Why Active Fundamental Investing Still Works in Australia—But Must Evolve

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Key Takeaways

- **Passive flows are changing how Australian equities trade.** Persistent index demand can reduce liquidity in large benchmark stocks, weaken the link between prices and fundamentals, and contribute to sharper price reactions when new information emerges.
- **Systematic investing is amplifying factor cycles.** As more capital follows similar signals, individual stocks and investment styles can become crowded and mispriced, creating both abrupt reversals and new opportunities for fundamental investors.
- **Strong performance is not always evidence of true alpha.** Returns driven by favourable exposures to Quality, Growth or Momentum may fade when market leadership changes, making it essential to distinguish genuine stock-selection skill from style bias.
- **Fundamental investing must combine patience with a broader toolkit.** Deep company research remains critical, but it is increasingly most effective when supported by factor awareness, disciplined risk management and an understanding of liquidity, crowding and market flows.

FY26 has been an unusually difficult period for fundamentally managed Australian equity portfolios, with relative returns falling to historically low levels.

Structural changes in the Australian equity market, particularly the growth of passive and systematic investing, are increasingly influencing liquidity, price discovery and the way investment returns are generated. Many fundamental managers have struggled to produce alpha, while factor-driven strategies have generally performed more strongly. ClearBridge has been among a relatively small number of active fundamental managers to outperform during this period, and over the last 3, 5 and 10 years[1].

The ClearBridge Australian Equities Investment Team have been on the frontline of active fundamental investing in Australia for more than 40 years. Its Australian Equities Investment Team combines fundamental and quantitative analysis across the market to identify forces that may be difficult to see at the individual-company level.

Below, ClearBridge Head of Australian Equities, Reece Birtles, shares the team's observations of the evolving investment frontline, and considers how active fundamental managers, and clients can respond.

[1] Data calculated for the ClearBridge Select Opportunities Fund in A$. Universe of managers based on Funds and ETFs within the Morningstar Australia Fund Equity Australia "large" categories with AUM and net of fees returns available for 30 June 2026. *Vanguard Australian Shares Index ETF (ASX:VAS) is used as proxy for the lowest fee "investible" passive index fund the S&P/ASX 200 Accumulation Index. Fundamental & Systematic investment focus categorisation of universe based on the investment team's analysis and assumptions.

Three Observations That Help Explain the Challenge

Passive flows are changing liquidity and price discovery

Passive strategies have become central to many portfolios, supported by fee pressure, tighter risk constraints and the Your Future Your Super framework. Yet passive investors trade primarily to replicate an index, not in response to valuation, earnings or liquidity. Persistent index demand can therefore increasingly influence trading and prices.

The ClearBridge team's work suggests that this is reducing liquidity in some large index stocks. Using Commonwealth Bank of Australia (CBA) as an example, a theoretical model based on estimated superannuation inflows indicates that the proportion of daily turnover potentially attributable to index buying has more than doubled since 2015 and may now be around 25%. At the same time, CBA's share turnover has fallen to approximately half that of the average Australian company.

Lower liquidity can weaken the link between price and fundamentals. CBA's share price was historically more closely aligned with earnings, dividends and ClearBridge's proprietary discounted cash-flow valuation, but that relationship has weakened as passive ownership has risen.

The same dynamic can amplify volatility. During quieter periods, active investors may be reluctant to trade against persistent index demand, leaving prices vulnerable to sharp adjustment when new information arrives.

ClearBridge has tracked earnings revisions and share-price reactions for the largest 50 Australian companies across reporting seasons over the past decade. In February 2026, earnings revisions were relatively modest, yet the dispersion of share-price reactions was the highest observed over the period. There was comparatively little new fundamental information, but unusually large price volatility.

For fundamental investors, being right can take longer to be rewarded. Expensive index-heavy companies may keep rising while attractively valued companies remain overlooked, and alpha may arrive in concentrated bursts rather than gradually.

Systematic investing is amplifying factor cycles

Assets allocated to rules-based strategies have also grown significantly. These approaches offer diversification and disciplined exposure to factors such as Momentum, Quality, Growth and Value. But when many investors use similar signals, capital can move in the same direction at once, pushing stocks and styles away from underlying value.

