



A Franklin Templeton Company

# The Best of Both Worlds: Can Fundamentals and Systematic Co-exist in the Next Phase?

## Key Takeaways

- ▶ **Systematic investing has become the default — but scale creates risks.**  
Crowding, higher correlations and index-driven flows are increasingly influencing price formation in Australian equities.
- ▶ **Factor diversification is not fail-safe.**  
Periods of sharp reversals and “quant winters” highlight that systematic strategies can underperform materially when regimes shift.
- ▶ **Passive and systematic flows can distort markets.**  
Price-insensitive trading and concentration in large index names are contributing to greater volatility and weaker price discovery.
- ▶ **Fundamental insight remains critical in identifying risk and inflection points.** Forward-looking analysis can detect deteriorating quality and changing business dynamics before they are reflected in quantitative signals.
- ▶ **A hybrid approach can improve portfolio resilience.**  
Combining systematic discipline with fundamental insight helps reduce unintended factor exposures and delivers more consistent alpha across cycles.
- ▶ **The next phase of portfolio construction is integration, not substitution.**  
Investors should consider complementing systematic allocations with active fundamental strategies that isolate true idiosyncratic mispricing.

## Systematic investing: is it going too far?

The late 1990s marked a formative period for many fundamental investors, coinciding with the collapse of Long-Term Capital Management (LTCM). This was a watershed moment for quantitative investors, highlighting how models reliant on historical data could fail catastrophically during “black swan” events. Industry veterans who started their careers a decade or so earlier also experienced a major jolt to quantitative thinking during the October 1987 crash, given the role of portfolio insurance in amplifying the downturn during the great crash.

Quantitative-based “systematic” investing has evolved through those moments and has been in a constant push and pull with fundamental investing.

Today, when we talk about systematic investing, we are now generally referring to rules-based or algorithmic investment techniques. All passive investing is systematic — but not all systematic investing is passive.

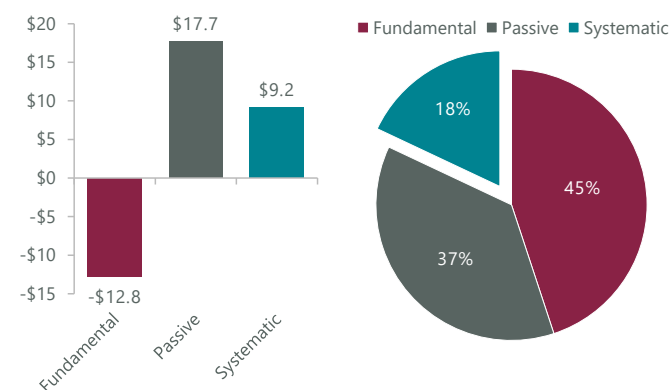
On the non-passive side, there is a large body of academic research supporting the case for systematic and factor investing based on diversification benefits, smoother outcomes from holding multiple factors and evidence that factor premia exist over long horizons.

The industry has developed an increasingly sophisticated array of implementation options. Today, multi-factor approaches, dynamic allocation across factors, and machine-learning overlays are commonplace. Each primary factor theme — value, quality, momentum, low volatility, size etc. — has seen a veritable zoo of alternative approaches to create exposures to the factor themes. These are now readily accessible through smart beta Funds and ETFs at materially lower fees over time.

As a result, the level of assets for both passive and non-passive systematic investing has grown significantly over the past few years.

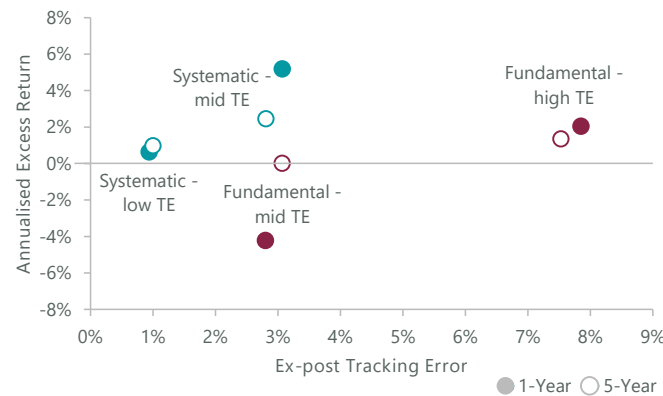
As Exhibit 1 shows from both a flow and AUM perspective, systematic strategies have become the default solution for many institutional investors as they address issues such as tighter risk requirements, a drive for lower fees, and, importantly, passing Your Future Your Super (YFYS) performance tests. The relative risk-adjusted performance of the systematic strategies has reinforced why this growth has occurred (Exhibit 2).

**Exhibit 1: Australian equity 3-Year Net Flows (A\$bn) and current AuM mix (%)**



Source: ClearBridge, Morningstar Direct; as of 31 December 2025.

