



# INVESTMENT OPPORTUNITIES IN MID CAP STOCKS

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*You will go most safely in the middle.*

Ovid, Roman Poet  
 43 BC -18 AD

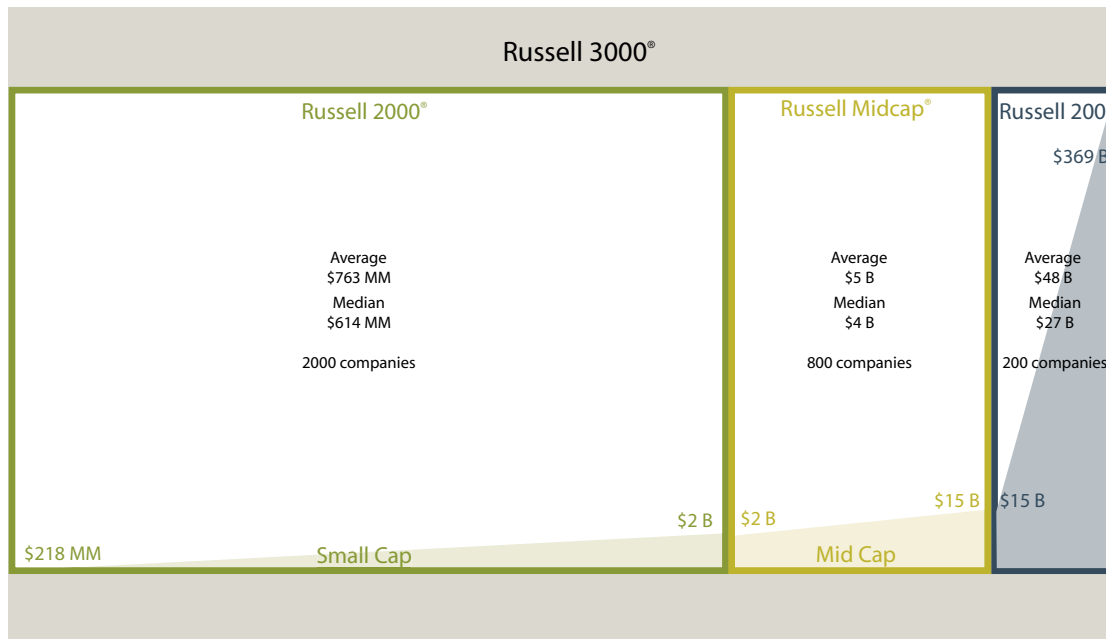
The marketplace for publicly traded mid-sized companies has largely been ignored by the average investor. Reasons for this lack of interest are based on several generally accepted myths. First, many investors believe that by investing in broad index products, they have the “market” fairly well covered. Others feel that large and small cap allocations are sufficient to achieve portfolio outperformance over the long term. In fact, by not including mid-sized companies in their portfolios, investors are missing the boat of improved returns at surprisingly reasonable levels of risk.

## What is a mid cap company?

Companies are commonly grouped based on their market capitalizations (as well as other factors) into indices. While many people commonly use the S&P 500 as a market index, the Russell Investment Group’s indices are constructed using a more standard, objective methodology. Russell Investment Group’s broad market index, the Russell 3000®, includes the 3,000 largest companies in the United States and makes up about 98% of the investable value of the entire U.S. stock market. The Russell 3000® is divided into several sub-indices representing small, middle and large sized companies. The Russell Top 200® holds the largest of the large – 200 super-sized companies - while the 2,000 smallest comprise the Russell 2000® Index.

The 800 companies in-between make up the Russell Midcap® index. These 800 mid cap firms range from approximately \$2 billion to \$15 billion in size and account for 26% of the value of all the companies in the Russell 3000®. (See Figure 1 – Russell Indices)

Figure 1 – Russell Indices



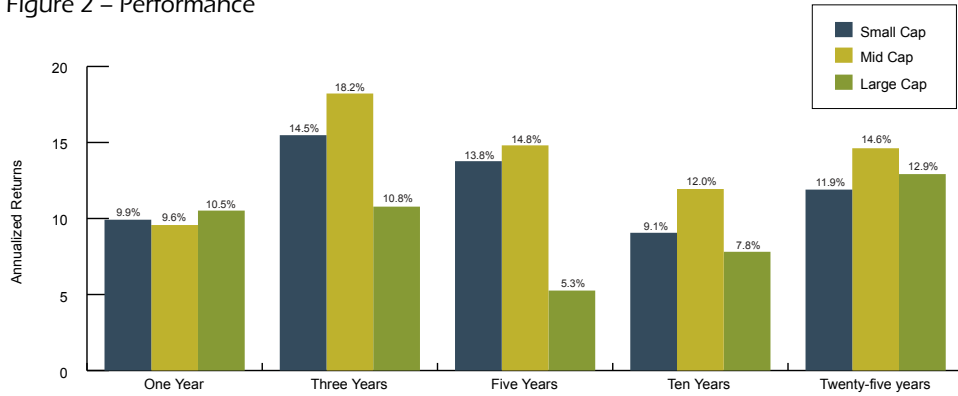
## Why should the average investor pay more attention to mid-sized companies?