Light & Wonder's May quarterly update provides a useful example. The update was broadly consistent with guidance and included no change to the full-year outlook. Nevertheless, the share price fell about 9% on the day before rising roughly 13% the next. A two-day move of this size is difficult to explain through fundamentals alone.

The stock's consumer-discretionary and other factor exposures had become less attractive amid heightened geopolitical and economic uncertainty. The update may therefore have acted as a trigger for investors using similar models to reduce positions simultaneously, contributing to a sharp fall and reversal.

Systematic activity also makes genuine value harder to distinguish from factor exposure. A stock may look cheap because of weak earnings momentum, while a Quality or Momentum stock may attract demand beyond what long-term cash flows justify.

Healthcare illustrates this challenge: many stocks have declined together despite meaningful differences in their businesses and outlooks. This can create opportunity, but it complicates the distinction between deteriorating fundamentals and broader factor selling.

The ClearBridge team therefore assesses stocks through several lenses, including valuation, quality, profitability, growth, capital deployment, earnings revisions and price momentum. This helps identify when a factor has become crowded or mispriced.

Technology and artificial intelligence are accelerating the speed at which systematic investors process information, increasing the value of context over speed alone. ClearBridge's research indicates that much of its alpha has historically been realised over nine months or longer, based on sustainable earnings, cash flows, competitive position and valuation.

At the same time, sharper short-term dislocations can create trading opportunities. Turnover in ClearBridge's high-conviction portfolios historically averaged around 20% to 25% a year. Over the past few years, it has been edging closer towards 40-50%, reflecting the Valuation opportunity and the greater frequency with which stocks have moved through large valuation ranges over short periods.

Style exposure is not the same as true alpha

The strong performance of Quality, Growth and Momentum has also made genuine manager skill harder to distinguish from favourable factor exposure.

Many active portfolios maintained persistent tilts towards these styles. In some cases, apparent alpha was largely a sustained style tailwind rather than superior stock selection.

Over the past 12 months, market leadership has shifted and both Quality and Momentum have experienced periods of underperformance. As these tailwinds weakened, the difference between stock-selection skill and embedded factor exposure became more visible.

Headline returns therefore tell only part of the story. Investors need to know whether returns remain after adjusting for Value, Quality, Growth, Momentum, market beta and company size.

ClearBridge uses factor-based attribution and regression analysis to separate systematic exposures from returns generated through security selection and portfolio construction.

This distinction is also important when combining managers. Two strategies may hold different stocks and describe their processes differently, yet still be exposed to the same underlying factor cycle. A portfolio of several managers may therefore provide less diversification than their labels suggest.

Building a More Resilient Fundamental Approach

Fundamental research remains essential, but it must be supported by a broader understanding of market structure. This is particularly important in Australia, where a concentrated index, heavy exposure to financials and resources, and a relatively narrow pool of liquid stocks can amplify the effects of passive flows and systematic positioning.

A resilient process therefore combines company research with factor awareness, disciplined portfolio construction and close attention to liquidity, crowding and market flows. It must also balance patience with flexibility: some mispricings may take years to correct, while factor-driven movements can create or remove meaningful opportunities within days.

The strong relative performance of the ClearBridge Australian Select Opportunities portfolio during FY26 provides an example of this approach working in practice. It demonstrates that meaningful alpha can still be generated when deep fundamental insight is combined with quantitative analysis, disciplined risk management and an understanding of the forces influencing current prices.

For advisers and their clients, this reinforces the importance of selecting core fundamental managers that can distinguish genuine company-level opportunity from factor-driven returns, manage concentrated risks and adapt across changing market conditions.

This does not replace fundamental investing. It strengthens it by helping managers understand both what a company is worth and the forces influencing its current price.

Explore the analysis behind these observations in the ClearBridge white paper, Australian Equities at an Inflection Point: Observations from the Frontline, including the implications for liquidity, factor crowding, portfolio construction and the search for true alpha. Please contact **au_cpm@clearbridge.com** for a copy.

About the Author

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- 33 years of investment industry experience
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