**Exhibit 2: Median performance of fundamental & systematic managers over one & five year periods**



Past performance is not a guide to future returns. Source: ClearBridge, eVestment Alliance; as of 31 December 2025. Gross performance data is presented without deducting investment advisory fees, broker commissions, or other expenses that reduce the return to investors. Index: S&P/ASX 200 Accumulation. Low tracking error (TE) managers: < 1.5%; Mid TE managers: 1.5 – 5%; High TE manager >5%. Categorisation based on the investment team’s analysis and assumptions for 41 Australian large cap manager returns available in eVestment database over the time period.

The incentives for institutional investors are not going away, and we concur that systematic investing offers a powerful foundation for portfolios. However, each individual factor can suffer from prolonged drawdowns and infrequent, but extreme underperformance.

Like a crowd in a dark cinema when someone yells ‘fire’, everyone rushes to the nearest exit they think is safe, only to realise too late that the real danger is the stampede itself. In this paper, we discuss a hybrid combining discretionary fundamental investing with systematic factors. We believe this offers fiduciary investors and advisers the potential to diversify from an over-reliance on systematic factors.

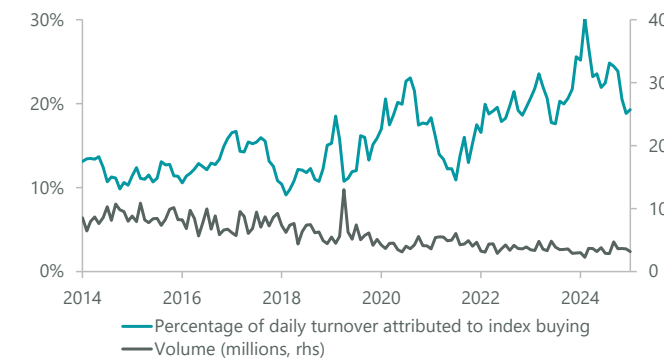
**The dominance of systematic investing**

Passive and non-passive systematic investing now sit at the very centre of portfolios — both in Australia and globally. Passive indexing has become dominant and self-reinforcing, and as flows increase, so does its influence on prices, liquidity, and behaviour.

This can be seen in turnover and volume trends in high index flow stocks like Commonwealth Bank of Australia or Wesfarmers (Exhibit 3)<sup>1</sup>. The willingness of investors to trade to match an index, regardless of price, is creating a persistent upward bias to price discovery for many stocks and greater volatility in these names.

Price impacts during reporting season are also becoming more volatile where the lower turnover driven by index can reverse sharply as fundamentals and noise traders return in the short term. The index flow

**Exhibit 3: Indexing’s impact on turnover and volume: Wesfarmers example**

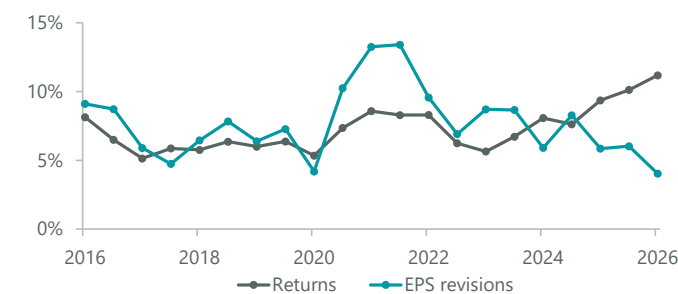


Source: ClearBridge, FactSet; as of 31 December 2025. Index flow: based on the investment team’s analysis and assumptions.

distortion is most evident when markets are quiet and there are fewer information traders, however, when the market sees new information on a stock, such as during results season, the overall volume of shares traded typically increases and the impact of pure index buying diminishes as it is overpowered by the trading based on the new information. This typically results in small levels of information or ‘news’ causing large price reactions.

We have seen this for several companies in the top 50 where their earnings were revised less than +/-2% (what we would consider ‘in-line’) but had big share price reactions. Compared to prior periods, this is becoming more pronounced each reporting season (Exhibit 4).

**Exhibit 4: February 2026 reporting season cross sectional variance for the top 50 ASX stocks**



Past performance is not a guide to future returns. Source: ClearBridge, FactSet; as of 28 February 2026. Data for the S&P/ASX 200 Index. Expected next 12 Months (NTM) data is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed and may differ materially from the figures mentioned. The figures may also be affected by inaccurate assumptions or by known or unknown risks and uncertainties. In respect of the broker consensus data the number of brokers included for each individual stock will vary depending on active coverage of that stock by a broker at any point in time. A median of brokers is typically utilised. All estimates avoid stale forecasts which are removed after a certain number of days. Revisions: change in broker consensus NTM forecasts after companies have reported their results on a specific measure. Down: <-2%, Inline: between -2% and +2%, Up: >+2%. Returns: price move during reporting season month.

This isn’t just a “vibe”, there is a growing body of academic research supporting the case that passive investing may be distorting markets. Think of papers such as [The Inelastic Markets Hypothesis](#) or [Passive Investing and The Rise of Mega-Firms](#).

