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The narrow market, untangled

Building a stronger core in a concentrated market

May 2026

Executive summary

The Australian equity market is one of the most concentrated developed markets in the world. The S&P/ASX 200 holds approximately half its weight in ten stocks, with more than half allocated to financials and materials. Market capitalisation weighting was designed as a measure of market health, not as a tool for portfolio construction. In a market this narrow, applying it as the default for a core allocation produces an exposure profile that reflects the size of the largest companies rather than their quality, valuation or contribution to portfolio risk.

The structural features of the Australian equity market raise a specific question for investors: whether single-factor strategies, applied to a universe this narrow, can deliver the characteristics they are designed to provide. Our April 2026 paper, *The limits of quality in Australia*, showed that they have not. The same universe constraints that compromise the benchmark compromise approaches built on top of it.

We will show that despite these structural challenges, there is an alternative way to invest in a diversified portfolio of Australian equities. The approach expresses quality characteristics by targeting several complementary factors and has historically achieved excess returns over the long term, working within the structural limitations of the Australian market rather than against them.

Defining factors

Factor investing identifies systematic drivers of equity returns and constructs portfolios to target specific exposures, with the aim of delivering distinct investment characteristics. The four most-studied factors in equity markets are quality (companies with high profitability and stable earnings), value (companies trading at low valuation multiples), momentum (companies with strong recent price performance), and low volatility (companies with lower historical price variability). Each factor is associated with a specific pattern of returns and risk behaviour that has been documented across multiple decades of academic research, including foundational work by Novy-Marx (2013) on the profitability premium and Fama and French (2015) on the five-factor asset pricing model.

The value of factor investing is in the characteristics it provides, not simply in the returns it generates. A quality allocation buys defensive behaviour: shallower drawdowns, faster recovery, lower beta. A low volatility allocation buys mean reversion. The long-run excess return associated with each factor is a consequence of these characteristics, not the primary objective.

These characteristics have been reliably observed in international markets, where factor frameworks operate on deep universes of thousands of investable securities. The question this paper addresses is whether the same factor frameworks behave as intended when applied to the Australian equity market, where the universe is materially smaller and the structural starting conditions are different. Section 1 examines those structural conditions.

1. The ASX 200 and the question of a core holding

This paper is the third instalment of a sustained VanEck research programme on construction-led investing in Australian equities. In 2022, *The Australian Concentration Conundrum* set out the structural reasons single-factor strategies have historically failed in Australian equities: stock concentration, sector imbalance and a finite investable universe. In April 2026, *The limits of quality in Australia* updated that analysis with four additional years of data and confirmed the conclusion with specific reference to the quality factor.

This paper moves the argument from diagnosis to refined prescription. This paper is split into 6 sections.

- Section 1 qualifies the structural limitations.
- Section 2 examines why single-factor strategies have not resolved them.
- Section 3 introduces the Quality Plus framework.
- Section 4 presents the empirical record.
- Section 5 addresses implementation.
- Section 6 concludes.

Passive investment in the S&P/ASX 200 is routinely presented as the neutral, low-cost default for Australian equity exposure. The characterisation deserves examination. Market-capitalisation weighting is not a neutral decision. It is an allocation rule that systematically overweights the largest and most liquid stocks regardless of their fundamental characteristics, valuations or contribution to portfolio risk. In the Australian market, the consequences of this rule are, in our view, structural rather than incidental.

1.1 Concentration by stock and sector

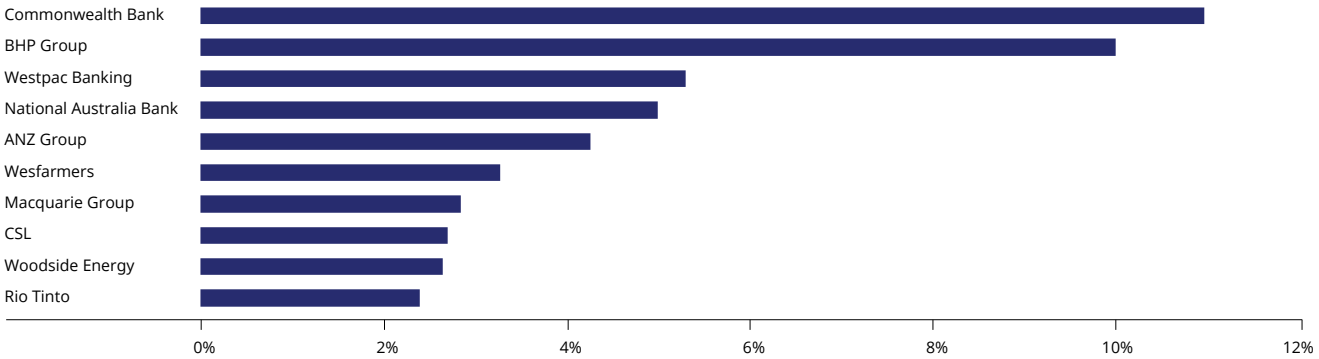
The structural features of the Australian equity market discussed in this section were analysed in detail in our 2022 paper, *The Australian Concentration Conundru*m. The summary that follows updates that analysis to March 2026 and provides the context for the construction-led argument that follows.

The S&P/ASX 200 is one of the most concentrated equity indices in the developed world. As at 31 March 2026, the top ten holdings accounted for approximately 50% of index weight. This is a direct consequence of applying market-cap construction to an investable universe of approximately 200 names. Concentration at this magnitude has two implications for a core allocation. First, the diversification that investors may assume they are acquiring through an index product is limited in practice. Ten positions is not a diversified book. Second, the index's performance is exposed to the idiosyncratic outcomes of a small number of dominant companies.

The sector picture is more restrictive. Financials and materials together represent over 50% of the S&P/ASX 200. These sectors have fundamentally different risk characteristics. Australian banks are highly leveraged by the nature of their business model, with balance sheet leverage as a feature of the business rather than a flaw. Mining companies carry volatile earnings driven by commodity cycles that are largely exogenous to management quality. Neither sector tends to exhibit the stable earnings growth, high return on equity and low financial leverage that empirical research has identified as durable drivers of long-run outperformance.

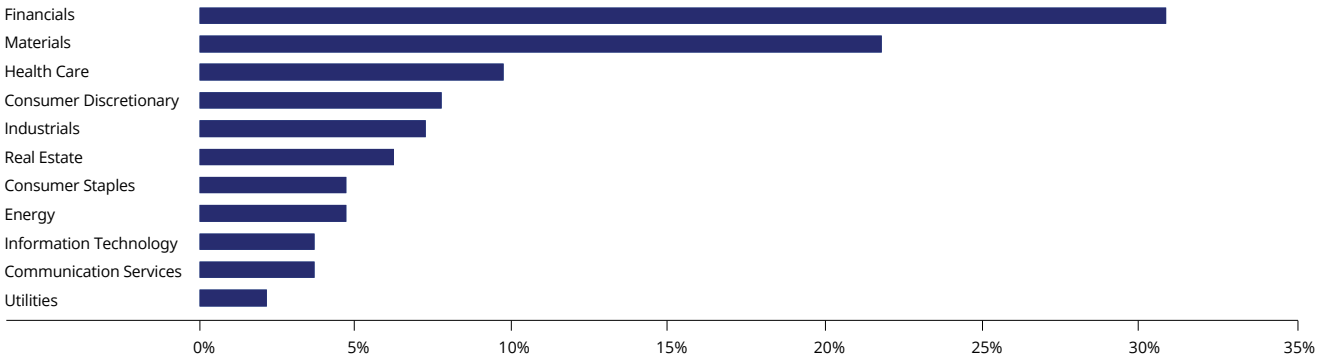
Exhibits 1 & 2: ASX 200 stock and sector concentration

Top 10 holdings account for approximately 50% of the ASX 200



Source: VanEck, FactSet, as at 31 March 2026. These weightings may vary over time.

