

## Alpha beyond the Magnificent Seven

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**Jacinta King (00:00):**

Welcome to The Ideas Exchange by ASX, connecting you with investment experts, market updates, and ideas. I am Jacinta King, business development manager, investment products at ASX, and this is our regular podcast, covering everything from investment trends through to different ways to invest using a variety of products.

**Speaker 2 (00:20):**

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**Jacinta King (00:47):**

Today, we welcome to the studio a very special guest who joins us from Schroders, a British-based company founded in 1804. And Schroders has more than 200 years of experience, and arguably few can match the breadth and global extent of their capabilities. Frank Thormann is portfolio manager at Global Equities, and he's based in Germany, but joins us today in Sydney. A very warm welcome to Australia, Frank, and to The Ideas Exchange.

**Frank Thormann (01:15):**

Thank you so much for having me and thank you for the kind introduction.

**Jacinta King (01:18):**

You're most welcome. Now, is this your first trip to Australia? I have to ask, before-

**Frank Thormann (01:22):**

It is. It is. It's my first trip to Australia and my first time to Sydney, so it's a great pleasure to be here.

**Jacinta King (01:27):**

Well, you've timed it well because we've had a deluge of rain, so I'm really pleased that the sun is shining for you. I'm sure you have a jam-packed schedule. Do you have time, most importantly, to take in our harbor and some of the beaches whilst you're here?

**Frank Thormann (01:39):**

Yeah, I spent the weekend exploring, and it's been beautiful.

**Jacinta King (01:43):**

Brilliant. I'm really pleased to hear that. Now we'll get down to business then. So we'd like to focus our discussion today around the theme of outperformance without the Magnificent Seven. So we're being a bit controversial there, I think, Frank. But before we tackle that directly, let's start with your investment philosophy. So in your role as portfolio manager, can you tell us about Schrodgers and what sets you apart from your peers in the global investing space when it comes to active management and generating alpha in your fund? To take a moment for our listeners, alpha is the measure of an investment's performance that indicates its ability to generate returns in excess of its benchmark.

**Frank Thormann (02:24):**

So the strategy that I'm responsible for is a concentrated global equity strategy. So concentrated in our language means roughly 40 to 60 companies equities only, with the intention to outperform the broad global equity indices. And we do that in a way where we look for companies where we have really high conviction in their ability to surprise positively, usually over the medium to long-term, versus consensus expectations. And is that conviction that companies that on average surprise positively, that those are on average rewarded by investors and on average outperform. And really, the entire philosophy is based on the premise that over the at least medium to longer-term stock prices follow earnings if we spend all of our attention trying to have really sharp and differentiated views on companies' forward-looking earnings.

**Jacinta King (03:19):**

Now in some reading in preparation for today, there was mention of a growth gap, and the two traits, that you're style-agnostic, and within the portfolio you have some long-term core holdings, but you also look at short-term tactical. I was trying to understand that better. So maybe you could just delve a bit more into that for our listeners. Would you call that a long short portfolio or is it slightly different to that kind of investing, with those short positions that you're holding?

**Frank Thormann (03:48):**

Generally, the word short in investment is used to describe when you're selling something which you don't own. So in this instance, these are

long-only investments. The differentiation between longer is more the anticipated holding period. So as I described a minute ago, what we look for is companies where we have this conviction in their ability to surprise positively. So in our language, we call that a growth gap, and the gap is our assessment of forward-looking earnings power versus consensus. And so the larger that difference, that growth gap, the more excited we get, so the greater we think there is potential for positive surprise, the greater the upside.

(04:33):

Now we do make a distinction within that growth gap philosophy. The roughly 70 to 80% of our investment is what we call a core growth gap, as compared to 20 to 30%, which we call opportunistic. And the main difference is the anticipated holding period. So the core growth gaps are companies which we intend really to hold three, four, or five years and beyond, so very long-term holdings. And usually, the reason, the source for the conviction for their ability to surprise positively comes from a search for a really deep structural competitive advantage that the company's proven historically and it continues to build. And importantly, that the power of that competitive advantage is not fully recognized by consensus. And that's the source for positive surprise. Just to contrast that to 20 to 30% of investments which we call opportunistic are more short determined nature, hence the requirement for positive immediate results is greater. And these could be companies that go through a strong positive cyclical inflection, company restructuring, or perhaps a very strong product cycle.

**Jacinta King (05:47):**

Okay. Now also in that article I read that you talked about the importance of free cash flow and capital discipline, so that caught my attention, because I was thinking, if you could explain why these characteristics are important and provide how they inform capital allocation decisions within your portfolio.

**Frank Thormann (06:06):**

Yeah, thank you for the question. I think it's, in my opinion, really important and often quite neglected by most investors. Almost all companies employ incredibly talented investor-relation teams, and their job, in addition to communicating financial results, I sometimes think of it as a bit of a beauty show where they try to put on lots of makeup and try to make the bride as beautiful as possible, to make their company appear in a really favourable light. And so often, companies calculate what they call adjusted earnings and adjustments. Often they're very generous in taking everything out that's unfavourable and adding everything in that's favourable. And of course, this is all within legal bounds.

