, it's very important to find businesses that you're invested in that are going to grow their earnings over time. When we think about the Australian market, we break it down into three sections. First, you've got the large caps, the Australian large caps, which we would broadly classify them as the top twenty companies by market capitalisation. They really dominate the domestic indices. In the ASX-200, they represent sixty percent of the index, and therefore they make up sixty percent of most investors' portfolios. A lot of those companies are very well established, but they have limited opportunities for further share gains, and so their growth going forward, we think, is going to be anaemic. And that's before we consider the individual circumstances of some of those businesses.

If you think about the banks or the telcos or the supermarkets, they are facing increasing competitive threats on a go-forward basis that may make earnings growth challenging and may even disrupt their existing earnings. And so, we don't think that that is a particularly attractive part of the market.

Twenty-five percent of the ASX-200 is in the banks. The banks are facing their first serious competitor in decades in Macquarie, which is coming to the mortgage market with a competitive advantage, being a lower cost to serve, which gives them enormous ability to take share, and that's what they've been doing for the last decade, and we expect that will continue to be the case.

If you go to the other end of the market, a lot of small and micro-cap businesses in the domestic market are subscale. They're not the major player, so therefore they have inferior economics to their larger peers that have the economies of scale to deliver stronger revenue and earnings growth over time.

And those companies really dominate the mid-cap part of the market. In Australia, we've got quite a lot of companies that you could think about that are the largest in their sphere, and yet there's still plenty of opportunities for organic share growth and expansion into adjacent categories. So, think about businesses like Resmed or Carsales or JB Hi-Fi or Reece. These are businesses that we think will have long runways of strong revenue and earnings growth, and we think over time that will lead to much better total returns than other parts of the market. We're focused there because of the attractive qualities of those companies, not just for the sake of being focused on mid-caps. We think they'll deliver the best risk-adjusted returns and, to be honest, the best overall return profile.

Damien McIntyre

So, what makes the Australian mid-cap sector such an attractive hunting ground for returns right now?

Tim Carleton

Well, it's a very interesting market. We've seen over the last six months that quality midcaps have significantly derated, and they're now probably trading at their most attractive valuations in quite some time. And there's a few reasons for this, and most listeners will identify with many of these.

There's been a huge trend towards passive investing over the last few years, and this seems to have accelerated in the last 12 months. And obviously in 2021, the Your Future, Your Super rules came into being, and they have really encouraged large super funds to look very similar compositionally to the index for each of their different asset classes, including Australian equities. I think we've seen that trend accelerate, and you've seen active managers generally lose a lot of mandates, and those mandates have been going to passive or passive-like strategies. And what generally happens there is your active managers will be overweight these faster-growing, high-quality businesses in the midcap universe, and they'll often be underweight some of the largest businesses. So, when the money leaves active and goes to passive, you see this trend towards the larger caps outperforming, and the smaller and midcaps have selling pressure.

In addition to that, we've had a number of developments in the market. There have been developments in AI, and that's done two things. That's attracted a lot of capital towards particular companies that are viewed as beneficiaries in the short term. And because there's only so much capital in listed markets, definitionally, that has pulled capital out of other areas, particularly areas that are potentially at risk. We saw the so-called SaaSpocalypse. It was really a trend away from existing technology-based businesses that were perceived to potentially be at risk by developments in AI.

And then on top of that, we've had the conflict in the Middle East that's leading to concerns around higher energy prices and therefore more persistent and higher inflation than the market had anticipated. There are some concerns there that this will result in higher interest rates over time, and the potential for that to impact consumer spending and the discretionary companies within the ASX, most of which sit outside the ASX 20.

Then lastly, more recently we had the budget changes around taxation of capital gains, and that's led to concerns around house prices and, and again, the health of the consumer. And so, you put all of that together, and we end up with a market that is reasonably euphoric in areas that are perceived to be the winners from these AI developments. You end up with very expensive large caps, many of which are trading at near record multiples of earnings despite anaemic earnings growth. And then you end up with a whole lot of very high-quality businesses across a range of sectors – healthcare, technology, retail, insurance, communications – and really, they're on sale when you consider their price to earnings multiples over time. Most of them are trading at or near the lows of their historic price earnings multiple range if we go back over the last decade or two.

