In the Middle Lies Opportunity: The Case for Mid Caps

Despite their attractive risk and return characteristics, U.S. mid cap stocks are frequently overlooked by equity investors; that may be hurting their portfolios' potential returns.

- U.S. mid cap stocks have a demonstrated history of delivering superior returns when compared to small and large cap companies, thanks to higher underlying growth rates;
- Their attractive valuations and historic outperformance in bear markets suggest the time may be ripe to consider the asset class.

Two of the major factors that drive the returns of a company's equity are its ability to grow, and its ability to generate profit from its sales. Investors seeking the former typically look to small companies, which are in the early growth stages and are thought to have the greatest growth potential, while those looking for the latter generally turn to large cap companies, which have demonstrated their ability to generate profit.

But equity market investors often overlook an important company size: mid caps. While exact definitions may vary, a U.S. mid cap stock was historically defined as one with between $2 and $10 billion in market capitalization. However, the upper end of that range has expanded considerably over the last several years as markets have continued to run up. For instance, the largest company in the Russell Midcap Index now has a market cap north of $40 billion. In any event, we believe it is a market segment that is under-owned and often forgotten by investors since it's perceived as being not as profitable as large caps nor as fast-growing as small caps. In fact, the reality is quite the opposite, which means that not owning this segment of the market could prove to be a drag on portfolio returns.

Medium sized. Large returns.

We think the clearest benefit of mid cap stocks over their small and large cap equivalents stems from their returns over the long-term. Total return differentials between the S&P Midcap 400, S&P Smallcap 600, and the S&P 500 (large caps) are eye-catching: from 1995 (the earliest available data) to the end of Q1 2018, American mid cap stocks have generated annualized returns of 12.45%. That compares to 11.57% for small caps and 9.9% for large caps. And if those differences don't sound impressive, keep in mind that on a $100,000 portfolio over that time frame, the differences translate to a mid cap outperformance of over a quarter million dollars over small caps and over $600,000 over large caps (chart below). If that trend were to continue over an even longer time frame, the differences would be even more staggering.

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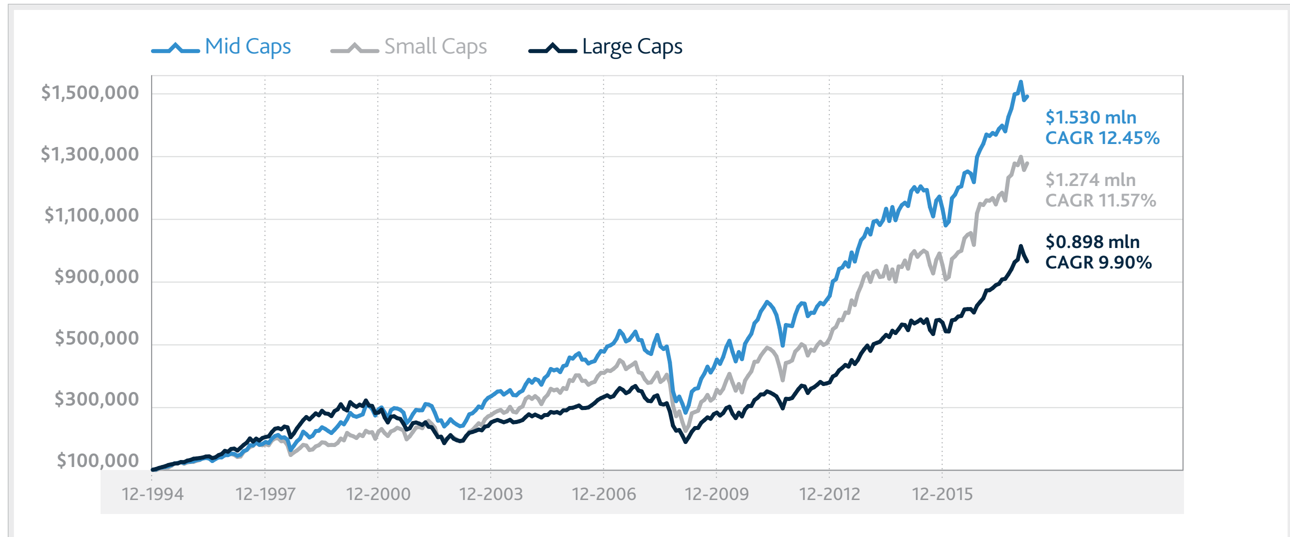
U.S. mid caps significantly outperform over time