Our concern today is that systematic investing has buried the risk of unintended consequences if regime shifts suddenly. That raises several critical questions such as have pushed the systematic dial too far and it is time to pivot back towards fundamental investing.

**Risks have not been eliminated in systematic investing**

Despite the sophistication, the risks inherent in systematic strategies have not disappeared. When regimes shift, backward-looking models become less robust. Factors that look stable can become unstable very quickly, correlations that appear diversified can converge, and liquidity can unwind across seemingly unrelated quantitative strategies. At the extremes, systematic strategies can start to resemble momentum trades — often without investors fully appreciating the exposure they’re taking.

When systematic strategies unwind, the pain can be real and factor reversals can be violent, like they were during the early days of the Covid-19 crisis (Exhibit 5). In Exhibit 6 we show that while systematic portfolios have performed well overall in Australia, there are periods of what can be called “quant winters”, where returns diverge meaningfully from fundamental outcomes.

We also have recently seen significant short-term swings in factors impacting the Australian equity market such as Gold and Growth, and while there is also long persistence of alpha from the Value style in Australia simple book-to-price has not adapted well over much of the last decade.

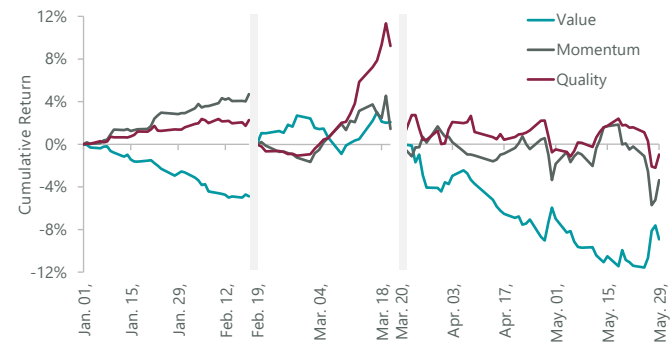
Passive indexing at scale introduces its own risks. It can amplify concentration, and we have seen that in Australia and the US. Whether that’s a stock like Commonwealth Bank of Australia locally or the Magnificent Seven globally, crowding means there is often no valuation anchor or fundamental insight to tell you when risk has become asymmetric. Correlation risk is also rising. Passive products are likely to co-move with the market compared to fundamental strategies, suggesting that the ‘tail is wagging the dog’.

By design, passive index investing can’t underperform its benchmark, but it can expose investors to very long periods of capital stagnation or drawdown.

<sup>1</sup> The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable. References to particular industries, sectors or companies are for general information and are not necessarily indicative of a fund’s holding at any one time.

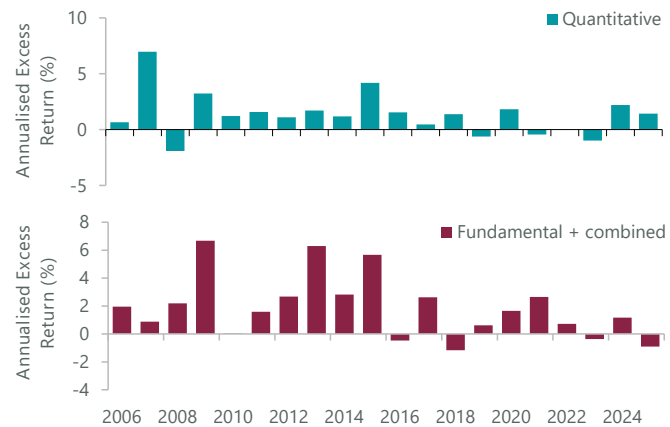
We are not convinced that modern systematic investing will be able to genuinely fix these market issues, even with the progress we are seeing in AI today. We propose that human, fundamental insight may be the key to understanding when models are drifting into danger. This should never be an either/or debate.

**Exhibit 5: Cumulative global factor performance through start of Covid-19 crisis**



Past performance is not a guide to future returns. These numbers do not represent the performance of an actual portfolio and should not be considered as an indication of future returns. Source: ClearBridge, JKP; as of 31 December 2025. JKP (2023) Global Factor Data. Available from <https://jkpfactors.com/factor-returns> (Accessed: 27 January 2026).

**Exhibit 6: Average excess returns by "primary investment approach"**



Past performance is not a guide to future returns. Source: ClearBridge, eVestment Alliance; as of 31 December 2025. Calendar year excess returns versus the S&P/ASX 200 Accumulation Index for actively managed Australian equity-long only strategies with gross of fee returns available in AUD. Filtered to exclude sector specific portfolios and to only show managers with mid-large to mega cap as their Primary Equity Capitalization.