(06:52):

At the same time, one way we try to assess how much makeup has been applied is to compare the company's provided adjusted earnings to free cash flow. It's our experience that actually in the cash flow statement, it's much more difficult to make these adjustments. So often, you can look at the bride without makeup by looking at the cash-flow statement and try to differentiate really what's the true underlying earnings power of a company versus what they tried to show to the outside world.

(07:25):

The second point is around capital allocation, and these company-management teams, the CEOs, they tend to be motivated by many different kinds of things, and frankly many of them are more motivated in their own ego or building an empire. And those kinds of companies often will gravitate towards making large acquisitions, puts them on the front page of a newspaper, maybe makes them look good, but is it really good for investors? Is it really good for the owners? And so we spend a lot of time trying to assess the quality of capital allocation decisions, and whether these decisions are more likely to benefit investors.

**Jacinta King (08:06):**

Now I'm going to shift a little bit here because I'm going to move back to the Magnificent Seven, the Mag Seven that we all see in the headlines. So given the investment approach and some of those points that you've just outlined for us, so let's tackle this question. So there are no Mag Seven stocks in your top 10 performers over the past five years, and that's not to say that you haven't held the Mag Seven, you just have maybe less allocations or have shifted out of them at different times. So what have you been doing differently to deliver impressive outperformance in your fund, if people are thinking, sentiment is "Oh, you've got to get the Mag Seven to get that performance"? Yeah, where have you been... yeah.

**Frank Thormann (08:45):**

Exactly, exactly. Allow me to take a step back. So the intention of this concentrated strategy, 40 to 60 stocks, is really to have them, as much as possible, to be independent of each other, and uncorrelated. So we really strive to find investment ideas in many different sectors, many different geographies, rather than trying to bet on the latest and greatest trend, hoping it continues. Those types of investment strategies, if you get it right, you can look like a hero. Unfortunately, often things are worse and then it doesn't look so good. So we really try to put together a strategy that's much more diversified.

(09:24):

So in that context, actually, the Mag Seven on aggregate have been weighted relatively neutral, neutral meaning the allocation that we've had compared to global equity benchmarks has been roughly similar. At the

same time for me as a stock picker, we've had very, very strong views on individual companies. So some of them have been more heavily exposed, and others, we haven't had any exposure at all. And to your point that the top 10 of our winners over the past five years have come from non-Mag Seven companies just illustrates that point that not that we haven't been invested, but actually we've been able to find really good ideas in other spaces.

**Jacinta King (10:08):**

Are they still within that tech sector or outside of some other sectors as well have been good performers?

**Frank Thormann (10:14):**

It's been really diversified. We've had some good investments within technology and communications, but there've been very good investments in other sectors as well.

**Jacinta King (10:24):**

Now I'm going to stick with the tech sector. It's still top of the leaderboard when you look global equities, also Australian equities, majority of companies that make up the tech sector are US based. I'd just like to take a moment and hear your thoughts on U.S. exceptionalism. Is it waning, or is there still much opportunity in this space because those companies have done well for so long, and potentially might continue to do so?

**Frank Thormann (10:51):**

Probably both. Probably both. So myself as an active investor, as we've discussed, the question I always ask, is there anything that's happening within the company that continues to be unrecognized, underappreciated by consensus? Obviously, in some of these hotter technology-sector investments, market expectations have usually moved up, sometimes quite considerably. So there the opportunity to continue to surprise positively, perhaps it's becoming a bit more difficult, hence really important for us to continuously reassess. To what extent have consensus expectations moved up? And is this really a company that continued to surprise positively? In some instances we find that that's the case. In other instances, we become a bit more concerned that expectations have moved up too quickly. So we continue to find great investment ideas within technology, but also in other sectors. And actually, sometimes it's these neglected sectors that really don't spend much time looking at where you can find at least as much potential for positive surprise.

**Jacinta King (11:59):**

Yes, you're right, because we did an episode a couple of episodes back with one of our key brokers here, Bell Direct and Grady, was talking about that they had done a 10-year review. One of the key findings was it's really

important not to forget some of those sectors that aren't getting the headlines, because there could be missed opportunities because of that sort of more constant growth and returns over that longer term period.

(12:24):

Now I'd like to, if you don't mind, just think a bit more stock-specific. And thinking about perhaps some examples out of the U.S., because I had a look at your portfolio holdings, and if one looks at your fund's geographic exposure, you are invested in several countries outside of the U.S. So would you mind sharing with us one or two companies that you think are maybe like a hidden gem, or the quiet achievers that are doing extraordinary things and are well-placed for the future?