Growth of $100,000 invested in various U.S. market caps in 1995

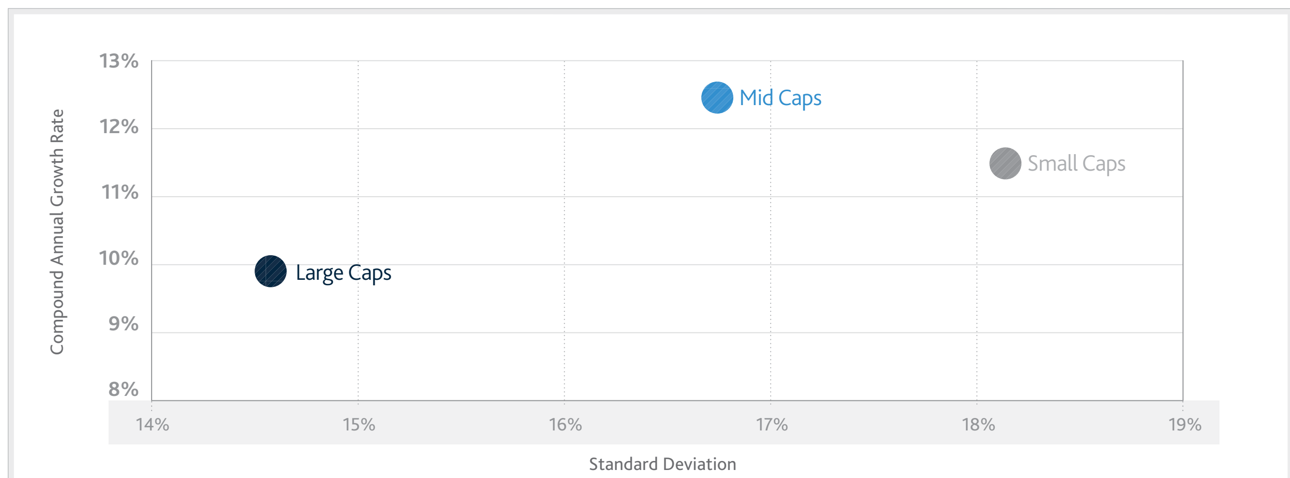


Source: Normalized monthly total returns until March 2018, where December 1994 = $100,000. Indices: Small caps, S&P Smallcap 600 Index TR; Mid caps, S&P Midcap 400 Index TR; Large caps, S&P 500 Index TR. Data retrieved using Morningstar.

One would assume that this long-term outperformance comes with increased risk as well, but that actually has not been the case. For instance, over the same time frame, while the standard deviation of returns for mid caps was higher than that of large caps, it was also clearly lower than that of small caps.

