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MID CAP INVESTING

HOT TIPS ON MARKET ‘SWEET SPOT’

Investors are beginning to notice that the under-researched mid cap asset class – especially around the $1bn–5bn mark – can offer a winning combination of upside potential and limited downside risk

Imagine a racehorse which, for 10 years, wins more races than any of its rivals, but is hardly ever bet on by the public – seldom even by professionals – and gets only minimal coverage in the racing pages.

Implausible certainly, but this is exactly what has happened in the investment world. Mid cap value beat all other US equity asset classes over the 10 years to 2002, according to Lipper statistics, and yet it accounts for only 2.9 per cent of invested equity assets. (See Charts 1 and 2.)

Institutions do invest in mid cap, but only to a limited extent and frequently lumped into one mandate along with small cap. Retail investors, even at the high net worth end of the market, have tended to opt for one or other of the large cap, small cap extremes, and have overlooked what is actually a very appealing compromise.

However, institutions are starting to award more mid cap mandates. This trend can be expected to continue, and where the big pension funds lead, high net worth individuals tend to follow. In this case, they could be well advised to do so.

WHY MID CAP?

By mid-cap, we mean stocks with market capitalisation of between €1bn and €10bn. However, the “sweet spot”, where the asset class is at its most compelling, lies at the smaller end – up to around €5bn. This gives a mid cap universe of some 2000 US stocks, rather smaller than the 5000 or so in the small cap market.

So what is the secret behind the success of this unsung asset class? To start with, there is the case to be made for both small and mid cap, as opposed to large cap, in terms of their untapped potential. Smaller companies are under-researched compared to bigger firms. The Microsofts and GM Motors of this world are so well covered by Wall Street analysts that it can be sometimes difficult for an active manager to come up with any new information. Large cap stocks are thus generally thought to be priced efficiently by the market.

At the smaller end of the market, fund managers have more scope for original thinking, and this applies to the mid cap arena as well. Mid cap stocks get 30 per cent less coverage by Wall Street analysts than their large cap counterparts, leaving more pricing inefficiencies to be

1 INVESTED EQUITY ASSETS (% PORTFOLIO)

	Growth	Core	Value	Total
Large Cap	10.8	22.8	9.6	43.2
Multi Cap	9.5	6.8	8.7	25
Mid Cap	4.1	2.9	2.9	9.8
Small Cap	2	3.7	1.8	7.5

2 AVERAGE ANNUAL TOTAL RETURNS (%) (1992-2002)

Large Cap Growth	10.85	Large Cap Value	10.8
Mid Cap Growth	7.61	Mid Cap Value	11.06
Small Cap Growth	9.85	Small Cap Value	10.86

Source: Lipper

‘Mid cap stocks get 30 per cent less coverage by Wall Street analysts than their large cap counterparts, leaving more pricing efficiencies to be uncovered and exploited’
David Schofield, Janus International

uncovered and exploited. This is particularly true at the smaller end of the mid cap range, and explains the term sweet spot.

But mid cap companies generally also have more seasoned balanced sheets and more experienced management teams. Being larger and therefore relatively well capitalised, they are better equipped to cope with difficult markets, or ride out tough times. Generally speaking, they have lower levels of debt. They tend also to be less volatile. Not only are there winners to be picked, but they are more likely to get up again from a stumble.

Moreover, the size of a small cap portfolio will inevitably be limited by concerns regarding owning too much of any one stock. Suppose a manager has a portfolio of 90 to 100 stocks, and each company in the universe has a market capitalisation of €1bn. There will be a proportion, say 6 per cent, that the manager is happy to own of any given company. Even if he buys the full 6 per cent of 100 companies, he has a total portfolio capacity of €6bn, which is quite small.

If he tries to invest too much, he risks diluting his added value, which is why small cap managers have to be very rigorous about closing funds.

Investors, in opting at one end for a large cap, perhaps index tracking, portfolio, and at the other for a riskier, more aggressive, small cap option, are completely ignoring a middle option which combines the potential of the small cap stocks with some of the balance sheet solidity of higher cap stocks.

WHY VALUE?

Taking a value approach to investing in this potentially lucrative asset class allows managers to minimise their downside risk. Value management, in this arena as in any other, involves seeking fundamentally solid companies when they are temporarily out of favour and market expectations are low. By picking stocks where downside risk is limited compared to upside potential, value managers can best exploit the unique advantages of the mid cap market, whilst controlling risk.