**Embracing convergence between systematic and fundamental approaches**

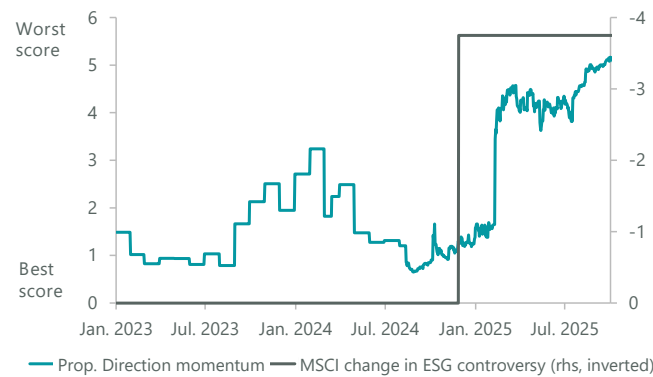
Systematic investing is here to stay, but a hybrid version that embraces fundamental insight is more 'fit for purpose'.

In the race to lower risk and fees, and pass performance tests, the benefit of integrating fundamental insight into investing needs to get more credit, particularly in identifying true business risk and inflection points that quantitative signals can miss.

Australian stock WiseTech Global is a good example of the value of convergence between systematic and fundamental approaches. It was a classic momentum, growth, and moat stock that quant signals loved and was widely held by thematic ETFs.

As we now know in hindsight, the company experienced a tumultuous share price in late 2024 with corporate governance scandal and leadership transition. However, as can be seen in Exhibit 7, fundamental analysis identified the deterioration in quality, governance and business risk early — well before momentum factor signals adjusted.

**Exhibit 7: Comparing fundamental and quantitative signals: WiseTech Global example**



Source: ClearBridge, MSCI; as of 31 December 2025.

**Controlling for factors within fundamental**

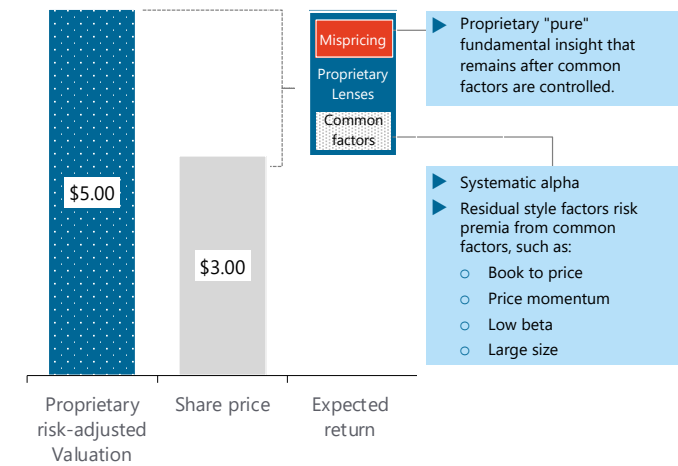
To combine systematic and fundamental investment styles well, you need robust measures. We don't believe you can simply bolt a stock picker to a momentum filter and call it integration as this can cause unintended factor bets.

Often, fundamental managers try to provide alpha by combining a style-based philosophy with forward looking fundamental insights. However, the impact of common factors in their favoured style bias can often play a larger role in explaining their expected returns than any specific insight into stock rotation or stock selection. This comes at the cost of higher tracking error, as style factor cyclical can lead to extended periods of time when a style is 'out of favour'.

The focus of all our active fundamental Australian equity portfolios is to maximise "Mispricing", or the proprietary

fundamental insight that remains after the systematic influence of style factors have been tightly controlled or neutralised (Exhibit 8).

