Invesco

The Bigger Australian

A factor investor's look at BHP's upcoming single-listing on the ASX, and what it means for investors in an already 'top heavy' ASX 300

Invesco Australian Equities

Executive summary

Some investors are worried about a high concentration of 'big names' in the ASX 300, and what it might mean for risk and return. The concern has heightened with BHPs imminent single listing on the ASX.

To explore this concern, we undertook a simulation using our investment model against a more concentrated benchmark to see how the model stood up on risk, return and transaction costs, and in particular, to see if our investment model's active return remained positive.

The delisting / single-listing event

On 31st January 2022 BHP plans to delist from the London Stock Exchange (LSE) and simultaneously disappear from the FTSE 100 Index, while maintaining a listing on the ASX – increasing its S&P ASX 300 index weight by approximately 70%; rising from around 5% to around 8% of the overall index on the same day. The 'Big Australian' will then become the 'even Bigger Australian' for ASX index investors (the ASX becoming the primary market for the world's biggest miner) while the firm itself is expected to maintain the same market capitalisation, albeit with a simplified structure and less administrative overhead. While BHP's C-suite can enjoy a simpler administrative life as they also seek to divest oil and gas assets, the cost of this change is a more concentrated equity market for Australian investors.

In the following paper we take a look at what the LSE (FTSE 100) delisting might mean for Australian investors by simulating the investment portfolio's performance with a more concentrated ASX 300 benchmark.

Simulation

By simulating the investment portfolio's performance with a more concentrated ASX 300 benchmark we performed an impact assessment on the investment model behind our funds including our flagship fund – the Invesco Wholesale Australian Share Fund. The investment team sought to explore the impact on the model's delivery of excess returns to determine if active factor investing would be less likely to deliver excess returns as the long-only constraint becomes more difficult to manage, with less room to move. The investment team ran two simulations using the Invesco Wholesale Australian Share Fund's investment parameters to simulate fund returns; the base case, using the true historical ASX 300 benchmark, and the concentrated benchmark case.

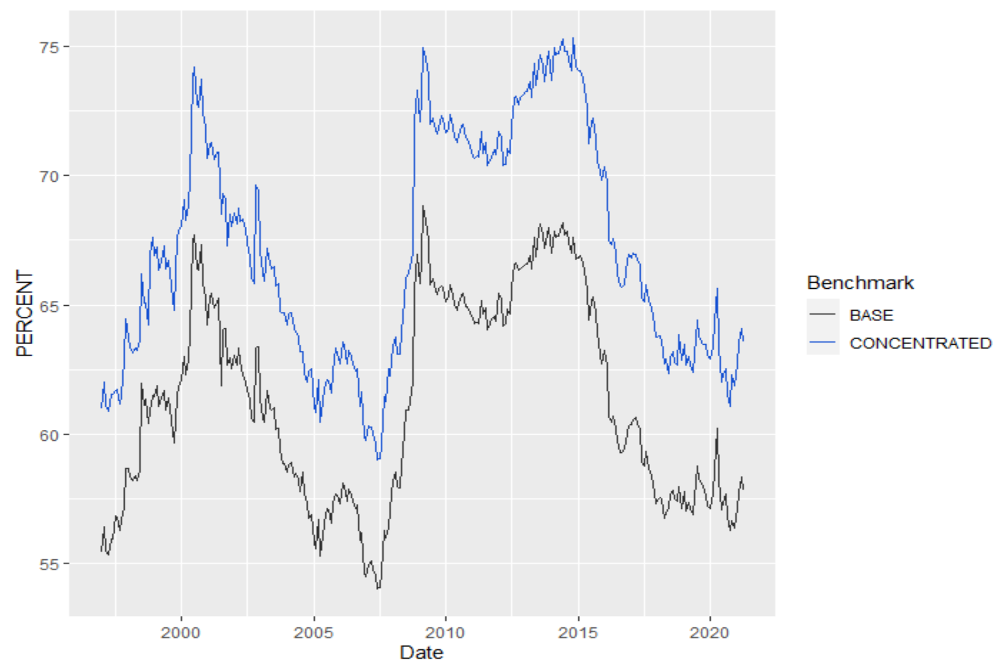
The concentrated benchmark

The **concentrated benchmark** is a concentrated version of the historical ASX 300 benchmark, inflating the top 20 stocks by index weight such that they were all 10% more weighty – including, of course, BHP. In order to accommodate the inflated top 20 stocks in the concentrated benchmark, we decreased the weightings of the ex-20 stocks on a pro-rata basis such that the overall index weightings summed to 100%. We kept the same list of top 20 stocks constant for each month[1].

Figure 1 presents a time series of the dominance of the Top 20 stocks in the ASX 300 by aggregate market weight. The Top 20 stocks have historically accounted for over 55% of the index weight in the **base benchmark**, rising to a peak of 68% in 2014 (the resources boom, in which BHP played a central role). The present concentration of the base benchmark is at the lower end of the range at around 58%, but still high by the standard of developed market stock exchanges globally[2].

The **concentrated benchmark** has weights of 1.1x the true weighting for each of the Top 20 stocks. Interestingly, the base benchmark concentration at certain times (2009 – 2015) has exceeded the concentrated benchmark at times (2018-present) – so 1.1x is by no means a heavy-handed simulated weighting on the concentrated benchmark.