U.S. mid cap stocks have had the best risk/return profiles

Annual growth rates and risk since 1995

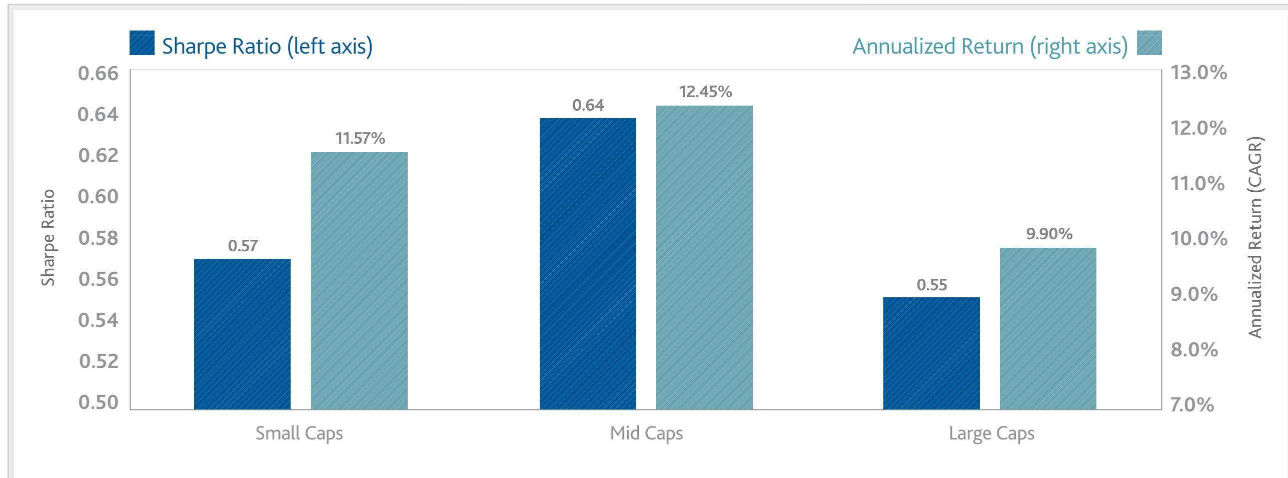


Source: Normalized monthly total returns from January 1995 to March 2018. Small caps, S&P Smallcap 600 Index TR; Mid caps, S&P Midcap 400 Index TR; Large caps, S&P 500 Index TR. Data retrieved using Morningstar and Bloomberg.

Therefore not only have mid caps generated superior returns when compared to smaller and larger companies, but they've done so even on a risk-adjusted basis. Naturally, this has translated into a Sharpe ratio that's significantly better for mid caps than for small and large caps.

U.S. mid caps are more attractive even on a risk-adjusted basis

Returns and Sharpe ratios since 1995



Source: Normalized monthly total returns from January 1995 to March 2018. Small caps, S&P Smallcap 600 Index TR; Mid caps, S&P Midcap 400 Index TR; Large caps, S&P 500 Index TR. Data retrieved using Morningstar and Bloomberg.