**Exhibit 8: The source of expected alpha**

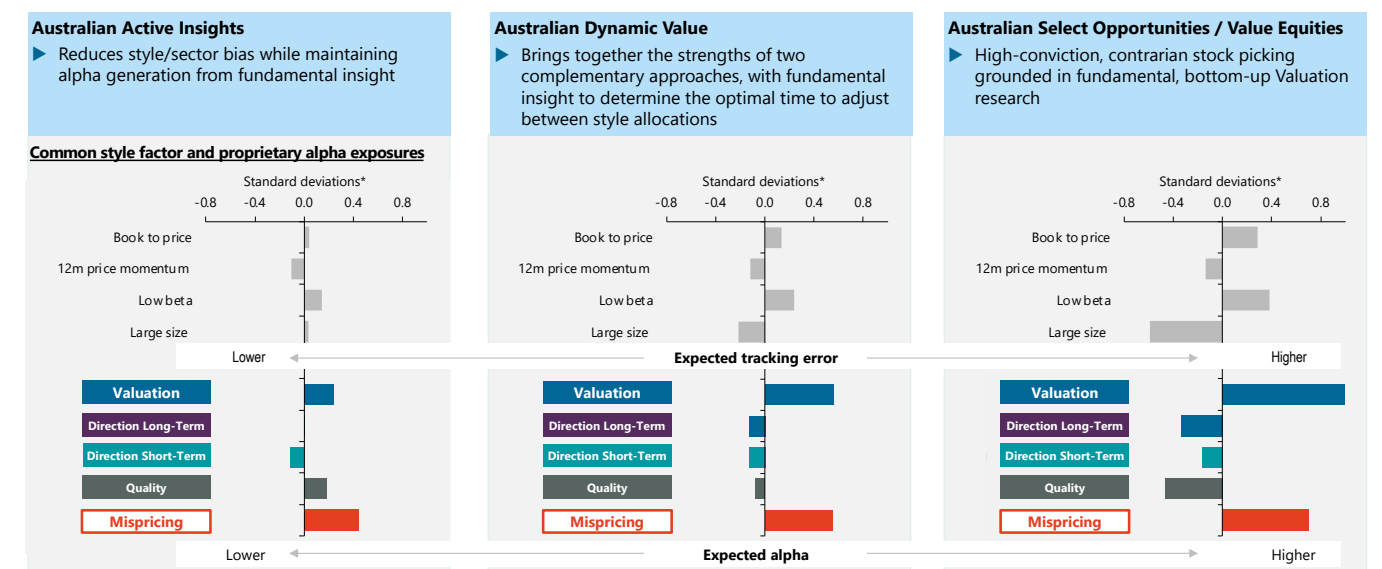


Past performance is not a guide to future returns. Data shown for illustrative purposes only.

**A hybrid, scalable approach to reflect targeted client style, risk and return outcomes**

We have designed a hybrid systematic and fundamental approach that focuses on fundamental lenses (e.g. Valuation) and seeks to isolate the idiosyncratic alpha from Mispricing, which we then can use to dial up or down factor and risk exposures based on client preferences (Exhibit 9).

**Exhibit 9: 'Mispricing': the focus for all active Australian equity portfolios**



Past performance is not a guide to future returns. Source: ClearBridge; as of 31 December 2025. Data shown for Clearbridge Australian Select Opportunities and Australian Active Insights representative accounts, and a simulated Australian Dynamic Value portfolio with a 40% allocation to Select Opportunities and 60% to Active Insights. \*Relative to the S&P/ASX 200 Accumulation Index.

For risk constrained investors, and to avoid amplification of unintended factor risk that may be prevalent elsewhere in a client's portfolio, we advocate using quantitative techniques to remove or reduce the impact of common style factors from fundamental insights. Our **Australian Active Insights** strategy implements this concept.

Alpha generated using this approach can be more consistent as returns are less susceptible to typical style cycles or factor reversals. Lower style factor influence can also reduce the risk of extended underperformance that could exceed time horizon and risk tolerances of risk-constrained investors.

For clients with longer time horizons and higher risk tolerances, style factor risk may be acceptable, and we offer our flagship **Australian Select Opportunities / Value Equity** strategy. As Exhibit 9 highlights, the Mispricing and Valuation opportunity available from this strategy is amplified, but so is the tracking error.

A further option is to only take factor risk when it is justified by the market environment, and as markets value different things at different times, exposures should be adjusted dynamically. We implement this in our **Australian Dynamic Value** strategy, which tilts between Select Opportunities / Value Equities and Active Insights in a risk-controlled manner based on insights into the expected market environment driven by our proprietary forward-looking fundamental Valuation research.

**Multi-lensed research provides the foundation**

For a hybrid approach like this to be successful in identifying true Mispricing, it requires multiple forward-looking lenses that each add insight. It must also be supported by a strong team culture, with quantitative resources such as internal and external data sets, and cloud-enabled tools to augment judgment and provide real-time analysis.

Our Australian Equities platform is built on the consistent, fundamental research process and DCF valuations for the ASX universe that underpins all portfolios managed by the 17-member ClearBridge Australian Equity investment team.

We have designed our framework to capture forward-looking fundamental and qualitative insights across multiple proprietary research lenses: **Valuation**, **Quality**, **Direction Short-Term (ST)**, and **Direction Long-Term (LT)**.

Our multi-lensed framework allows our analysts to detail their independent insights in a step-by-step and consistent manner. It creates a common language for expressing our views on the risks and opportunities

for each company across the investment universe, fostering an environment of team ownership and ongoing dialogue.

Each of our proprietary research lenses has fundamental insight and can then be used systematically to split out idiosyncratic Mispricing from systemic alpha. They each have a track record of providing significant value-add potential when compared to traditional Fama-French and other style factors, as illustrated in Exhibit 10 below.

**Mispricing in practice**

The outputs from our multi-lens research do carry factor biases resulting from the characteristics of the research lenses and the interactions between them. For our **Australian Select Opportunities / Value Equity** strategy, we leave the aggregate benefit of our pure fundamental insights and style factor influences in place and prioritise Valuation. The important differentiation in our approach for the **Australian Active Insights** strategy is how we seek to reduce factor bias while maintaining its fundamental alpha generation.

By using our forward-looking proprietary alpha and risk signals, we can isolate where our insights are most unique, and unexplained by any common factor and super sector risks.