### Outperformance

Mid cap stocks have delivered impressive performance over a long period of time. The Russell Midcap® has outperformed the Russell Top 200® (Large Cap) and Russell 2000® (Small Cap) indices for the past 3, 5, 10, and 25 years ending September 30,

2006. During the past year, small and large size companies have done only slightly better. (See Figure 2 – Performance)

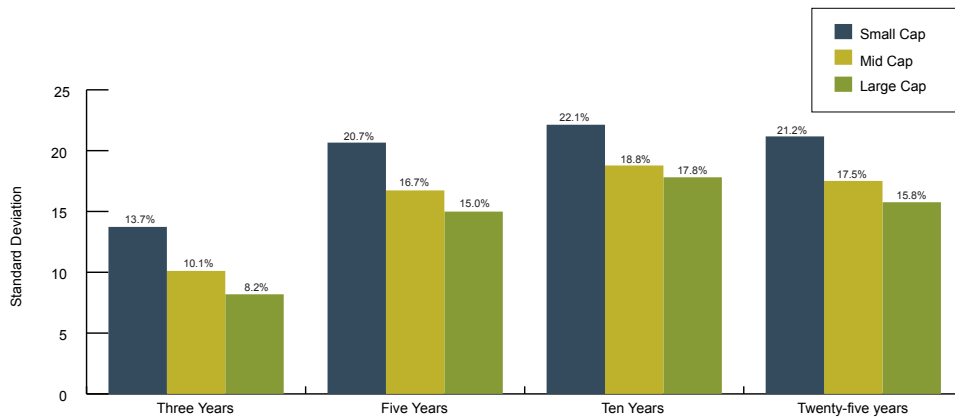
Figure 2 – Performance



**Standard Deviation**

Not only have mid caps steadily outperformed, they’ve outperformed with less volatility. Standard deviation is a measure of the historical variability of the return earned by an investment. Mid-size companies once again excel. Over the past 25 years, the Russell Midcap® index’s standard deviation is 17.5% while the Russell 2000®’s standard deviation was 21.2%. (See Figure 3 – Standard Deviation) During this same 25 years, mid cap’s average annual index return was 2.7% higher despite its lower volatility.

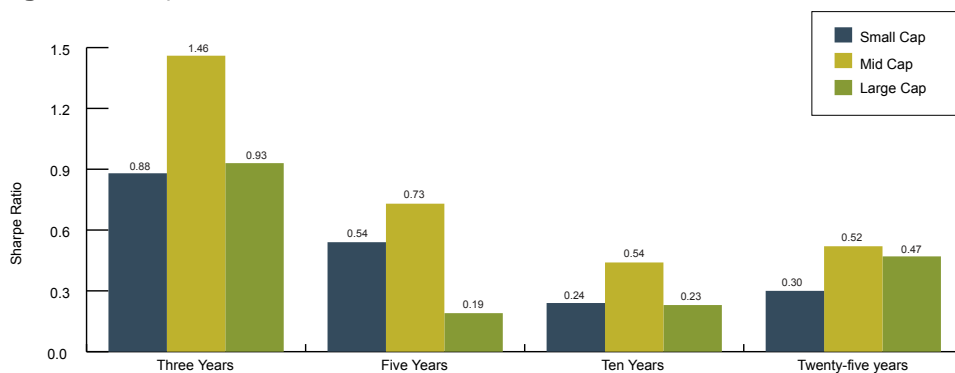
Figure 3 – Standard Deviation



**Sharpe Ratio**

Professional investment managers are constantly assessing the level of risk estimated for a portfolio versus its ability to generate good returns, measured by the Sharpe ratio. If an investor is willing to take on an increased level of volatility, they should be compensated with a higher return than by investing in other areas of the market. Mid size companies have produced superior Sharpe ratios over the past 25 years, consistently trouncing both small and large segments in this key measure of risk-adjusted performance. (See Figure 4 – Sharpe Ratio)