The setup from this point in time looks reasonably opportunistic from an active manager's perspective, and that is of course happening at the exact time when active managers have been under the most pressure that they've faced probably in the last decade.

Damien McIntyre

Now, AI, it drives the market up or down on any given day. And as you say, I mean, capital is rotating either into the AI trade or out of the AI trade more frequently now than it has in the year or so prior. So, I want to ask you two questions. The first question is, when you see a company plough money into AI investment, what are you hoping to see those companies get out of that? What return are you looking for out of that capex?

Tim Carleton

Well, that's going to depend ultimately company by company. What can be said about AI is that the developments there will be transformative. There shouldn't be any doubt that like most major technological developments through time, there will be incredible leaps in knowledge, understanding, and developments that are beneficial to humans. We are thinking about this all of the time. Within Auscap, we are thinking about how we can apply AI to complement our existing investment process. So, we hired someone into the team in February precisely to go down this rabbit hole and explore ways that we can sensibly implement AI to improve our efficiency. In fact, we think that there is a decent chance that in many ways AI will level the playing field for managers when it comes to analysing lots of data. You might not need a team of 20 PhDs out there trawling through data sets. We may well have AI or AI robots able to do exactly that. So, they're the sorts of things that we're exploring.

What we don't think it will be able to do is replicate the on-the-ground work that good fundamental investors do. We try to spend a lot of time in and around the operations of the companies that we're invested in or we want to be invested in. We want to understand the culture of the firms that we're investing in. We want to understand the true competitive advantage that one business might have over another in its field. If you think about an AI world, we think there's a reasonable likelihood that the traditional work of a fundamental investor becomes more important, becomes more differentiated than it was historically. And that is reasonably exciting, I think, for the active managers out there. But you need to make sure that you are staying abreast of AI developments and trying to implement those developments into your investment process to improve the efficiency of the team.

When it comes to firms making investments, we want to see our companies – and this is particularly relevant coming into reporting season – with tangible goals about what they're looking to achieve because the risk is that when a new technology comes along, everyone gets very excited, throws a lot of money at the new development, but without any particular goal in mind, and that's when you can often see a lot of capital wasted. From a portfolio perspective, we want to make sure through the next reporting season and the next few reporting seasons, that the companies that we're invested in are focused on specific goals in terms of their use and adoption of AI, and that they are focused on achieving a return on the capital that's invested, and we're not throwing out the traditional rule book around being disciplined around capital management.

Damien McIntyre

One of the golden rules of allocating capital is to understand what your cost of capital is, and when you deploy it, are you going to get a return in excess of that? Everyone's excited about AI, but I must admit from my seat in the grandstand, I don't really hear a lot about people talking about the metrics. I think we're in love with the idea that this is going to be transformative, but as you say, no one's really brought it down to a number or a metric that we're looking to improve. And I think the deeper we get into this, and particularly with the more dough we throw at it, the metric is now the pointy end of the conversation, isn't it? Or at least it should be.

Tim Carleton

Yes. Certainly, there's a lot of AI euphoria out there and, you know, there are a lot of valuations that don't make sense. I think what investors want to remember is this is not the first time that we have seen revolutionary technology come along. I mean, our lifespans are so short, particularly our adult lifespans where we're working. We often think that whatever developments are happening now are fundamentally different to any other advancement in human history. But they're not.

If we go back a few hundred years, you had the development of the canals back in the late 1700s and the early 1800s. They were transformative. We had the railway boom in the 19th century in the US. Electrical lighting was produced around the same time. Today's Tesla is in fact named after the inventor whose work on alternating current systems laid the foundation for modern electricity. If you think about a huge development over the last couple of hundred years, it's hard to go past the invention of electricity and its widespread adoption.