Financials and Materials exceed 50% of the ASX 200



Source: VanEck, FactSet, as at 31 March 2026. These weightings may vary over time.

1.2 The finite universe

Global equity benchmarks such as the MSCI World ex Australia Index draw from thousands of investable securities. In contrast, the S&P/ASX 200 universe contains 200 names. The difference is material for portfolio construction. Any approach that begins from the Australian universe inherits the gravity of the large-cap anchors it contains. A 40 or 50 stock portfolio selected from 200 names will necessarily share material overlap with the benchmark's most dominant positions.

Stock concentration, sector imbalance and a finite investable universe together define what we have previously called the Australian concentration conundrum. These are the starting constraints that any Australian equity allocation must address. A passive S&P/ASX 200 allocation does not address them. It accepts them.

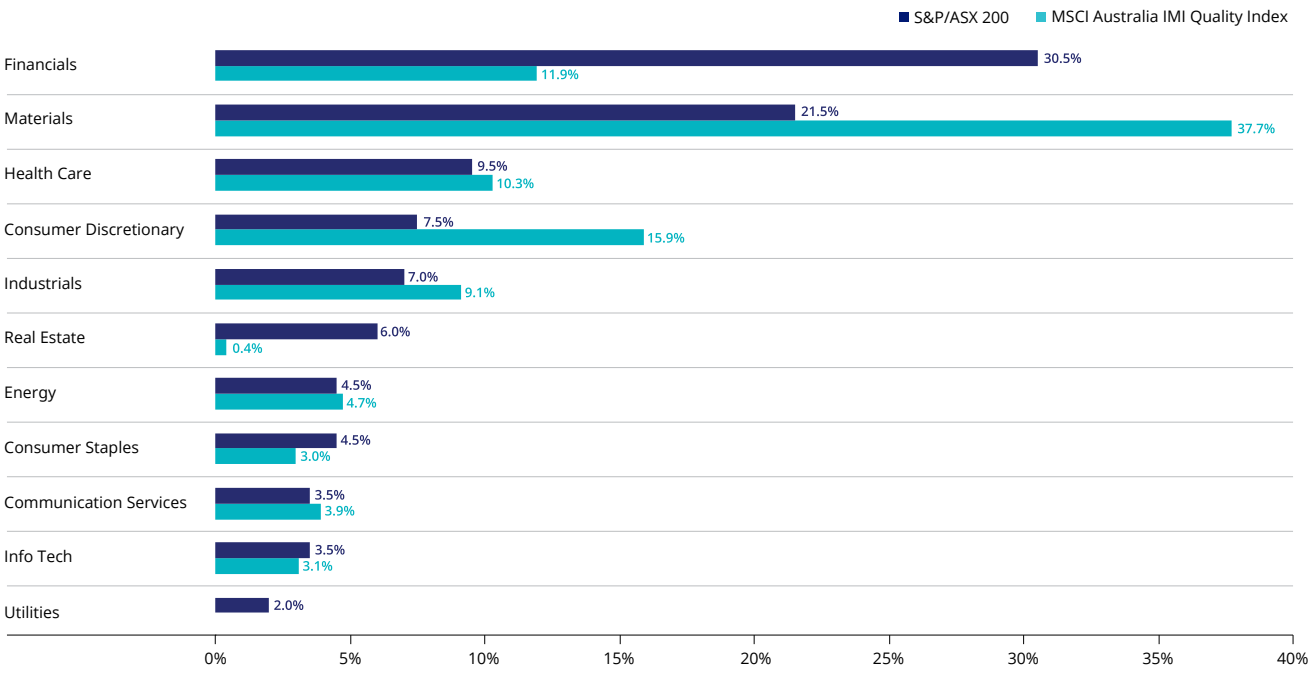
2. Why single-factor strategies fail in Australian equities

The structural conditions outlined in Section 1 raise a question for portfolio construction. Single-factor strategies, quality, value, low volatility and momentum, have historically delivered the characteristics they were designed to provide in international markets. The empirical question is whether they replicate those outcomes in Australian equities. Our analysis across two prior research papers, *The Australian Concentration Conundrum* (2022) and *The limits of quality in Australia* (April 2026), indicates they have not. The evidence below sets out four observations from that analysis. Together they explain why a single-factor approach, regardless of which factor is chosen, has historically struggled in this market.

2.1 Quality in Australia is not defensive

An Australian single-factor quality screen does not produce a defensive portfolio. As at 31 March 2026, the MSCI Australia IMI Quality Index held 42% in materials and energy combined, a third more than the S&P/ASX 200 in those sectors. Only 13% sat in traditional defensive sectors (consumer staples, health care and utilities). This is the opposite of what investors expect from a quality strategy. In international markets, single-factor quality typically overweights the same defensives that the Australian construction underweights. The Australian outcome is a direct consequence of applying a fundamental quality screen to a universe in which the highest scoring quality names are concentrated in cyclically exposed sectors.