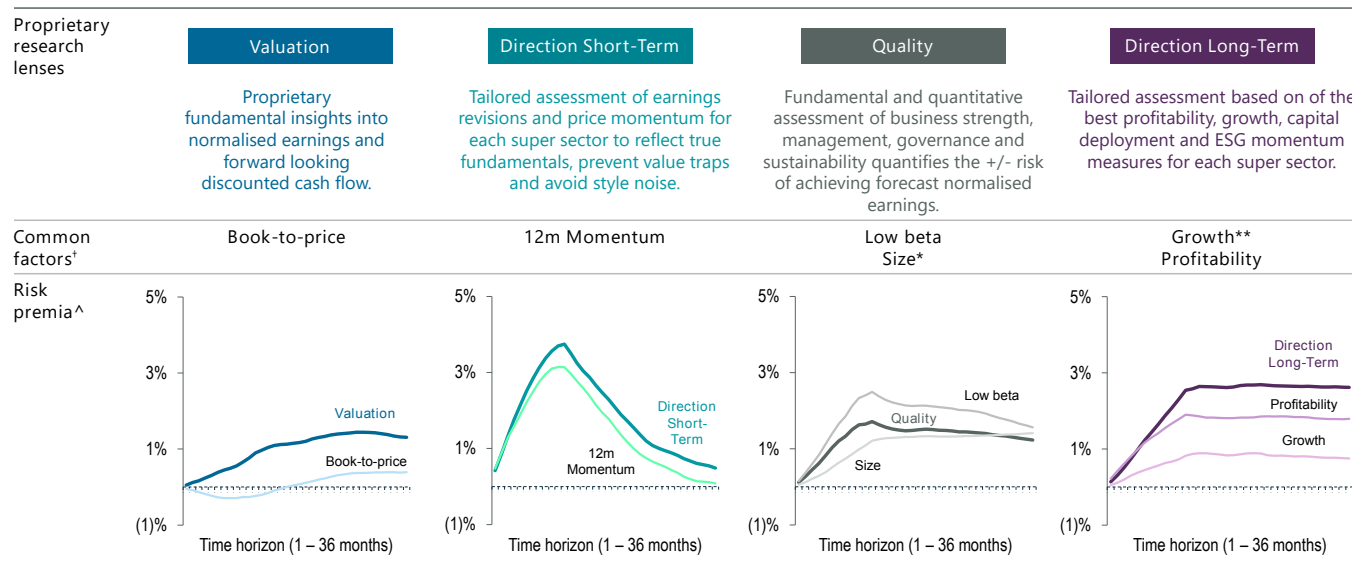
We use our analysts' research lens outputs to build style-neutralised expected returns for each stock. We undertake a proprietary analysis of the analysts' raw risk-adjusted expected returns against common style factors such as book-to-price, price momentum, beta, size and growth. We also address any imbalances that may arise through exposures to the four super sectors of the benchmark - industrials, financials, real assets and resources. The final step amalgamates adjustments for each stock's expected returns to create a style-neutral measure we call Mispricing.

Throughout this process we are seeking to leave the task of the research analyst unchanged – their expertise and insight is driving the discounted cash flow forecasts we use in calculating expected return. However, by transforming fundamental expected returns into Mispricing, we are seeking to isolate the truly idiosyncratic insight that 'survives' after systematic factor risks are considered.

In Exhibit 11 we have shown a stock example to illustrate. AP Eagers has been a high momentum, rising valuation stock. In the chart, we have broken down the appeal of the stock into its raw valuation appeal (return to fair value), the expected return from its quality & ST & LT direction components (risk adjustments) and how its style profile relative to the broader style influences can drive returns (factor/sector neutralisation). The sum of this is reflected as Mispricing and shows benefits of attaching value to multiple lenses.

As our active positions are aligned with the magnitude of their Mispricing, together with experienced fundamental oversight, the portfolio positioning aligns directly with our fundamental expertise. Exhibit 12 shows how higher active weights are typically outside of the top 20 index stocks due to our differentiated fundamental insight, while top 20 stocks do have a role as underweights to balance out residual factor and sector exposures to help provide the more stable, consistent alpha.

**Exhibit 10: Risk premia of proprietary lenses and common style factors**



Past performance is not a guide to future returns. These numbers do not represent the performance of an actual portfolio and should not be considered as an indication of future returns. Source: ClearBridge, FactSet; as of 31 December 2025. Time series data shown for illustrative purposes only. Depicts investment horizons up to 3 years. Periods over a year are annualised. Sample Period: 31 March 2011 to 31 December 2023. Data is relative to the S&P/ASX 200 Accumulation Index. Gross performance data is presented without deducting investment advisory fees, broker commissions, or other expenses that reduce the return to investors. Theoretical results are shown without transaction costs that would reduce the return to investors. †Common factors reflect those identified in academic research such as Fama-French (1992), Jegadeesh-Titman (1993), Titman (2004), Ang (2006); Frazzini (2014) and Novy-Marx (2013). ^Risk premia: denotes the average return associated with a one standard deviation change for a proprietary research lens' signal score or Fama-French or other factor score. Positive and larger risk premia indicate better efficacy. \*Size depicts a premium for large-cap stocks over small cap stocks. \*\*Growth represents a composite factor, incorporating discrete Capital Deployment measures for each proprietary super-sector.

