

# Emerging Leaders Update

March 2024



## WATERSHED

Funds Management

### *Between 2 Screens Emerging Leaders Update*

In our latest edition of Between 2 Screens, Lydia Pearson delves into the Emerging Leaders SMA with Portfolio Manager Ben Bowen, exploring the drivers of its impressive outperformance of the benchmark, reflections on the latest reporting season in small caps, and the outlook for small caps over the year ahead.

You can view the full discussion between Lydia and Ben [here](#)

#### **Key Points:**

- **Selective Stock Picking Drives Outperformance:** The portfolio has outperformed due to strategic stock selection in the small-cap sector, despite high cash levels, with examples of recent successes including Audinate (AD8), Seven Group (SVW) and Life 360 (360).
- **Reporting Season Shows Dispersion:** The Small Ordinaries index's modest rise of 1.7% over the reporting season period masked significant variances between sectors and individual stocks, emphasising the importance of careful stock selection.
- **Cautious Post-Reporting Stance:** The team remains cautious, noting that positive earnings reports often stemmed from cost-cutting rather than revenue growth. Market optimism for certain stocks seems premature.
- **Small Caps Offer Long-term Growth:** Despite recent underperformance against the ASX200, small caps show promising long-term growth, with FY25 EPS growth expectations significantly higher for small caps.
- **Active Management Adds Value:** The portfolio benefits from the inefficiencies in the small-cap market, where active management can significantly outperform during recovery phases.
- **Strategic Cash Positioning:** High cash reserves position the portfolio to take advantage of upcoming attractive investment opportunities.

#### **Key Themes:**

- **Despite holding high levels of cash – stock selection has driven outperformance**

The recent strong performance of the Watershed Emerging Leaders Portfolio reflects a cautious yet opportunistic investment approach over the last 4-5 months, where having a focus on identifying high-potential stocks within the small-cap space has driven substantial gains. Notably, there were 5-6 investments

in the portfolio that recorded significant gains, such as Audinate (AD8), Seven Group (SVW), and Life 360 (360) all recording double digit gains of 40-60% over the last several months.

The recent reporting season presented a mixed bag of results, with the Small Ordinaries up only 1.7% over the period. Beneath this however, we saw heightened levels of dispersion between winning and losing stocks, highlighting the importance of stock selection.

- **Post February reporting season – the Portfolio remains cautiously positioned**

Since Ben’s last update on the Emerging Leaders Portfolio in September, we have maintained a cautious stance, and after the most recent reporting season, we remain skeptical that the cycle of earnings downgrades has concluded.

***“There’s a lot of jostling at the starting line for the recovery. We think that might be premature.”***

It was noteworthy for example that a lot of the more positive earnings reports were based on cost management initiatives as opposed to top-line revenue growth. It was also interesting to observe several consumer discretionary companies release results showing slowing or negative sales growth but have their stock price rally dramatically. This suggests that investors are seeking to look-through current weak conditions, however we are seeking to be disciplined in our approach to deploying capital at attractive entry points as they present themselves.

***“We feel really comfortable at the moment, even in a market that has done really well, that we are sitting on a lot of cash as there is definitely going to be a great opportunity in the small company space.”***

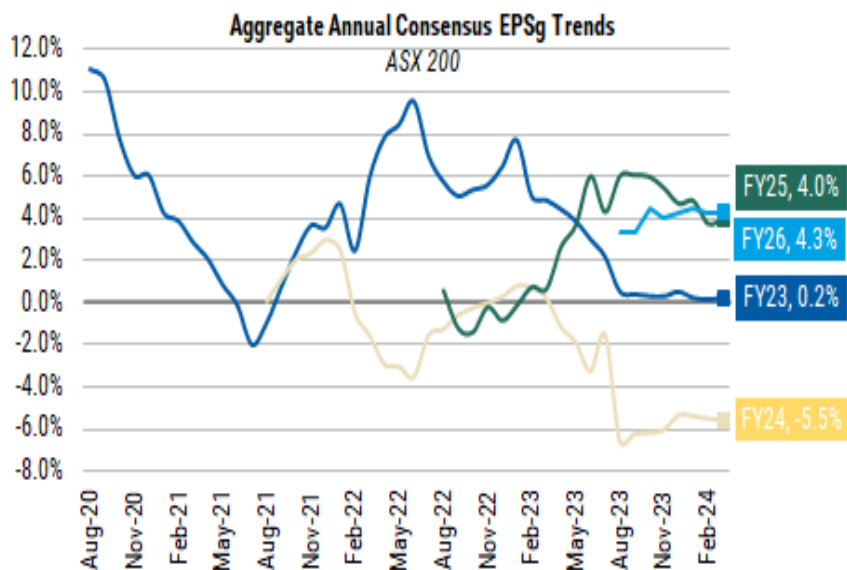
- **However, on a medium-longer term basis small caps look attractive**

We have seen over the last 2-3 years small caps significantly underperform the ASX200. However, this performance differential is likely to close at some point, providing a very attractive opportunity looking forward. The difficult part will be judging whether we have reached the point of a sustainable earnings recovery.

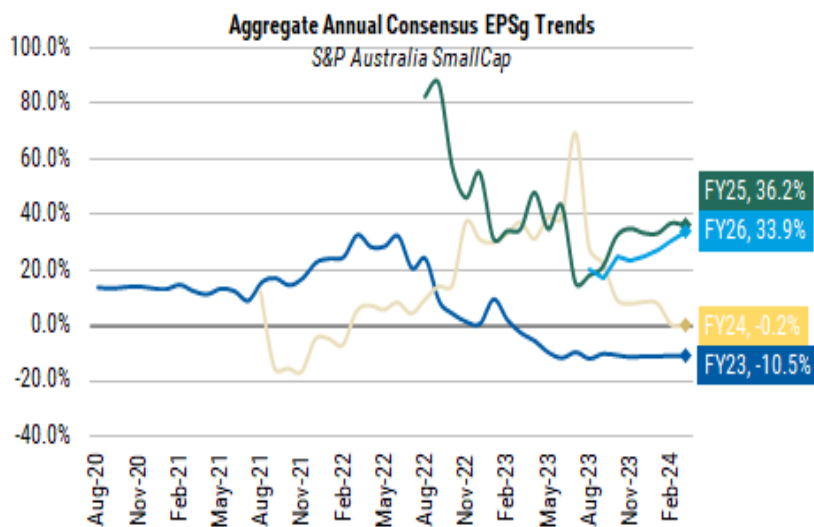
**ASX 200 (black) vs ASX Small Ordinaries (blue) – Relative Return over 3 years to March 2024:**



Source: LSEG



Interestingly, if you look at Earnings Per Share (EPS) expectations for FY25 the market consensus is for 4% EPS growth in the ASX200 (see above), whereas the Small Ords is at over 35% (see below), highlighting the attractive growth opportunities in this space:



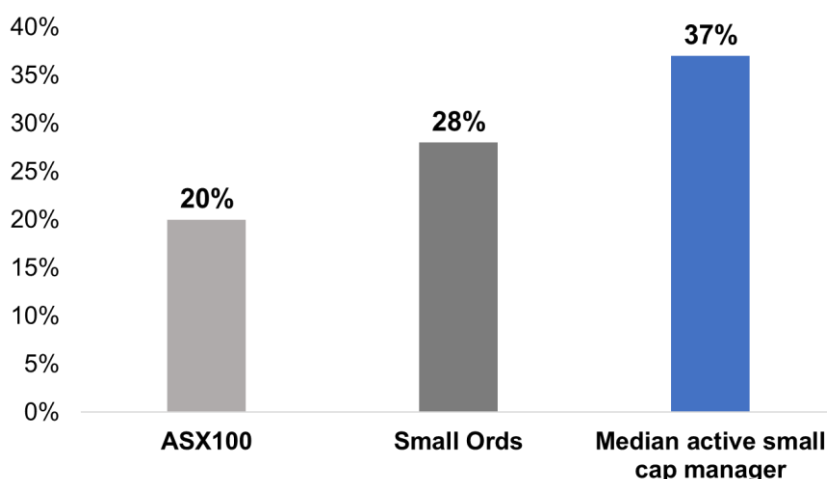
Source: Morgan Stanley

Therefore, shorter-term concerns aside, when we shift into a more 'risk-on' market, small caps are likely to see much stronger performance.

Finally, looked at from an active management perspective, given the inefficiencies in the small caps space, there is evidence to suggest that stock picking adds a significant amount of value in the recovery phase of market cycles.

The following chart looks at the returns of stocks in the first 18 months of a recovery phase, with small caps in aggregate outperforming larger stocks (ASX100), but with the median active small cap manager able to achieve significant alpha on top of this.

## Average returns during recovery periods:



Source: Mercer, Factset, Firetrail

In summary, the Emerging Leaders portfolio has continued to achieve strong performance despite remaining cautiously positioned with high levels of cash. We are starting to see very attractive opportunities in small caps but are being highly selective in our approach, particularly given the earnings outlook remains challenging for many stocks. Looking longer term however, small caps is a very attractive space and we see the potential for an extended run of outperformance as we enter the next cycle.

The performance of the Emerging Leaders SMA is provided below, if you would like any further information please feel free to reach out to Lydia Pearson or Shantelle Lay.

Net Performance (February 2024)	1 MONTH	3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	INCEPTION
Watershed Emerging Leaders Portfolio	6.33%	12.43%	8.97%	15.48%	6.82%	10.32%	11.48%
S&P/ASX Small Ords. Accumulation Index	1.72%	10.06%	6.88%	7.84%	1.38%	4.42%	6.36%
Relative Performance	4.60%	2.37%	2.08%	7.64%	5.44%	5.90%	5.12%

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