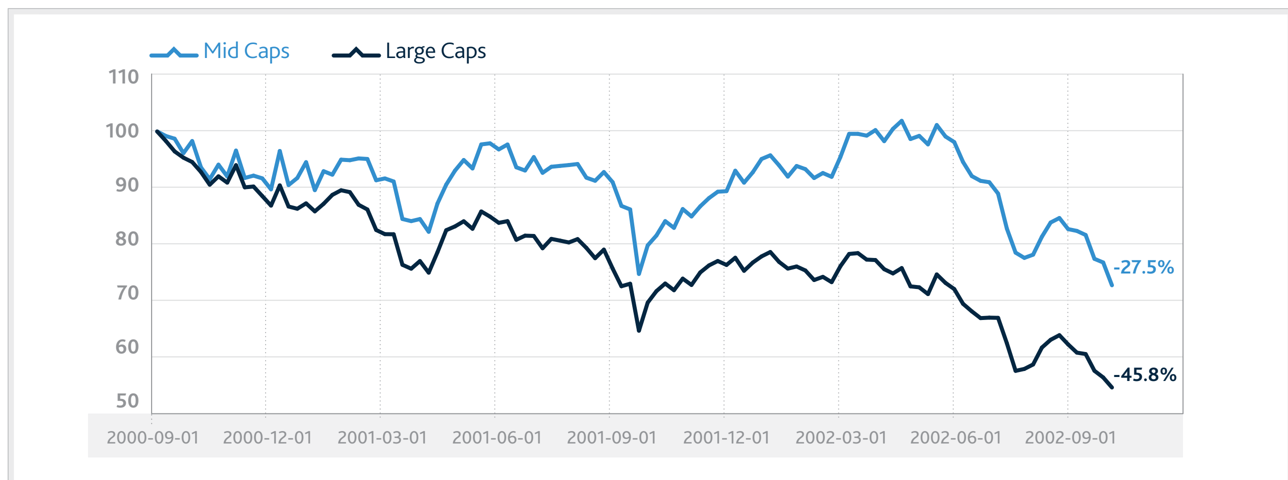
Mid caps aren't scared of the bear

We've observed that over long time frames, mid cap stocks have outperformed small and large cap companies, and done so with attractive risk levels. But considering that we've been in a bull market for nearly a decade, one could be forgiven for fearing that we could soon see the bear rear its head. And the traditional thinking is that in bear markets, one should be invested more heavily in larger companies which can supposedly weather the storm better than smaller ones.

However, recent history shows that mid caps have held up surprisingly well in bear markets. During the dot-com market crash, the S&P 400 Mid Cap index fell by 27.5% from peak to trough, handily beating the 45.8% fall posted by the S&P 500 index of large caps.

U.S. mid caps outperformed in dot com crash

US large and mid caps normalized return peak to trough



Source: Indices: Mid caps, S&P Midcap 400 TR Index; Large caps, S&P 500 TR Index. Weekly data, normalized as of Sept. 1, 2000 = 100, through to Oct. 4, 2002. Data retrieved using Bloomberg.

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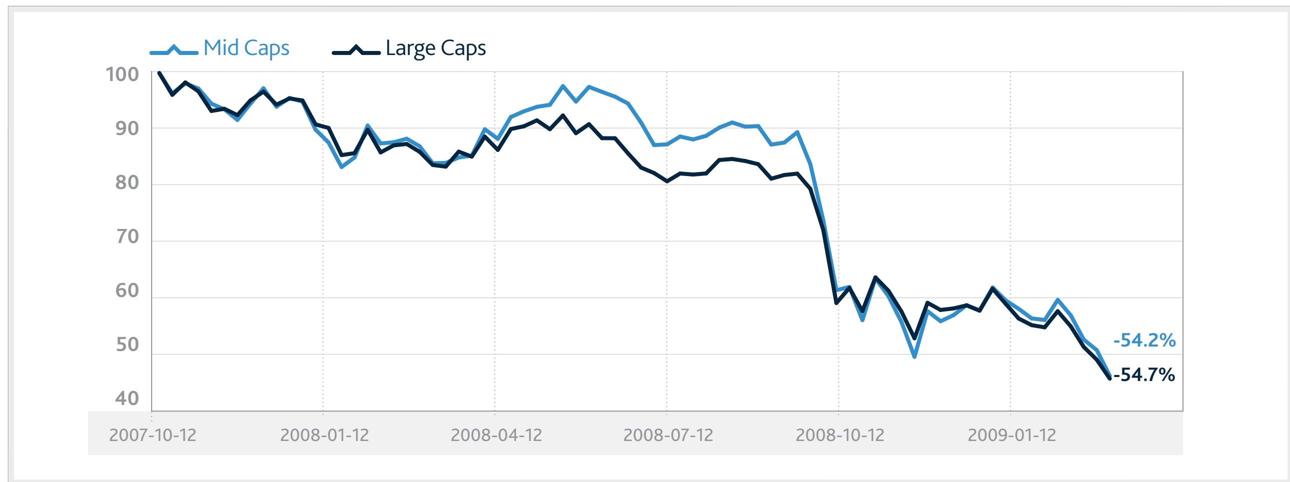
Though the differences are less staggering in the bear market caused by the 2007 housing market crash, mid caps (-54.2%) nevertheless outperformed large (-54.7%) cap stocks once again, albeit marginally.