We had the automobile boom in the early parts of the 20th century, and then in the last fifty years, some of the developments have been more rapid but equally influential. The invention of the computer, the internet, we've had the cloud, we've had the smartphone. Lots of these booms are based on massive technological developments. But that hasn't always meant that the booms have been profitable for investors.

In fact, I would go so far as to say that the majority of technological booms are unprofitable and bad experiences for investors. And the reason for that is fairly obvious. I mean, booms have this amazing ability to capture the imagination of untold future profits and sort of a world without limitations. That naturally attracts a lot of capital. And when a sector attracts a lot of capital, you end up with strong competition. If you have a highly competitive environment in any sector, that reduces the economic rent that the players that are operating in that space can extract from the market.

The unusual thing really over the last twenty years, and it was really an outcome of the internet bust in the early 2000s, is that you ended up with a bunch of tech companies operating in different segments where they became particularly dominant in their particular field. So, you think about Amazon and its dominance in online retail and the cloud. You think about Apple and its dominance in smartphones. Microsoft for many decades now in PC software, Google in search, Facebook in social media. These companies managed to become the dominant player in what was a very high demand area where there were significant economies of scale and network advantages from being the major player.

That is in complete contrast with a lot of other sectors that have also experienced booms where there is a field of major competitors all throwing capital at the issue. And the obvious one really is the telecommunications space. You think about the amount of data that we consume today versus twenty-five years ago. Forget about calling capacity and texting capacity. The data that we're using every single year is more than we were using the previous year. The incredible thing about that space is we're all using infinitely more data than we were a couple of decades ago, and yet most of us are paying pretty similar prices on our phone plans to what we were paying back in the early 2000s.

And so, all of the investment that all of these telecommunications companies have made into these industries haven't resulted in super profits precisely because they're competitive. They've had to make that investment just to keep up with their peers. The moment that happens, the potential for super profits disappears. If you think about that in the context of AI, at the moment we're in an arms race where you have probably a bunch of the most well-capitalised companies in tech in the world all throwing, not billions, not tens of billions, but hundreds of billions of dollars to develop AI and agentic AI.

The chance is very, very high that no one will emerge with the dominant system. And we're seeing that at the moment. You're seeing on a regular basis the latest model from a different player is leapfrogging the ability of the prior objectively best AI model. And so, they're almost stuck in the perfect prisoner's dilemma. They can see that if they let one or two players become dominant, that will look like a major mistake in five, ten, fifteen, twenty years' time. And so, as a result, they're all committing to spending vast amounts of capital competing in this space. And by definition, the fact that they're all doing that means that there's likely to be pricing competition.

We're already seeing that in terms of token costs being undercut by various players. There's likely to be competition, and it's unlikely that we're going to see super profits. In fact, normally what happens in these environments where you do get this sort of perfect competition is actually no one even earns their required rate of return. And we have seen this in other really attractive sectors through time. Extreme competition means that everyone's constantly trying to win share. You win share by producing a better product and lowering your price. And the end result of that is no one earns a decent return on capital.

The unusual thing really about this bubble is that race is leading to a whole lot of other mini bubbles, such that it's sucking up a lot of capital, and the capital's got to come from somewhere. I like to think of the amount in equity markets as being relatively defined. It doesn't change a huge amount over time. So, if one part of the market's attracting a lot of capital, it's got to come from other sectors. And post-fact, everyone will come up with lots of reasons as to why some stocks have derated. But ultimately, if part of the market's attracting a lot of capital, then it comes out of the other parts of the market, which I think is a decent part of the reason why you're seeing some very attractive valuation metrics for high quality businesses elsewhere, not just in the Aussie market, but globally.

In this case, you've got the chip manufacturers; so, all of a sudden, we've seen this explosion in demand for compute, and the result of that is there's more demand than there is supply of chips. All of a sudden, the chip manufacturers are able to put up prices three to four times, and that just flows straight to the bottom line, and they are producing multiples of the anticipated profits that we were expecting only a year or two ago.