Exhibit 3: Sector composition of single-factor quality in Australia

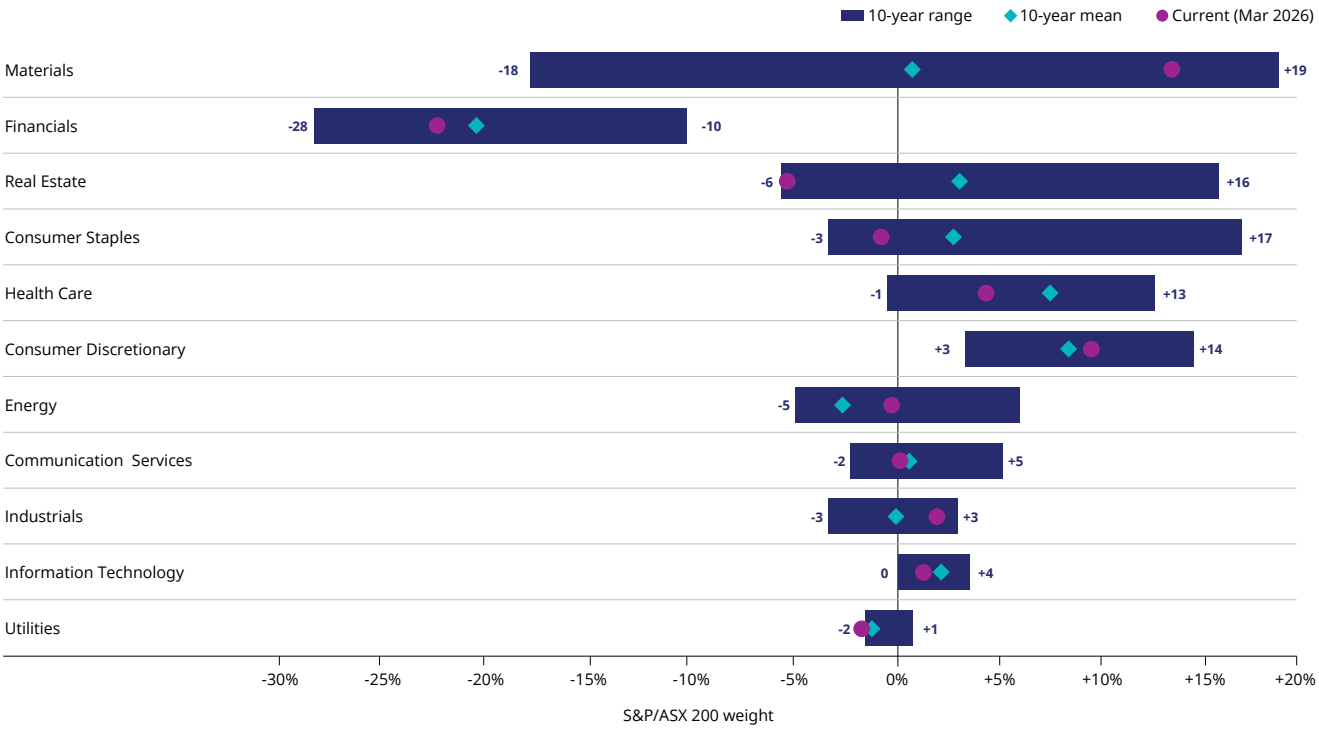


Source: FactSet, MSCI as at 31 March 2026. You cannot invest in an index.

2.2 Single-factor quality is a moving target

The sector composition of single-factor quality in Australia is not only undesirable, it is unstable. Over the ten years to 31 March 2026, active sector weights against the S&P/ASX 200 have swung dramatically. Materials has ranged from -18% to +19% active weight, a 37% spread. Financials has ranged from -28% to -10%. Real Estate has swung between -6% and +16%. The shifting active weights reflect the underlying volatility of which sectors satisfy the quality screen at any point in time. For an investor who allocates to quality expecting a stable defensive exposure, the actual sector profile is a moving target. The strategy provides factor exposure in name, but not a consistent set of investment characteristics.

Exhibit 4: Active sector weight ranges, 10-year history

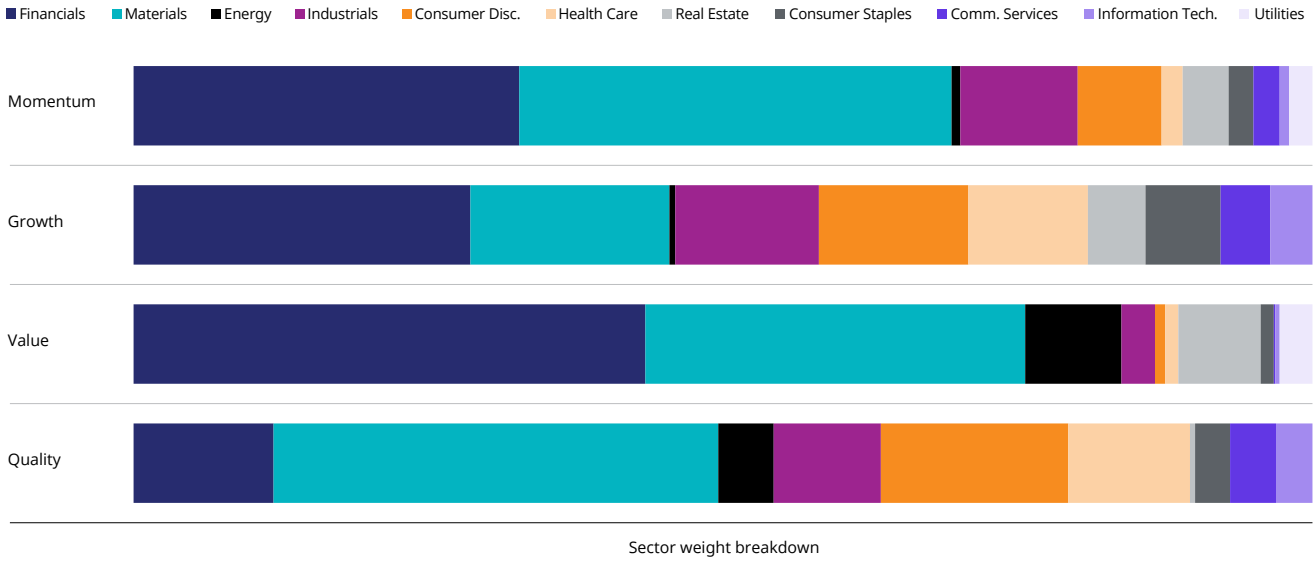


Source: MSCI, S&P Dow Jones. MSCI Australia IMI Quality Index quarterly sector weights minus S&P/ASX 200 sector weights, 41 quarterly observations from March 2016 to March 2026.

2.3 Single factors converge on the same exposures

Different single-factor strategies are expected to deliver different exposures. In Australia, they tend to converge on the same concentrated bets. As at 31 March 2026, the Australian single-factor quality index held 49.6% in Financials and Materials. The single-factor value index held 45.5% in the same two sectors. Quality and Value are designed to be uncorrelated factor exposures. In a concentrated market, the starting universe pulls them toward the same large-cap dominant names. The investor who builds a multi-factor allocation by combining single-factor strategies in Australia may find the diversification across factors is materially less than expected. The factors are converging on the same constraints rather than offsetting each other.

Exhibit 5: Single factor concentration in Financials and Materials



Source: FactSet, MSCI as at 31 March 2026.

2.4 The case for combining factors within a construction framework

The empirical observations above point to a specific implication. Each single factor, applied in isolation to the Australian universe, has known failure modes. Quality alone overweights materials. Value alone overweights cyclical names where low valuations reflect earnings cyclicality, not margin of safety. Low volatility alone sacrifices return for stability. Momentum alone produces excessive turnover. Combining factors at the security level can offset these failures, where one factor's weakness coincides with another's strength.

Combining factors is necessary but not sufficient. A multi-factor screen applied without further discipline still inherits the large-cap concentration of the parent universe. The factors offset each other at the security level, but at the portfolio level the construction can still collapse into the same handful of dominant names. The complete answer is a construction solution: a framework that combines complementary factor characteristics within explicit constraints on stock and sector concentration. Let us consider an alternative approach that works within the structural limitations of the Australian equity market, that expresses intended factor characteristics.

3. Inside the Quality Plus construction

The MSCI Australia IMI Quality Plus Index (AQTY Index) is a custom index developed by MSCI in collaboration with VanEck, designed to address the structural limitations of the Australian equity market identified in our prior research. The construction proceeds in four stages, each addressing a specific failure mode observed in single-factor quality construction in Australia. The intent is to convert a factor signal that has historically been insufficient in isolation into a portfolio outcome that exhibits the characteristics associated with the factor internationally.