**Exhibit 12: Portfolio targets unbiased mispricing**



Past performance is not a guide to future returns. Source: ClearBridge; as of 31 December 2025. ClearBridge Australian Active Insights representative account shown versus the S&P/ASX 200 Accumulation Index for illustrative purposes only.

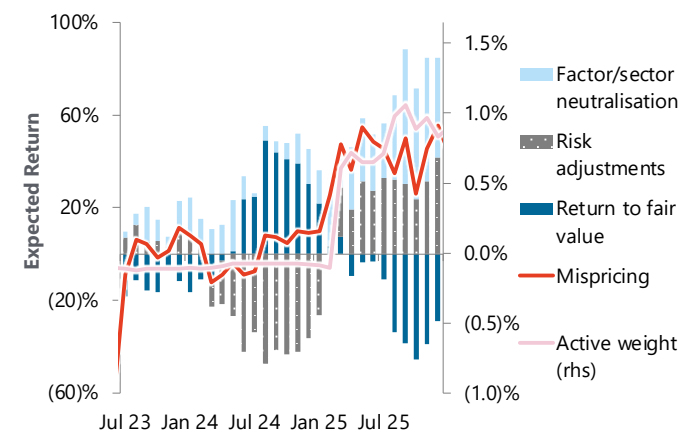
**Dynamic and fundamental integration at work**

This is not a set and forget exercise. The key to a true hybrid approach is for the portfolio management team to understand how bottom-up fundamental ideas translate into factor exposures, and how those exposures evolve through time.

In Exhibit 13 we have shown the magnitude of regression coefficient adjustments used to maintain our desired factor neutral exposures for our Active Insights portfolios. By actively monitoring and adjusting portfolio exposures, rather than holding them static, we can work to deliver more consistent outcomes across market cycles.

Another good stock level example of integrating multiple fundamental research lenses rather than relying on a pure quant approach is Commonwealth Bank of Australia, a stock we mentioned earlier in the context of the impact of high index flow on its upwards price bias. For fundamental managers, the stock was a consensus underweight, as index flows pushed the valuation higher. This created a 'pain trade' in that it needed to be held for benchmark relative risk purposes, despite its poor valuation metrics.

**Exhibit 11: Blending signals: AP Eagers example**



Past performance is not a guide to future returns. Source: ClearBridge; as of 31 December 2025. ClearBridge Australian Active Insights representative account shown versus the S&P/ASX 200 Accumulation Index for illustrative purposes only.

The internal multi factor style score in Exhibit 14 shows how much pure quant models across multiple factors 'loved' the stock through 2024 and 2025, as it kept rising to historically stretched levels. Until they didn't...

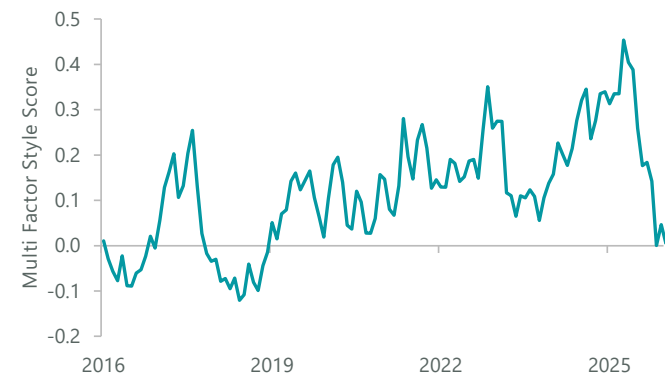
**Exhibit 13: Dynamic management: Portfolio factor exposures**



Past performance is not a guide to future returns. Source: ClearBridge; as of 31 December 2025. ClearBridge Australian Active Insights representative account shown versus the S&P/ASX 200 Accumulation Index for illustrative purposes only.

For us, fundamental insight had already long flagged the risk. Our overall factor discipline managed that risk by not blindly following the quant trail. That's integration working as intended.

**Exhibit 14: 'Pain trade' case study of multi factor style scores: Commonwealth Bank of Australia example**



Past performance is not a guide to future returns. Source: ClearBridge; as of 31 December 2025. Data is relative to the S&P/ASX 200 Accumulation Index for illustrative purposes only.

**Conclusion**

Systematic investing has rightly earned its place at the core of modern portfolios. Its efficiency, scalability and long-term factor premia have delivered clear benefits to institutional investors. However, scale has changed its behaviour.

Crowding, rising correlations and episodic factor reversals mean systematic strategies can introduce risks that are not always visible until regimes shift. At the extremes, the pursuit of diversification can result in more uniform positioning, and more fragile outcomes. This is not an argument against systematic investing, but against relying on it in isolation.

A hybrid approach that integrates forward-looking fundamental insight with systematic discipline offers a more resilient path forward.