...and held their own in housing bubble market crash

US large and mid caps normalized return peak to trough



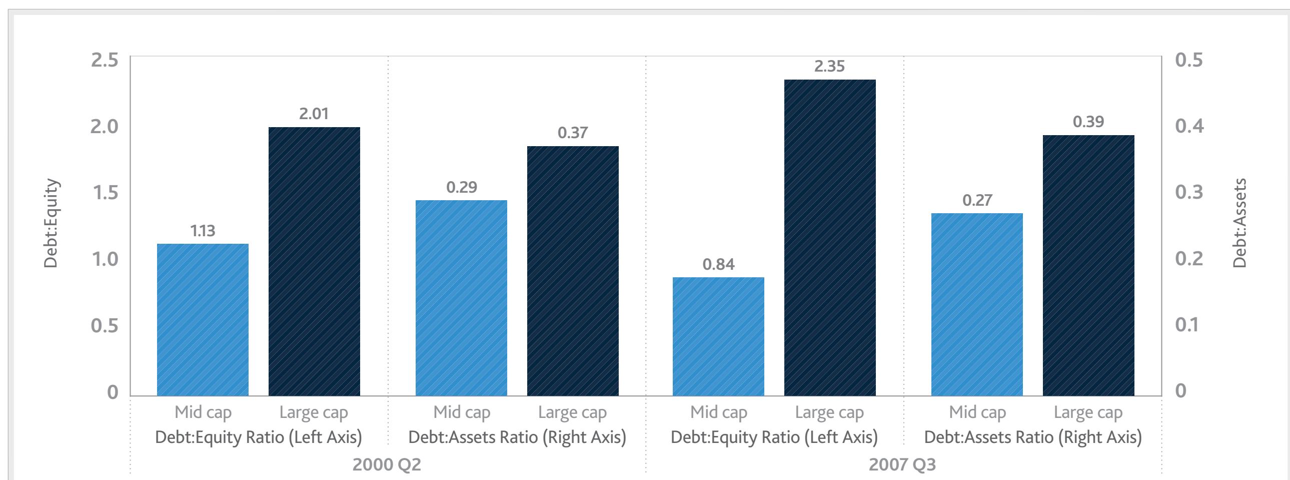
Source: Indices: Small caps, S&P Small Cap 600 TR Index; Mid caps, S&P Midcap 400 TR Index; Large caps, S&P 500 TR Index. Weekly data, normalized as of Oct. 12 2007 = 100, through to March 6, 2009. Data retrieved using Bloomberg.

While we can't pinpoint exactly what explains mid caps' historical outperformance in tough times, it would make sense that in down markets, investors would seek out companies with more robust balance sheets – that is, less indebted companies. Why? In a strong economy, debt can be beneficial to large companies, as it reduces the company's tax burden thanks to the deductibility of interest payments. However, debt is less beneficial in hard economic times; a tough economy means less profits, and therefore a company's debt tax shield provides less value while simultaneously increasing the likelihood of bankruptcy.

So which company size has a stronger balance sheet? Indeed, in the quarter prior to the bear markets in both 2000 and 2007, mid cap companies had significantly lower – that is, better – debt to equity and debt to assets ratios than large caps.

Debt ratios were significantly higher for large caps leading into bear markets

Debt:Equity and Debt:Assets in the quarter prior to last two bear markets

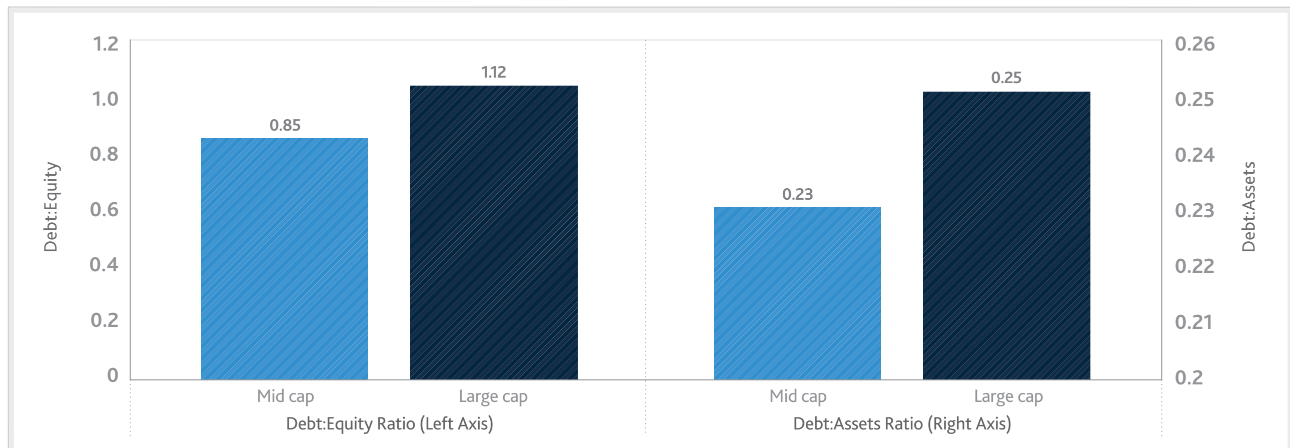


Source: Indices: Mid caps, S&P Midcap 400 Index; Large caps, S&P 500 Index. Quarterly data. Retrieved from Bloomberg as of April 27, 2018.

Indeed, even now mid cap companies show significantly better debt ratios than large caps, as we can see from the most recent debt ratios.

Even now, debt ratios are higher for large caps

Debt:Equity and Debt:Assets as of Q1 2018



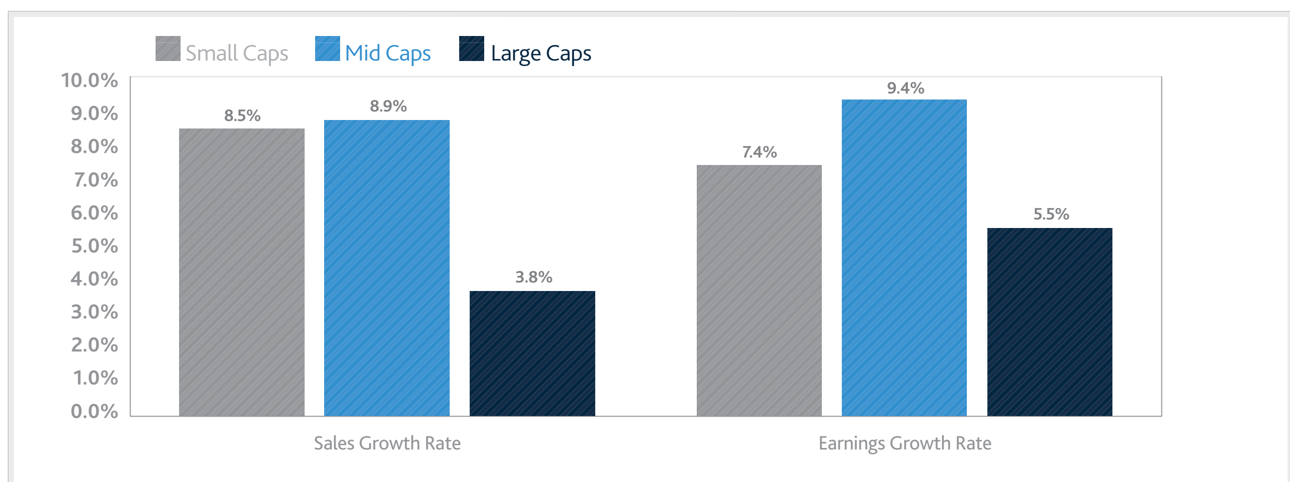
Source: Indices: Mid caps, S&P Midcap 400 Index; Large caps, S&P 500 Index. Quarterly data. Retrieved from Bloomberg as of May 1, 2018.

The sweet spot of the market

So what exactly have been the drivers behind mid-size companies' outperformance over time? Digging a little deeper, the answer may lie in the fact that mid cap companies are in the "sweet spot" between small and large companies. Contrary to the widely held belief that small companies offer the greatest growth potential, mid-sized ones in fact have demonstrated revenue and earnings growth rates that are higher than those of both small and large cap stocks.

U.S. mid cap stocks revenue and earnings growth rates best those of small and large caps

Sales and earnings growth rates since 1995

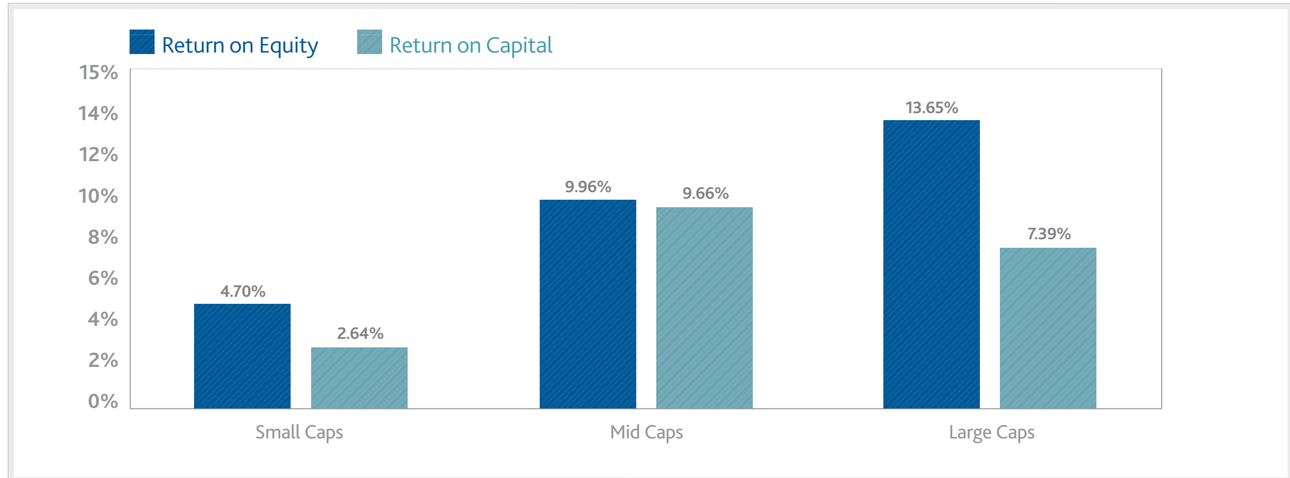


Source: Indices: Small caps, S&P Smallcap 600 Index; Mid caps, S&P Midcap 400 Index; Large caps, S&P 500 Index. Yearly earnings and sales growth rates are CAGR calculated from fiscal years 1995 to 2017 inclusive. Earnings is Earnings Before Extraordinary Items. Data retrieved using Bloomberg as of April 24 2018.

But have mid caps been successful at turning the revenue growth into profits? It would seem so. While they admittedly trail larger companies on return on equity metrics, mid caps are still far ahead of small cap companies. Additionally, mid cap stocks are actually more impressive than either of the other cap sizes when viewed from a return on capital basis – likely due to a combination of healthy profits and their aforementioned lower relative debt levels vs large caps.

Mid caps dominate small caps and keep up with large caps in profitability terms

ROE and ROC for three cap sizes



Source: Indices: Small caps, S&P Smallcap 600 Index; Mid caps, S&P Midcap 400 Index; Large caps, S&P 500 Index. ROE & ROC is from fiscal year 2017 data. Retrieved from Bloomberg as of April 24, 2018.

We think the added benefit is that unlike smaller companies, mid-sized ones have gotten past the early, riskiest stage of a company's growth and have established their ability to sell their products. We view them as essentially a "Goldilocks" asset class, combining the growth rate of a small company with the financial strength and profitability of a large one. Their location in the "sweet spot" between small and large companies certainly may be the reason why mid-sized companies have outperformed over time, including in down-markets.

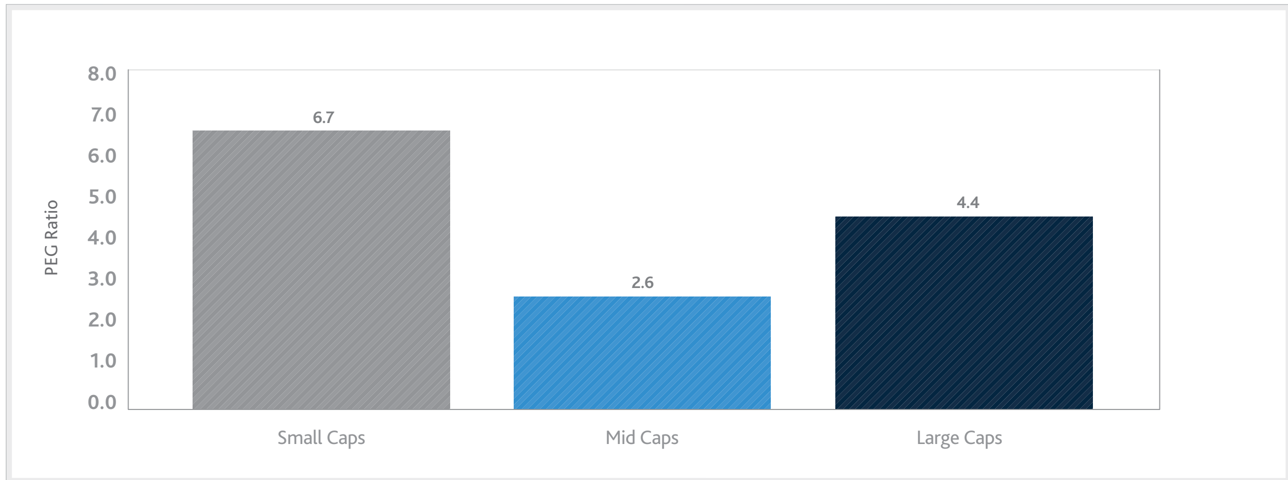
Pay less for more

In light of their better risk/reward and growth characteristics, surely one would expect investors to pay a premium to buy mid cap stocks over small and large ones? Again, that's apparently not the case. By comparing the PEG (price/earnings divided by growth rate) ratio between the three indices, we can see how expensive each market cap group is, taking into account the growth rates of its underlying stocks; the lower the PEG ratio, the more likely the stocks are undervalued relative to their growth rate.

In the graph below, we demonstrate that the PEG ratio is significantly lower for mid cap stocks than for either small or large caps. That is, mid cap names are in fact cheaper to buy than small and large caps, when taking into account each group's growth rates. For growth-oriented investors, buying mid caps essentially means paying less for more.

U.S. mid caps are significantly cheaper than small and large caps

P/E to Growth ratio



Source: Indices: Small caps, S&P Smallcap 600 Index; Mid caps, S&P Midcap 400 Index; Large caps, S&P 500 Index. Growth rate is CAGR of Earnings Before Extraordinary Items from fiscal years 1995 to 2017 inclusive. P/E data is annuals as of December 31 2017. Data retrieved using Bloomberg as of April 24 2018.

Bottom line: Don't forget about this forgotten asset class

On the surface, there's nothing overly exciting about mid cap stocks, as they're thought to lack the growth potential of small caps and the profitability of large caps. But digging deeper, mid cap stocks in general have demonstrated higher revenue and earnings growth rates than both small and large companies. This has led to significant equity outperformance over time, with attractive risk levels to boot.

Despite this, investors' lack of awareness about mid caps' performance means they have become the forgotten asset class. This actually bodes well for those seeking to enter the market, since on a relative valuation basis, one can buy mid cap names much more cheaply than small and large cap companies, especially when taking into account their growth rates. With a solid history of performance even in down-markets, it's easy to see why this Goldilocks asset class should have a place in equity investors' portfolios.

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The S&P MidCap 400 is a subset of the S&P 500 and serves as a barometer for the U.S. mid-cap equities sector. To be included in the S&P MidCap 400 Index a stock must have a total unadjusted market capitalization of $1.6 billion $6.8 billion.

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