Using traditional "value" measures such as low price to book value, price-earnings ratios, and so on, the key is to pick stocks that are near to their 52-week lows.

The question to ask then is why the stock is down. It might be an out of favour growth company – ie a firm in an out of favour industry, dragged down by its peers – or there might be a temporary problem, at company or sector level, that has depressed the stock price.

The value manager can establish downside risk by looking at balance sheets, cash flows, the valuation relative to historical lows and whether the company's products or services have a competitive edge in the marketplace, as well as factors such as high insider ownership or company share repurchase programmes. How far down, essentially, can this stock go?

That done, the upside potential of the stock can be

3 MID CAP VALUE PORTFOLIO (AS OF 30 SEPT 2003)

Top 10 Holdings	(% Portfolio)
Genuine Parts Co.	1.6
CIT Group, Inc.	1.5
Mercantile Bankshares Corp.	1.4
Washington Federal, Inc.	1.4
Fluor Corp.	1.3
Hillenbrand Industries, Inc.	1.3
IPC Holdings, Ltd.	1.3
CVS Corp.	1.3
Lincoln National Corp.	1.3
Omnicare	1.2
TOTAL	13.6

4 MID CAP VALUE PORTFOLIO – BY SECTOR (AS OF 30 SEPT 2003)

Sector	(% Portfolio)
Financials	24.3
Consumer Discretionary	14.6
Energy	13.9
Information Technology	12.2
Healthcare	12.2
Industrials	11.5
Materials	6.0
Consumer staples	5.3
TOTAL	100

Source: Janus

5 PERFORMANCE FOR PERKINS, WOLF, MCDONNELL & COMPANY LLC MID CAP VALUE (%) (AS OF 30 SEPT 2003)

	Mid Cap Value Composite	Russell Mid Cap Value Index
3Q 2003	7.29	5.94
Year-to-date	24.73	19.83
1 year	34.54	26.81
3 years (average annual returns)	14.00	6.63
5 years (average annual returns)	21.31	11.96

Note: Perkins, Wolf, McDonnell & Company LCC will act as sub-adviser to Janus International Limited. Performance figures represent a composite of fully discretionary portfolios and include reinvestment of dividends and other earnings. Performance is shown gross of fees.

Source: Janus

established. Is there a catalyst for appreciation? Can we expect this particular company, despite its current under-valuation, to reassert itself? This involves analysing what the earnings potential would be when any temporary problems have been corrected, looking at the potential growth rate of the company, and considering the valuation measures – price to earnings, price to book value, price to sales, etc – that are most relevant to the industry.

The value managers can then pick firms with a strong reward to risk ratio – a sensible minimum would be 2 to 1, or 3 to 1 in the case of so-called fallen growth stocks.

Another advantage is that, while the manager waits it out for the valuation to correct, this fundamentally sound value company is likely to be paying dividends.

This year, the star performers in the mid cap value arena have been in the technology and healthcare sectors. (See Charts 3 and 4.) Two stocks which have rebounded particularly well are laboratory instruments manufacturer Silicon Storage Technology (SSTI) and clinical testing product laboratory Corporation of America.

Another potential winner, generally ignored by investors but actually well positioned to benefit from an upturn in worldwide construction, is Fluor, the construction services provider.

WHY NOW?

This solid overlooked market segment could potentially be a shrewd investment for the long term investor. While from a value investing perspective we see current stock valuations near the high end of their historic range, and sensitivity to downside risk seems appropriate now, there are still many excellent companies out there with strong balance sheets and cash flows selling at below average valuations. Perkins believes these companies have relatively less risk, while still having good appreciation potential that he expects may surprise over the long term.

Moreover, as the valuations in this post-bear landscape are down, so the fundamentals are not only intact, but getting better. The trailing three-year sales growth for the average Russell Mid Cap Value Index as at the end of the second quarter is three times gross domestic product (GDP), despite the recession. And FirstCall/Russell figures put long term earnings growth at five times GDP. For those who know how to pick them, there are horses in this arena that are not only fast and strong, with favourable odds, but getting healthier.

David Schofield, institutional sales director, Janus International

CORPORATE STATEMENT

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