We're seeing the data centre demand explode, and again, this to us feels like an area where there is the potential that there will be a lot of wasted capital on a go-forward basis. Because you're almost making the assumption by the build out of all these data centres that Moore's Law, that I think has been around since the mid-1970s, that the amount of transistors that we can put onto a chip doubles every couple of years. You're assuming that that is actually going to break down and that we have reached the limit in terms of how much we can get onto a single chip, and therefore, the efficiency of chips in five and 10 years' time won't be multiples of their current efficiency, which means that it's very dangerous to assume that we need all this space based just on extrapolating compute demand at existing chip efficiency. It's flowing all the way through to the contractors that work on these data centres and the commodity producers for the commodities that are going into these particular components.

At the moment, the world seems to have had one trade on, and it's the long AI trade, and it's really premised on the fact that there will be a decent return on capital at the end of the tunnel for these AI developers, and it's just not clear to us that that will be the case. In fact, history would suggest that that is probably reasonably unlikely.

For an active manager, that is creating a lot of opportunities because I think that's a reasonable part of the explanation as to why you've got a whole lot of other businesses in a lot of sectors around the market that are languishing, despite operationally doing quite well. And I would expect in this reporting season coming up that what you're going to see is that a lot of these companies continue to grow their revenues, continue to grow their earnings. They're adopting AI sensibly, and that they have an opportunity through AI to actually improve their competitive position, and that's going to lead to faster earnings growth on a go-forward basis. And yet, you know, a lot of these companies are trading at pretty attractive levels. We will have to wait and see over the coming months and years.

Damien McIntyre

An observation of the last six months, or maybe it's a wee bit longer with the SaaSpocalypse trade, but effectively what the market's saying or been saying is that Company X, your multiple should be lower because AI at some is going to cut your lunch somehow. And what was once a prized and valuable entity will be replicated, and you'll lose your moat or competitive advantage. As you say, that's sucked a lot of capital out of those businesses and, you know, throwing the dough into AI-friendly trades. So, the question I want to ask you is if you're seeing a lot of opportunity in the market right now, how do you get conviction the game's not over?

Tim Carleton

The way we think about it is we try to understand what the competitive advantage really is. There are a lot of companies that get thrown into that technology-related bubble where we don't think the moat is the technology. We have pointed this out in relation to some of the domestic classifieds businesses, REA and Carsales. They are able to monetise the audience because they are so dominant compared to the many other players that operate in that space in the local or international markets. And that is their moat.

The moat is the fact that they have all of the vendors in the one spot, and as a result, that means that they get far more of the prospective buyers going to their particular site or their particular app. And as a result, they are responsible for most of the leads that result in a sale. And that's what the companies are able to monetise. If you take REA as an example, there's actually very little difference in the technology at first glance between them and I think there's a dozen different operators in the Australian market operating property portals. And yet, most of those property portals are not able to monetise the listings because they don't generate leads for vendors, and it's the lead generation for the vendor that matters. The vendors want as many leads, as many potential buyers coming to their property to think about purchasing as possible. The technology facilitates their economic moat, but it's not the cause of their economic moat. To the extent that there are companies that just provide technology, those companies without another additional moat, then those companies, I think, are probably more at risk.

The way we think about it is, let's understand what the economic moat is and where we think the economic moat is not the technology. If anything, AI might be an enabler of enhancement of that moat because these are companies that have large revenues and therefore large budgets that are just focused on solving one problem. So even if AI was to come up with a better mousetrap, you would expect that a company like REA would be a very, very close follower. And given they have, I think, thirteen million monthly active users that, at last check, are responsible for more than a hundred and fifty million monthly site visits, it's far easier for REA to replicate a better mousetrap, particularly in an AI world, than it is for a competitor to try to take that audience, and we've had exactly that experience. Domain was supported by the largest media organisation in Australia for most of the last decade, and yet they were unable to shift any meaningful audience away from REA. So that's the first point I'd make.