By isolating true idiosyncratic mispricing and actively managing factor exposures, it is possible to:

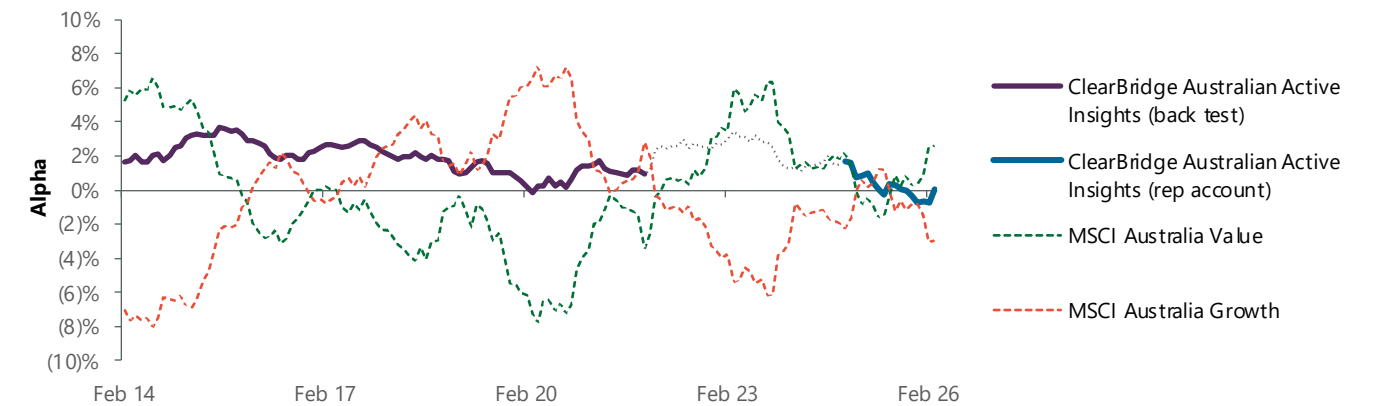
- reduce unintended factor concentration,
- navigate regime shifts more effectively, and
- deliver a more consistent and smoother alpha path across cycles.

As illustrated in Exhibit 15, this approach, as implemented in our Australian Active Insights strategy, has the potential to deliver smoother excess returns, avoiding the pronounced cyclicity often associated with style-driven outcomes.

For institutional investors, the implication is clear: the next phase of portfolio construction is not a choice between fundamental and systematic — but a deliberate combination of both.

Systematic strategies provide an efficient foundation. Fundamental insight provides the context, judgement and risk awareness that models alone cannot. In a market where many investors are positioned the same way, that combination matters more than ever.

**Exhibit 15: Rolling three-year excess returns (relative to the S&P/ASX 200 Accumulation Index)**



Past performance is not a guide to future returns. These numbers do not represent the performance of an actual portfolio and should not be considered as an indication of future returns. Source: ClearBridge; as of 31 March 2026. Data shown for a ClearBridge Australian Active Insights representative account and back test in AS\$, gross of investment management fees, custody fees, administration fees, net of trading expenses, and includes the reinvestment of distribution income which is net of non-reclaimable withholding taxes. Franking credits are excluded. Periods over a year are annualised. Back test sample period from 1 March 2011. Actual returns shown from 1 December 2021. Theoretical results are shown without transaction costs that would reduce the return to investors. Please refer to risk warnings within the Important Information at the end of this paper.

The performance results of the back test and representative account are presented as supplemental information to the GIPS Report for the ClearBridge Australian Active Insights Composite in AUD. The composite contains fully discretionary Australian Equity accounts containing diversified portfolios of Australian Equity securities. For comparison purposes the composite is measured against the S&P/ASX 200 Accumulation Index. Composite inception date: 1 November 1988. This representative account was selected because it is the longest running account for the strategy and most closely reflects the strategy's current investment mandate. Supplemental information complements the GIPS-compliant presentation but is not itself subject to GIPS verification. The Firm (defined for GIPS purposes as the ClearBridge Australian Equities Investment team, a division of FTAL) claims compliance with the Global Investment Performance Standards (GIPS®). GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organisation, nor does it warrant the accuracy or quality of the content contained herein. To receive a complete list and description of composites and/or a presentation that adheres to the GIPS standards, please contact [AUSClientServices@ClearBridge.com](mailto:AUSClientServices@ClearBridge.com).

**About the Author**



**Matthew Davison**  
Managing Director, Portfolio Manager

- 27 years of investment industry experience
- Joined the firm in 2013
- Merrill Lynch – Equity Research Analyst
- Citi – Equity Research Analyst
- National Australia Bank – Investments and Advisory Analyst
- Bachelor of Commerce (Honours) from the University of Melbourne
- Graduate Diploma in Applied Finance and Investment from the Financial Services Institute of Australasia

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### **Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.**

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- The strategy may invest in derivatives (index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions..
- Investors should also be aware of the following back-test risks. The back-test results presented in this document are based on simulated performance results. Please be aware these have certain limitations. Back-tested performance returns do not represent the impact of trading. The trades in the back testing have not been executed and may not fully reflect the impact of market factors such as liquidity. The investment team no representation that any account will or is likely to achieve returns similar to those illustrated as a result of the back testing presented.

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