3.1 The parent universe and the two sub-portfolio architecture

The starting universe is the MSCI Australia IMI Index: large, mid and small cap Australian equities excluding Real Estate Investment Trusts. Approximately 200 stocks, broadly comparable to the S&P/ASX 200. From this universe, the index applies a two sub-portfolio structure that selects approximately 50 securities, with each sub-portfolio contributing 50% of the final weight. Sub-portfolio 1 targets the stocks that cumulatively cover 50% of parent market capitalisation, weighted by a combined factor score. This preserves a large-cap anchor while applying factor discipline to weight selection. Sub-portfolio 2 draws from the remaining universe on the same combined factor score, then applies a momentum filter that retains only the top half of candidates by momentum rank. The second sub-portfolio is the mechanism by which the index accesses mid-cap quality exposure that single-factor, large-cap-anchored approaches have historically missed.

3.2 The quality-led composite score

The composite score that drives stock selection is quality-led. Quality is the anchor characteristic, reflecting MSCI's established quality fundamentals: profitability, investment quality, earnings quality, earnings variability and leverage. These fundamentals provide the foundation of the composite, anchoring the portfolio in companies with the financial characteristics that distinguish business quality.

Two complementary characteristics are applied to the quality signal. The choice of complements is deliberate. Enhanced value enters the new Quality Plus composite to enforce valuation discipline, screening out stocks where the quality signal is strong but the valuation is already full. The pairing of quality and value characteristics has a well-established academic foundation, discussed in the Defining Factors section. Low volatility is the second complement, added to address a specific failure mode observed in standalone quality in the Australian market. Where in deep international markets quality alone has tended to deliver a beta below 1.0, in the Australian universe quality alone has not. Low volatility contributes price stability at the security level that the Australian quality universe has not provided on its own. The three characteristics are complementary: quality provides the earnings and balance sheet anchor, enhanced value prevents the portfolio from becoming expensive, and low volatility dampens downside sensitivity.

Momentum is applied as a ranking and overlay mechanism, not as a co-equal factor. Specifically, in the second sub-portfolio, momentum filters out stocks whose fundamentals may be deteriorating before that deterioration is fully visible in quarterly financials. A stock receives a higher momentum score if its share price has outperformed the market over the prior two years and risen over the most recent six and twelve months. The role is to act as a deterioration screen rather than a return driver.

Each characteristic, in isolation, has known limitations in Australian equities. Quality alone produces cyclical overweights, particularly to materials, that undermine its defensive claim. Value alone is prone to cyclical traps, since Australian value screens are mechanically exposed to the banks and miners whose cheapness often reflects earnings cyclicality rather than margin of safety. Low volatility alone has tended to sacrifice too much return and to deliver bond-like yields. Momentum alone can produce turnover and whipsaw risk. The combination is not arbitrary. It is the Australian implementation of the profitability-and-value combination validated in the international literature, with low volatility added to address the construction challenge of a concentrated, cyclical market, and with quality as the anchor.

3.3 Construction constraints

The composite factor score determines which stocks enter the index. Explicit concentration constraints determine how they are weighted. The final portfolio holds 50 stocks, with a 10% active cap at the sub-industry level and a 5% security cap. The constraints are the mechanism by which the construction limits the portfolio's exposure to the concentrated sector outcomes that have affected single-factor strategies in this market. A portfolio that passes a quality screen but then allocates 25% to two mining companies has not addressed the construction problem. The constraints are designed to rule that outcome out.

The index rebalances quarterly in February, May, August and November. The frequency is relevant. Single-factor Australian quality indices that rebalance annually can be additionally penalised by the cyclical nature of the market, where deteriorating factor signals can persist for months before an annual rebalance allows the index to respond. Quarterly rebalancing reduces the latency between factor signal and portfolio response.

4. The empirical record

The AQTY Index has a data series extending to 29 February 2000. Data prior to the live index launch in May 2026 is simulated. We present the analysis that follows with the appropriate caveats on the distinction between simulated and live performance. The 26-year simulation period encompasses multiple complete economic cycles: the post dot-com recovery, the GFC, the European debt crisis, the 2015 to 2016 commodity drawdown, the COVID-19 shock, the 2022 rising rate cycle, and the 2025 Liberation Day volatility event.

4.1 Long-term simulated returns

Over the full simulation period, AQTY Index returned 11.00% per annum against 8.26% for the S&P/ASX 200, an annualised excess of 2.74%. A hypothetical $10,000 invested at the start of the period grew to approximately $152,000 in the AQTY Index and approximately $79,300 in the benchmark. The wealth premium of 92% reflects the compounding of a sustained excess return across more than two decades and multiple complete economic cycles.

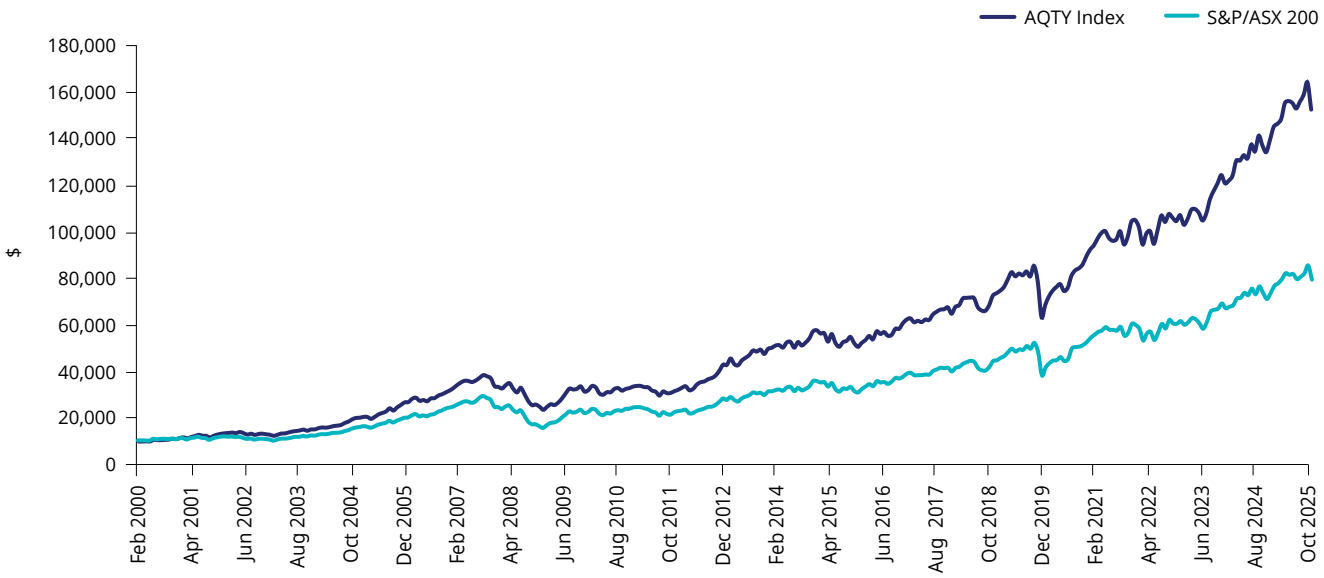
The relative performance does not appear to be a function of the starting date. Across one, three, five, ten and fifteen year measurement windows to 31 March 2026, the AQTY Index outperformed the S&P/ASX 200 in each horizon. The three-year figure of 3.82% reflects the recent relative performance of quality-led construction through the 2022 rising rate cycle and the 2024 to 2025 market environment. The fifteen-year figure of 2.36% is a more conservative long-run estimate that excludes the strong simulated GFC period. Importantly, the past performance of the index is not an indication of future performance.