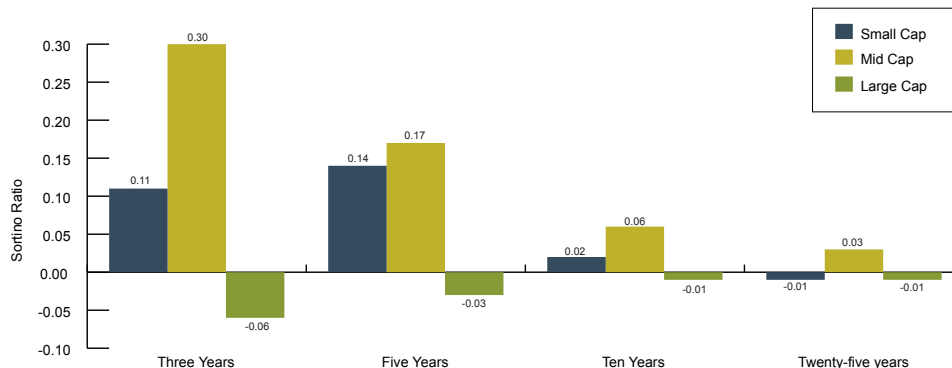
Figure 4 – Sharpe Ratio



### ***Sortino Ratio***

The Sortino ratio is a way of measuring the “bad” volatility of an investment. It looks at the probability an investment vehicle will generate negative returns, while the more commonly used standard deviation and Sharpe ratio use both positive and negative returns in measuring an investment’s risk. When comparing the Russell Midcap® index to both the large cap and small cap alternatives, it again prevails with a more attractive Sortino ratio than either. (See Figure 5 – Sortino Ratio)

Figure 5 – Sortino Ratio



### **What makes mid cap stocks such an attractive blend of return and risk?**

Often in their prime growth years, mid-sized companies are past the riskier, start up phase of smaller companies yet still in a nimble phase of development. They are more responsive and able to react quicker to change than the more elephant-like large cap companies.

#### ***Advantages over small companies***

Mid cap companies have cleared the challenges that emerging businesses face in initial development and have reached a point of financial stability. Many generate enough cash flow to pay regular dividends to their shareholders, further support over the stock-price volatility of small caps. Their business operations tend to be based on proven business models, with seasoned management teams and recognizable brands and products. Economic cycles also tend to have less of an effect than on smaller companies.

Since mid cap stocks normally trade at twice the volume of a typical small cap company, they tend to be easier and less expensive to trade. Their more efficient trading environment adds value for both individual and large institutional investors.

#### ***Advantages over large companies***

Fundamentally, mid-size companies have the ability to expand faster than larger companies. We’ve witnessed that over the past five years as companies in the Russell Midcap® index have seen their earnings per share increase at 21% annually. Based on analysts’ earnings expectations in September 2006, they should continue to expand at 13% per year for the next five years. In contrast, large-size companies have expanded earnings at just a 14% rate for the past 5 years while the expectation for future fundamental growth is closer to 12%.

Structurally, mid-size companies tend to be less complex and bureaucratic. They often have simpler financial statements providing greater transparency of earnings, making it easier for investors to understand the company and its operations. The benefit of understanding what an investor has purchased increases the investor’s knowledge base and comfort level so they are less likely to make ill-conceived, spur of the moment decisions.

Mid-size companies receive less coverage than larger companies by Wall Street analysts. Although basic information is readily available from a variety of sources including the internet, fewer analysts covering the company usually means large institutional investors are not as involved in the stock. While it may take more work by the individual investor to keep track of company developments, this can create pockets of market inefficiencies where the average investor can get an advantage.

Mid-size companies can be viable acquisition targets for larger, ambitious companies looking to enhance their own products

or market share. Share prices can appreciate significantly when a company is the target of interested bidders. During 2005, there were a total of 133 mergers and acquisitions. While most acquisitions were made in the small cap area with 21% of those small banks or financial institutions, 36 mid-size companies were taken over by their larger competitors to the benefit of the mid-size shareholders. This accounted for 27% of the activity in 2005. In contrast, there were only three acquisitions that year above \$10 billion in market value.

### **Conclusion**

Mid sized companies clearly offer investors benefits too great to ignore. Every equity portfolio, whether conservative or aggressive, should have a portion invested in mid cap stocks. With a healthy allocation to mid cap, overall portfolio returns can be improved while offsetting the risk of higher volatility.

There are a number of ways to invest in mid cap stocks. Through Exchange Traded Funds (ETFs), for example, one can access a segment of the market for relatively low cost without choosing particular stocks. Mid cap ETFs include the Russell Midcap® Index Fund (symbol: iwr) and the S&P MidCap 400 Index Fund (symbol: ijh). Professional management can be hired to provide actively managed mid cap portfolios. Many mutual fund alternatives are also available for smaller accounts.

Mid cap stocks have proven they deserve their own allocation. Savvy investors will profit by paying extra attention to this middle road, aiming for the top of the heap.

*Sources: Informa Investment Solutions, Thompson Financial and Holt-Smith & Yates Advisors, Inc.*



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**Holt-Smith & Yates Advisors** is an independently-owned investment advisory firm founded in 1987. The Madison, Wisconsin based firm specializes in customized portfolios designed to exceed the varied financial goals of High Net Worth and Institutional investors by combining the strength of in-house actively managed concentrated Large and Mid Cap Growth and concentrated Large Cap Core Equity and Fixed Income portfolios with passively managed index products. Their Mid Cap Growth product is a team managed portfolio of 30-40 holdings, designed to take advantage of opportunities in the mid capitalization area. For more information, contact Heike Tavenner at 608.249.4488 or [heike.tavenner@hsya.com](mailto:heike.tavenner@hsya.com).



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