The second point I'd make is we do think in an AI world it's increasingly important to spend time with the companies on the ground at their operations to research what the companies are doing inside their businesses. There's an old saying in markets that not everything that can be counted counts and not everything that counts can be counted, and we think that that's going to become a more important feature of markets going forward, not a less important feature.

The qualitative analysis that goes alongside your quantitative analysis, we think is going to become a differentiating factor for active managers. I expect that we'll sit here in five or 10 years' time and active managers will have had a reasonably strong period of performance because a lot of those intrinsic factors, catching up with management, spending time with different layers of management, spending time in and around the business, they are actually very important considerations in the analysis that goes into an investment decision.

Damien McIntyre

Tim, you've been vocal on the importance of active management in Australian equities. Can you explain your thinking?

Tim Carleton

Well, ironically, the more money that's invested passively, the more important we think active management becomes. We don't think it's particularly sensible to invest in companies just in proportion to their size. That's what a passive index does most of the time. So, you're most heavily invested in the largest companies, but just because they're the largest companies doesn't mean that they are necessarily going to be the best investments on a go-forward basis. In fact, passive trends have been so strong that actually the exact opposite might be true at the moment.

Passive investing has been particularly successful in the US over the last ten years, and we think that people don't appreciate why that's been the case. The ten largest companies a decade ago, five of those ten were five of the Mag Seven. When you look at the composition of the S&P 500 a decade ago, it was made up of a bunch of companies that have delivered very, very strong earnings growth over the last ten years. They've been some of the better performers in that S&P 500 index. And being passively exposed to them, you had a natural overweight position to some of those very, very strong performers. But that's not always going to be the case.

I mean, in Australia, we suspect when you look forward ten years, again, you know, we see a lot of risks to revenues and earnings for some of the largest businesses in Australia because their competitive position is being undermined or threatened by competitors, and competitors that in some instances have an advantageous position in the market. I talked about Macquarie in relation to the Big Four banks a little bit earlier. We think it's a dangerous proposition to have a passive exposure in the Australian market to the ASX 200 when twenty-five percent of that is domestic banks that are seeing their first serious competitor in decades. And that's ignoring the fact that we've got weakening house prices and potentially softer credit growth as a result of some of the CGT changes that have been announced recently. We naturally wouldn't want to have a quarter of our portfolio invested in these companies.

In fact, we have zero exposure to the large banks. We own Macquarie as the competitor that's taking share, but we have no real interest in the incumbents that we think are at risk. You then contrast that with all of the compelling opportunities that we see in high-quality businesses that are predominantly in that mid-cap space. They're not small businesses. These are businesses that have market caps typically between five and thirty billion. They're dominant in their sectors, they're trading on more attractive valuations, and we see a longer forward period of attractive earnings growth than we do for a lot of the largest companies. We think that now feels as good as ever to be an active manager, and we're looking forward to investing for our clients over the next couple of decades.

Damien McIntyre

Look, I am an active management zealot. I think from the financial adviser's perspective, we've discussed that the large asset owners or super funds in Australia which are unfortunately forced to play the Your Super, Your Future and this limits their risk budget. So, they end up with a disproportionate amount of their portfolios invested passively in order to manage their fees, and effectively that also drives down the active risk that they have in their portfolios.

To my way of thinking, if I'm in financial adviser land, they are my direct competitor, and I want to construct portfolios that compete with them from an active risk and active share standpoint because then you have a differentiated product. And I don't really know if the financial advisory industry have fully got their heads around that.

If you're trying to save on fees all the time, you're just going to end up looking like everyone else. You're not going to be sufficiently different. And then the question becomes, well, why do I invest with you when I can get X return for X fee, which may or may not be lower? So, I think that's a huge threat to financial adviser land, and I think that's why they should be thinking more openly about the benefits of active management.

Now Tim, thank you very much for your time this afternoon. I'm actually quite looking forward to reporting season, the fun and games of it. It always unearths some drama and some intrigue, so I wish you the very best of luck with reporting season for the funds. I look forward to talking with you again soon.

Tim Carleton

Sounds good. Thanks, Damo.