Frank Thormann (12:54):

Just to build on the response we just discussed about things that have been underappreciated, let me perhaps introduce the European banks. Often, when I start talking about European banks, people's eyes glaze a bit, and then they look at me and say, "Well, aren't they supposed to be in crisis? And Europe is the sick man of the world."

**Jacinta King (13:17):**

We can't forget that crisis, right? Yeah.

**Frank Thormann (13:20):**

The countries aren't really growing, so what's interesting about these banks? And quietly, well, first of, so to give you a couple of companies specific, so Intesa is an Italian bank, for example, and many people still think Italy is the sick man of Europe. But little by little, they've been making quite impressive reforms. So specifically, the Italian government bonds are now yielding less than French government bonds. So the capital market is saying that the sovereign risk in Italy today is more favourable than in France. But more importantly, in our assessment, Intesa is the highest quality, best-managed bank in Italy. And so even in a country with very little economic growth and frankly unfavourable demographics, if you go back to basics, and in banking, that starts with amazing customer service and you treat your customer well, you offer good products and reasonably priced products, you can gain market share year in and year out, and that's what they've been doing really well.

(14:28):

And then once you have the customers in the door in financial services, then you can cross-sell into higher-profitability products. So in Intesa's case, those tend to be insurance products, asset management products, and just cultivate deeper customer relationships. And then importantly, if you're a bank that's not growing very quickly, you also have very low requirements to put down additional capital. So actually the vast majority of earnings have been returned to shareholders. We discussed the capital

allocation strategy a minute ago, and Intesa's exemplary in really returning almost all of the earnings back to shareholders. So it's been a recipe that's been surprisingly successful. And then you compare that versus very, very muted investor expectations. It's been a great recipe for stock marketer performance.

**Jacinta King (15:22):**

Yeah, that's an interesting point. And perhaps in times of economic downturn for companies, retention becomes key, doesn't it? And not that you don't ever do that, but you go back to those basics and go, all right, it might be really hard to bring in new customers when people are holding their reserve, on where they want to spend their money or invest. But if we've got a great customer base, then there's a refocus on that retention piece, which can be done quite well if you get it right.

**Frank Thormann (15:53):**

Yes.

**Jacinta King (15:54):**

So what's interesting is rate volatility is still sort of hovering, I would say. There's political uncertainty, arguably, with the unknown or unpredictable behaviour of Trump in the U.S. But to me, the themes that we've been following this year in our podcast series is portfolio diversification is always key, is key, and still remains key. And what I found interesting in preparing for today is that even though you run concentrated portfolios, you've got that 40 to 60 stocks, I think I counted, you're holding about 50 or just over 50 stocks at the moment, minimal cash as well. You're always fully invested, typically, or-

**Frank Thormann (16:33):**

Correct. Correct.

**Jacinta King (16:33):**

Yeah. Can we finish on that and some of the reasons? Because I know that some of the global managers will have elevated cash at time. Maybe if you want to finish with just talking about how that benefits not to be able to go up into those higher cash position's volatility.

**Frank Thormann (16:48):**

Yeah. To clarify, the vast majority of our customers, they invest with us because they want exposure to global equities. So as a result, by design, the strategy is always fully invested. So we don't ask ourselves the question, do I think the market is going to go up or down this month or this year? That's for asset allocators to decide. We try to find the best companies within the global context. One point on diversification, so the strategy really attempts to find these hidden gems, these companies with

the ability to surprise positively in really all geographies as well as in all the different sectors.

(17:33):

We definitely invest in well-known large-cap companies, but really also try to go down to less well-known, more mid-cap companies. And then one other additional point in just constructing portfolios is a risk analysis. So we've talked about how the magnitude of anticipated positive surprise, that to us calibrates the potential upside, but then in addition, we really spend a lot of time also looking at the risk profile of these individual companies, how risky they are in terms of how much debt they have on the balance sheet, how volatile just the business model is. And that is the key input in sizing position. So the greater the riskiness of an individual company, the lower the position size. So those are the main factors, how we think about portfolio construction.

**Jacinta King (18:23):**

Frank, thank you so much. We want to thank you for your time to talk to us. We're very appreciative that you found time to include us in your busy schedule, I'm sure while you're here. If investors want to hear more from you or Schroders more generally, where can they look?

**Frank Thormann (18:37):**

Well, it's been a pleasure to be here and to talk to you. If investors have more questions or interested, I would definitely refer them to the Schroders website where they can find lots of information.

**Jacinta King (18:48):**

They can indeed. I really enjoyed delving around the website there. 60 years in Australia. I think many people know of Schroders. If you haven't, please go take a look. And also, you can head to the ASX website, and you can search under ticker ALPH, which is the fund that we've been referencing throughout our conversation. Thank you, as always, to our listeners. I'm Jacinta King. And if you liked this episode, please share and tune in again next month to The Ideas Exchange.

**Speaker 2 (19:18):**

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