Period	AQTY Index (% p.a.)	S&P/ASX 200 (% p.a.)	Difference
1 year	13.55	11.67	+1.88
3 years	13.36	9.54	+3.82
5 years	11.22	8.63	+2.59
10 years	11.28	9.44	+1.84
15 years	10.54	8.18	+2.36

Source: VanEck, Morningstar. As at 31 March 2026. AQTY Index performance against S&P/ASX 200. Performance shown is of the index, not of AQTY. Data prior to the live index launch date is simulated. Past performance is not indicative of future performance of the index or of AQTY.

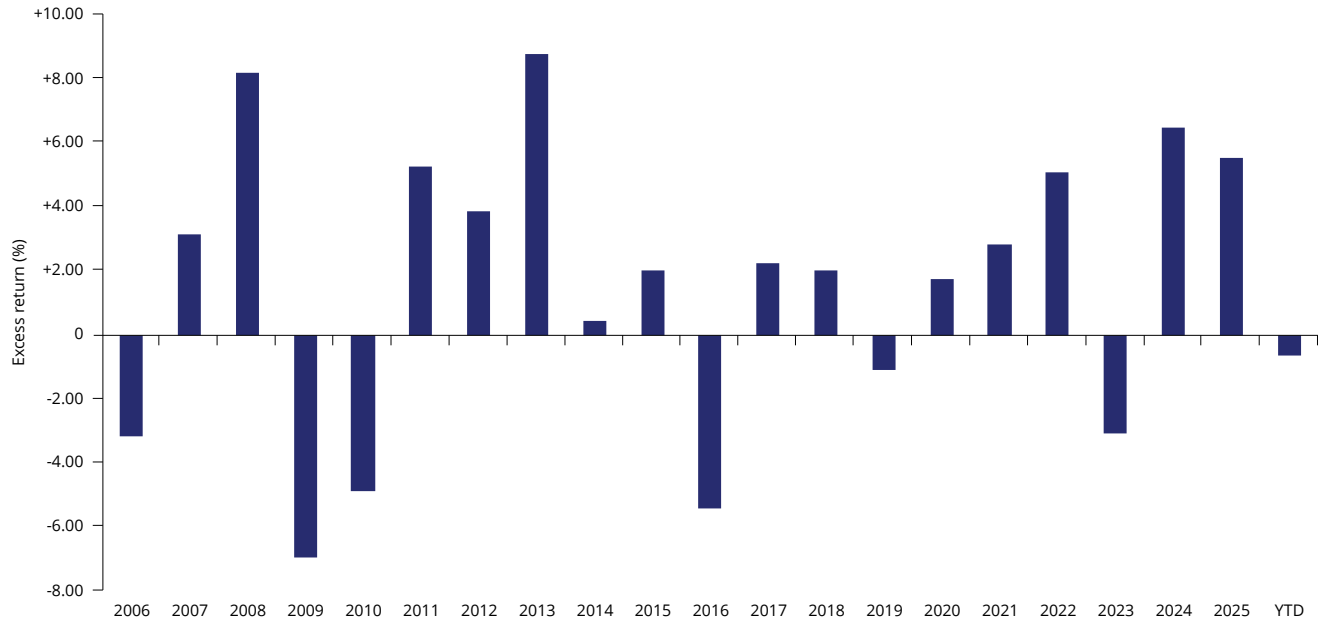
A feature of the record that we find notable is its consistency. Across every rolling five-year window in the 26-year simulation period, the AQTY Index outperformed the S&P/ASX 200 on an annualised basis. While the observation is based on simulated as well as live data, and does not guarantee future outcomes, it suggests that the construction premium has not historically been concentrated in a particular market environment or cycle.

Exhibit 6: Hypothetical growth of $10,000, AQTY Index vs S&P/ASX 200



Source: VanEck, Morningstar, 29 Feb 2000 to 31 March 2026. AQTY Index is MSCI Australia IMI Quality Plus Index. You cannot invest in an index. Past performance is not indicative of future performance of the index or of AQTY.

Exhibit 7: Calendar year excess returns, AQTY Index vs S&P/ASX 200

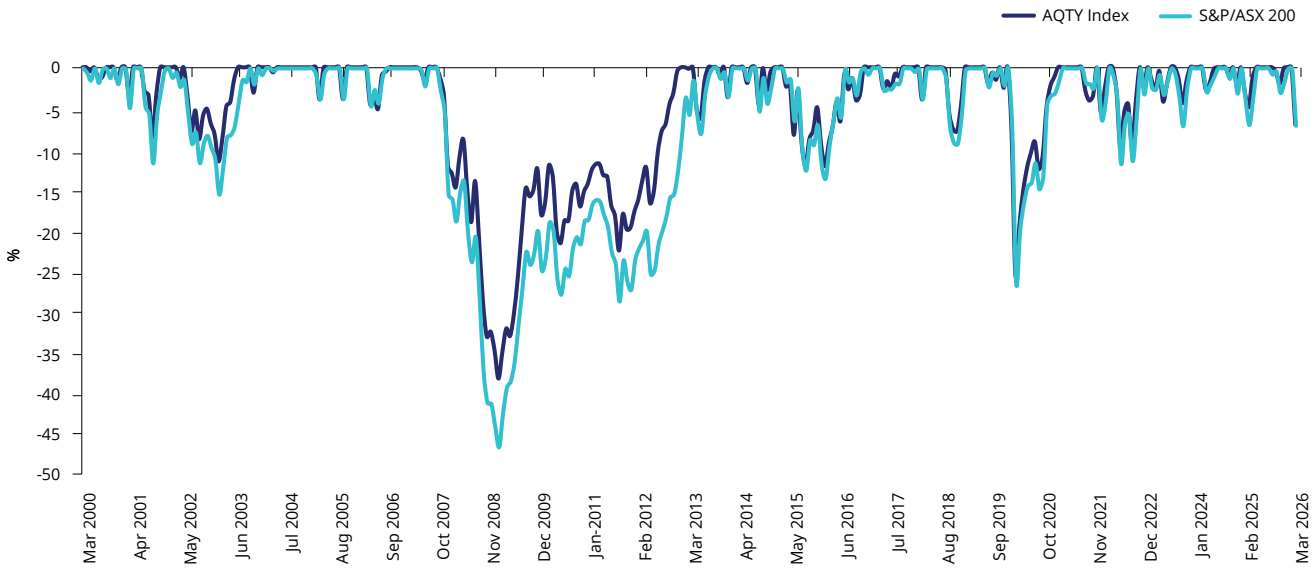


Source: VanEck, Morningstar, Calendar years 2006 to 2026. AQTY Index is MSCI Australia IMI Quality Plus Index. You cannot invest in an index. Past performance is not indicative of future performance.

4.2 Risk profile

The excess return was not obtained with additional risk. On the conventional risk measures, the AQTY Index carried lower risk than the S&P/ASX 200 over the full simulation period. Total risk, measured as annualised standard deviation of returns, was 12.47% against 13.17%. Maximum peak-to-trough drawdown, measured during the GFC from November 2007 to February 2009, was -38.62% against -47.18% for the benchmark, a difference of approximately 9% in the depth of the worst loss in the period. The AQTY Index recovered from its GFC drawdown in 47 months; the S&P/ASX 200 took 55. Value at Risk at the 95% confidence level was -7.15% against -7.79%. Average beta against the S&P/ASX 200 over the full period was 0.91.

Exhibit 8: Drawdown comparison, AQTY Index vs S&P/ASX 200



Source: VanEck, Morningstar, 29 Feb 2000 to 31 March 2026. AQTY Index is MSCI Australia IMI Quality Plus Index. You cannot invest in an index. Past performance is not indicative of future performance.

Exhibit 9: Risk and return metrics comparison, AQTY Index vs S&P/ASX 200

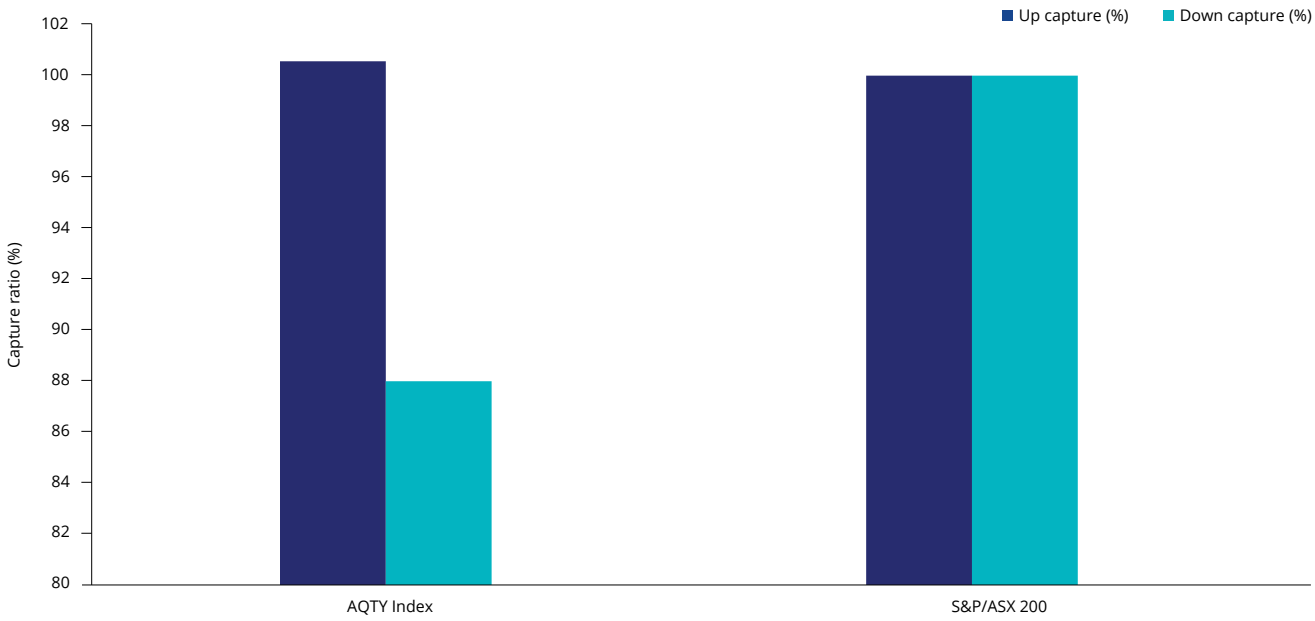
Risk metric	AQTY Index	S&P/ASX 200
Annualised return	11.00%	8.26%
Total risk (std dev)	12.47%	13.17%
Sharpe ratio	0.61	0.40
Information ratio	0.79	-
Beta vs ASX 200	0.91	1.00
Up capture ratio	101.7%	100.0%
Down capture ratio	85.5%	100.0%
Maximum drawdown	-38.62%	-47.18%
Drawdown recovery (months)	47	55
Value at Risk (95%)	-7.15%	-7.79%

Source: VanEck, Morningstar, 29 February 2000 to 31 March 2026. Past performance is not indicative of future performance.

4.3 Asymmetric capture

The measure we find most informative in characterising the construction's historical behaviour is the relationship between up-market capture and down-market capture. Over the 26-year simulation period, the AQTY Index captured 101.7% of the S&P/ASX 200's return in up months and only 85.5% of the benchmark's loss in down months. The pattern, slightly better than full participation in upside combined with approximately 14.5% less of the downside, corresponds to the defensive-with-upside profile associated with quality-led construction in international markets. It is a pattern that, on the evidence in our prior research, has not been consistently present in single-factor Australian quality alternatives.

Exhibit 10: Up and down capture, AQTY Index vs S&P/ASX 200



Source: VanEck, Morningstar. Up/down capture calculated from monthly returns against the S&P/ASX 200 over the full period. Past performance is not indicative of future performance.

4.4 Historical performance through the cycle

Quality-led construction is designed to perform best in economic environments adverse to cyclical asset classes. In *The limits of quality in Australia*, we presented evidence using US data from 2000 to 2025 that the international quality factor has delivered its strongest excess returns in lower growth and lower inflation regimes, and during the slowdown, contraction and recovery phases of the economic cycle. The Australian Quality Plus construction has exhibited a consistent pattern. The AQTY Index outperformed the S&P/ASX 200 in each of the five most significant stress events of the past two decades, periods when cyclical earnings, financial leverage and commodity sensitivity have tended to dominate index-level returns. In the strongest single-direction rally environments, the construction participated (up capture of 101.7%). In adverse conditions, it provided a measure of protection (down capture of 85.5%). For a core allocation held through a full cycle, this profile is, in our view, appropriate.

Stress event performance

Across the six major stress events of the period, the AQTY Index outperformed the S&P/ASX 200 in each case. During the GFC, the AQTY Index returned -39.4% against -47.8% for the ASX 200, an excess of 8.4%. During the COVID-19 drawdown, the outperformance was 2.3%. During the 2022 rising rate cycle, which was particularly adverse for duration-sensitive cyclicals and highly leveraged balance sheets, AQTY outperformed by 4.2%.

Exhibit 11: Cumulative returns through major stress events

	AQTY Index	S&P/ASX 200	AQTY excess
Dot-com (Mar 2002 to Mar 2003)	-5.8%	-11.4%	+5.6%
GFC (Nov 2007 to Feb 2009)	-39.4%	-47.8%	+8.4%
European debt crisis (Apr to Sep 2011)	-12.6%	-15.6%	+2.9%
China slowdown (Apr 2015 to Feb 2016)	-12.0%	-13.2%	+1.3%
COVID-19 (Feb to Mar 2020)	-33.6%	-35.9%	+2.3%
Rising rates (Jan to Sep 2022)	-5.4%	-9.6%	+4.2%

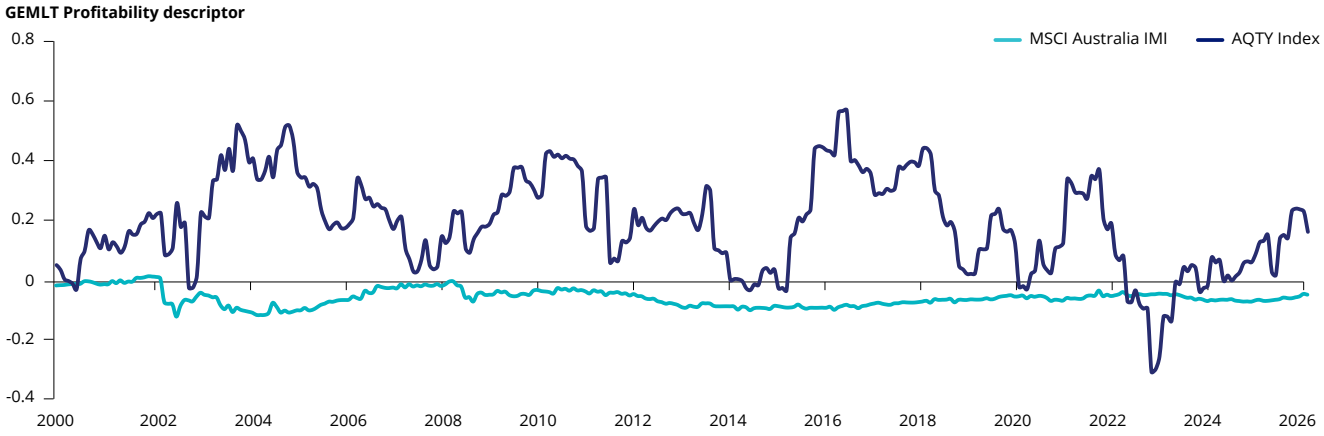
Source: VanEck, Morningstar. Past performance is not a reliable indicator of future performance.

4.5 Fundamentals and valuations

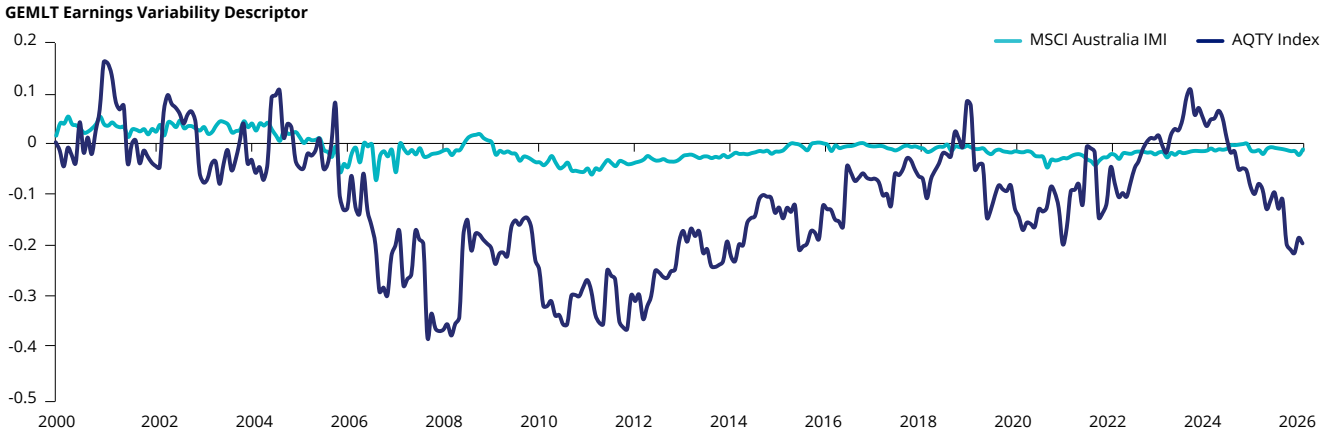
A snapshot of fundamentals can be obscured by where a strategy sits in the cycle. The more useful question is whether quality characteristics have been a structural feature of the index across cycles.

Exhibit 12 shows three of the MSCI quality factor descriptors used in the AQTY Index's combined factor score, plotted monthly across the 26-year simulation period. On profitability, gross profitability and earnings variability, the AQTY Index has shown a persistent and structural advantage against the parent MSCI Australia IMI universe. The pattern is observable from the index inception in February 2000 and has been maintained through multiple complete economic cycles, including the dot-com correction, the global financial crisis, the post-GFC recovery, the COVID-19 dislocation and the post-COVID rate cycle. The persistence is consistent with the construction's intent: quality is anchored in the security selection rather than introduced by sector or factor rotation.

Exhibit 12: Persistent quality characteristics: AQTY Index vs MSCI Australia IMI Index



Source: VanEck, MSCI, as at 31 March 2026.



Source: VanEck, MSCI, as at 31 March 2026.

A second consideration is valuation. As at 31 March 2026, the AQTY Index trades at a lower price-to-earnings multiple than the S&P/ASX 200 (18.99 against 20.73) and a lower price-to-sales ratio (1.77 against 2.15), while offering a higher dividend yield (3.66% against 3.32%). Stronger fundamentals, on lower multiples.

The construction explains this. The AQTY Index, as at 31 March 2026, underweights Commonwealth Bank by 6.6% relative to the benchmark, and overweights CSL and Wesfarmers by 5.4% and 5.1%. The portfolio holds less of the most expensive large-cap names, whose valuations reflect market capitalisation dominance, and more of the names where the quality signal is strong and the price is reasonable.

Exhibit 13: Valuation comparison

Metric	AQTY Index	S&P/ASX 200	Difference
Price/Earnings	18.99	20.73	-1.74
Price/Book	2.44	2.33	+0.11
Price/Sales	1.77	2.15	-0.38
Dividend yield (%)	3.66	3.32	+0.34

Source: VanEck, FactSet, MSCI, as at 31 March 2026. Past performance is not indicative of future performance.

4.6 Factor attribution: has the construction delivered what it was designed to deliver?

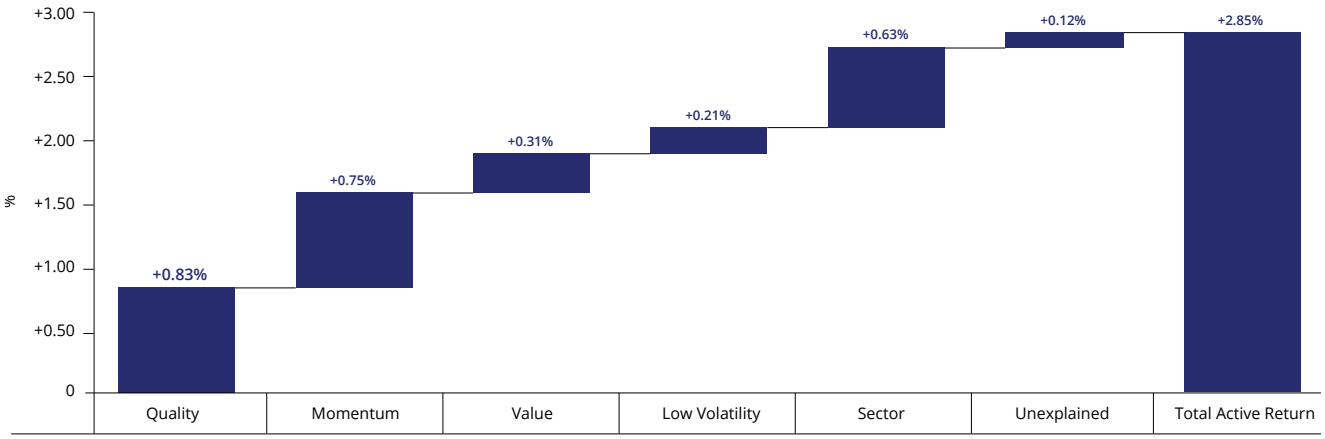
A construction-led framework makes specific claims about which factors drive outcomes. The Quality Plus construction has been designed around three targeted characteristics: quality, enhanced value and low volatility, with quality as the anchor. A reasonable empirical test is whether, over the simulation period, the excess return has been attributable to these targeted characteristics rather than to incidental factor exposures such as size, momentum or beta.

We have undertaken an analysis to address this question. The analysis is a bottom-up fundamentals attribution that decomposes the AQTY Index's active return against the S&P/ASX 200 from inception to 31 March 2026, into contributions from each targeted factor characteristic and from sector active weights.

The findings are consistent with the construction's design intent. Quality was the largest single contributor to active return over the period, reinforcing its role as the leading anchor of the strategy. Momentum, value and low volatility were additive to quality, contributing positively without overwhelming the quality signal. The sector active weights that emerged as an outcome of the factor screening process, rather than as explicit sector bets, were also a positive contributor to active return. The combination of these results supports the construction thesis: a quality-anchored composite, complemented by valuation discipline, price stability and momentum overlay, with sector exposures that emerge from the security-level screening rather than from sector-level decisions.

This pattern stands in direct contrast to the single-factor failure modes documented in Section 2. Where Australian single-factor quality has historically produced sector active weights that were unstable and cyclically tilted, the Quality Plus construction has produced sector active weights that have contributed positively to performance over the simulation period.

Exhibit 14: Factor attribution of AQTY Index active return versus S&P/ASX 200



Source: VanEck, MSCI. 29 Feb 2000 to 31 Mar 2026. Past performance is not indicative of future performance.

5. Implementation considerations

The evidence presented in section 4 has specific implications for portfolio construction. In our view, the data supports a role for a Quality Plus strategy as a core Australian equity holding rather than as a satellite position or factor tilt. This section addresses the practical considerations of implementing that view and the primary objection that advisers have raised in prior conversations on similar propositions.

5.1 The S&P/ASX 200 as a core benchmark

Passive S&P/ASX 200 exposure is, we have argued, a compromised core for the structural reasons set out in section 1. It provides concentration without the diversification implied by an index product, cyclical sector dominance without the stable earnings associated with defensive exposure, no quality discipline, no valuation discipline, and a market-cap rebalance that increases weight in the most expensive and most dominant stocks as they outperform. In a market as narrow as Australia's, we would not consider it a neutral allocation. It is an implicit bet on the continuity of the current market structure.

5.2 Quality Plus in the core role

On the simulated evidence in Section 4, an allocator substituting a Quality Plus strategy in for a passive S&P/ASX 200 exposure obtained higher annualised returns, a lower risk profile, shallower drawdowns through stress events, asymmetric upside-versus-downside capture, and valuation discipline relative to the benchmark.

5.3 Tracking error

The most common objection to substituting a construction-led strategy for passive core exposure is tracking error. The AQTY Index has underperformed the S&P/ASX 200 in six of the 20 calendar years from 2006 to 2025: 2006, 2009, 2010, 2016, 2019 and 2023. For advisers managing client portfolios, this creates the possibility of difficult relative-return conversations in any given year.

We would frame the concern as a behavioural rather than an investment matter. Tracking error relative to a compromised benchmark is the mechanism by which construction-led strategies generate long-run excess return. Across every rolling five-year window of the 26-year simulation, the AQTY Index outperformed the S&P/ASX 200 on an annualised basis. There has been no five-year holding period in the simulated history in which the Quality Plus framework would have been worse off than in the benchmark. We believe a reasonable reframing is to evaluate the strategy over the holding period relevant to the allocation, not over one-year windows.

6. Conclusion

Single-factor strategies in Australian equities have historically failed to achieve factor efficacy for three structural reasons: stock concentration, sector concentration, and a finite investable universe. The same three conditions limit the effectiveness of passive market-capitalisation exposure as a core holding for long-horizon investors.

One alternative is the Quality Plus construction, which expresses quality characteristics through a combined factor framework, has delivered risk-adjusted outperformance over the long term, and works within the structural limitations of the Australian equity market rather than against them. The approach is supported by academic research, including foundational work by Novy-Marx on profitability and Fama and French on the integration of quality alongside size, value and investment factors.

Appendix: methodology and data notes

Index references

- S&P/ASX 200 Total Return Index (AUD) throughout.
- MVIS Australia Equal Weight Index (Total Return, AUD) as the reference for MVW.
- MSCI Australia IMI Quality Plus Index (Total Return, AUD) as the reference for AQTY. Data prior to the live index launch is simulated.

Data period

- Full analysis period: 29 February 2000 to 31 March 2026 (26 years).
- The 26-year period is the longest continuous data series available for all three indices on a like-for-like basis.
- Stress event windows are defined by specific peak-to-trough dates within the analysis period.

Performance and risk calculations

- All return series are total returns in Australian dollars with immediate reinvestment of distributions.
- Total risk is calculated as the annualised standard deviation of monthly returns.
- Sharpe ratio uses monthly returns in excess of the risk-free rate.
- Information ratio is the annualised excess return divided by tracking error vs the S&P/ASX 200.
- Beta is calculated against the S&P/ASX 200 Total Return Index over the full period.
- Up and down capture ratios are calculated from monthly returns against the S&P/ASX 200.
- Maximum drawdown is peak-to-trough on cumulative total return series. Recovery periods are measured in calendar months from the prior peak.
- Value at Risk is calculated at the 95th percentile of the monthly return distribution.

Simulated data caveats

Data prior to the live index launch date for both AQTY and MVW is simulated by applying the index methodology retrospectively to historical constituent data. Simulated performance does not represent actual index or fund returns, does not account for the frictions and implementation costs that live strategies face, and should not be relied upon as an indicator of future results. Past performance is not a reliable indicator of future performance.

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The research programme discussed in this paper has also been referenced in commentary published in the Australian Financial Review.

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