Figure 1: ASX300 index % accounted for by the Top 20 by weight



Source: Invesco Australian Equities and S&P ASX300

[1] The exception here was the October rebalance, which resets the top 20 list, and coincides with the more substantial September S&P/ASX 300 rebalance, which often results in somewhat higher turnover than other months. We rolled both changes in the same month to minimise additional turnover from the concentration calculation.

[2] By comparison, the Top 10 shares in the S&P 500 account for around 30% of the index, the Top 10 shares in the FTSE All-share Index account for around 32% of the index, while the Top 10 shares in the S&P ASX 300 account for around 40% of the index, remembering though that the denominator is different for all of these; 500, 600 and 300 listings respectively.

Outcome of investment model; base vs concentrated benchmarks

In Figure 2. we can see that net active returns (annualised) over the 20-year simulation period remained positive for the investment model managing to a concentrated benchmark, though slightly lower than that of the base benchmark portfolio (see green row). The benchmark returns themselves (in grey) reflect this slightly lower return performance for the concentrated benchmark.

Figure 2: Simulation returns – Investment model; base case vs concentrated

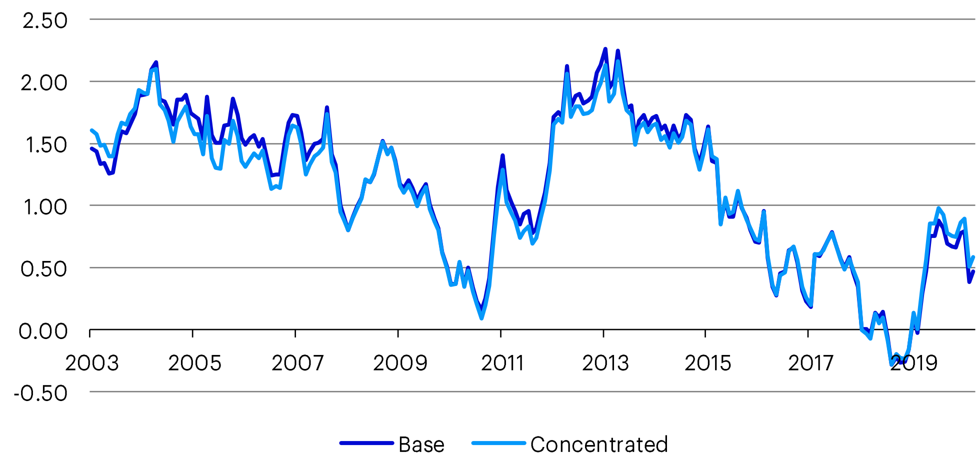
	Investment model to base case (actual ASX300 benchmark)	**Investment model to concentrated ASX300 benchmark**
Benchmark Return (%)	8.10	8.01
Benchmark Risk (%)	13.49	13.46
Annualised Net Return		
Portfolio Return (%, net of cost)	10.32	10.21
Active Return (%, net of cost)	2.23	2.19
Active Risk (%)	2.02	1.97
Information Ratio (net of cost)	1.11	1.11

Source: Invesco, covering from Jan 2001 to Feb 2021. Returns are total return, and the product of a simulation.

The slightly lower returns for the concentrated portfolio is in line with the lower active risk for the concentrated benchmark (less risk / less return); there is less room to move with the concentrated benchmark weightings. However the differences are not particularly significant.

The concentration does not seem to have an effect on the efficiency of our investment model at all, which demonstrates no particular drop in efficiency when managing to a concentrated benchmark versus the base benchmark (Figure 3). The Information Ratios track each other, with one or the other bobbing ahead here and there, and no persistent leader. In fact, if anything, the period of roughly 2011 to 2015 which in Figure 1 is the most concentrated period is in Figure 3 a period of robust information ratios (in other words, a period of strong portfolio returns above the benchmark exactly when the benchmark is most concentrated).

Figure 3: Information Ratio (Net, ex-post 3 year rolling window)



Source: Invesco Australian Equities and S&P ASX300 simulation - 31 Dec 2003 – 26 Feb 2021 (Rolling from 31 Jan 2001).

Conclusion

Our research leads us to the conclusion that investors in a fund tracking the ASX 300, particularly an active factor investing fund, have little to be concerned about on the imminent BHP expansion. Even a general increase of all Top 20 stocks by +10% in our simulation, a little bit more than BHP's solitary increase this month, had only marginal impact on return, risk and transactions costs over a 20 year simulation period.

For our investment model specifically, the simulations show that the strategy is equally likely to deliver risk-adjusted excess returns in a concentrated market, despite the long-only constraint becoming more difficult to manage. As the Insider Adviser proposed in September last year, when considering the concentration risk of the BHP single-listing, one of the approaches to dealing with the problem might be broad-based factor strategies. Our research backs this up. The ASX is big enough for the bigger Australian.

Important information

This document has been prepared by Invesco Australia Ltd (Invesco) ABN 48 001 693 232, Australian Financial Services Licence number 239916, who can be contacted on freecall 1800 813 500, by email to clientservices.au@invesco.com, or by writing to GPO Box 231, Melbourne, Victoria, 3001. You can also visit our website at www.invesco.com.au.

This document contains general information only and does not take into account your individual objectives, taxation position, financial situation or needs.

Invesco has taken all due care in the preparation of this document. To the maximum extent permitted by law, Invesco, its related bodies corporate, directors or employees are not liable and take no responsibility for the accuracy or completeness of this document and disclaim all liability for any loss or damage of any kind (whether foreseeable or not) that may arise from any person acting on any statements contained in this document.

This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else.

© Copyright of this document is owned by Invesco. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco.