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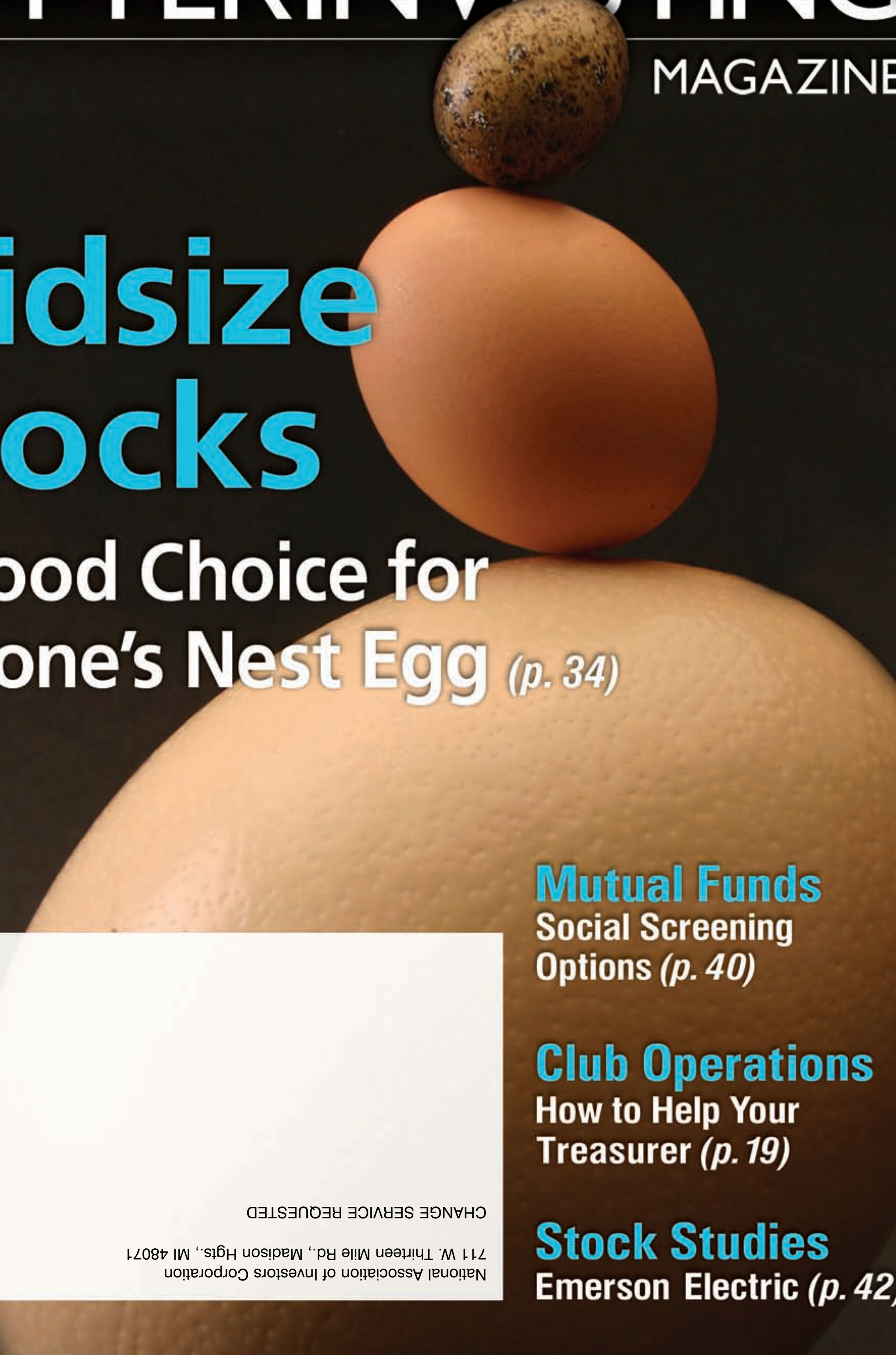

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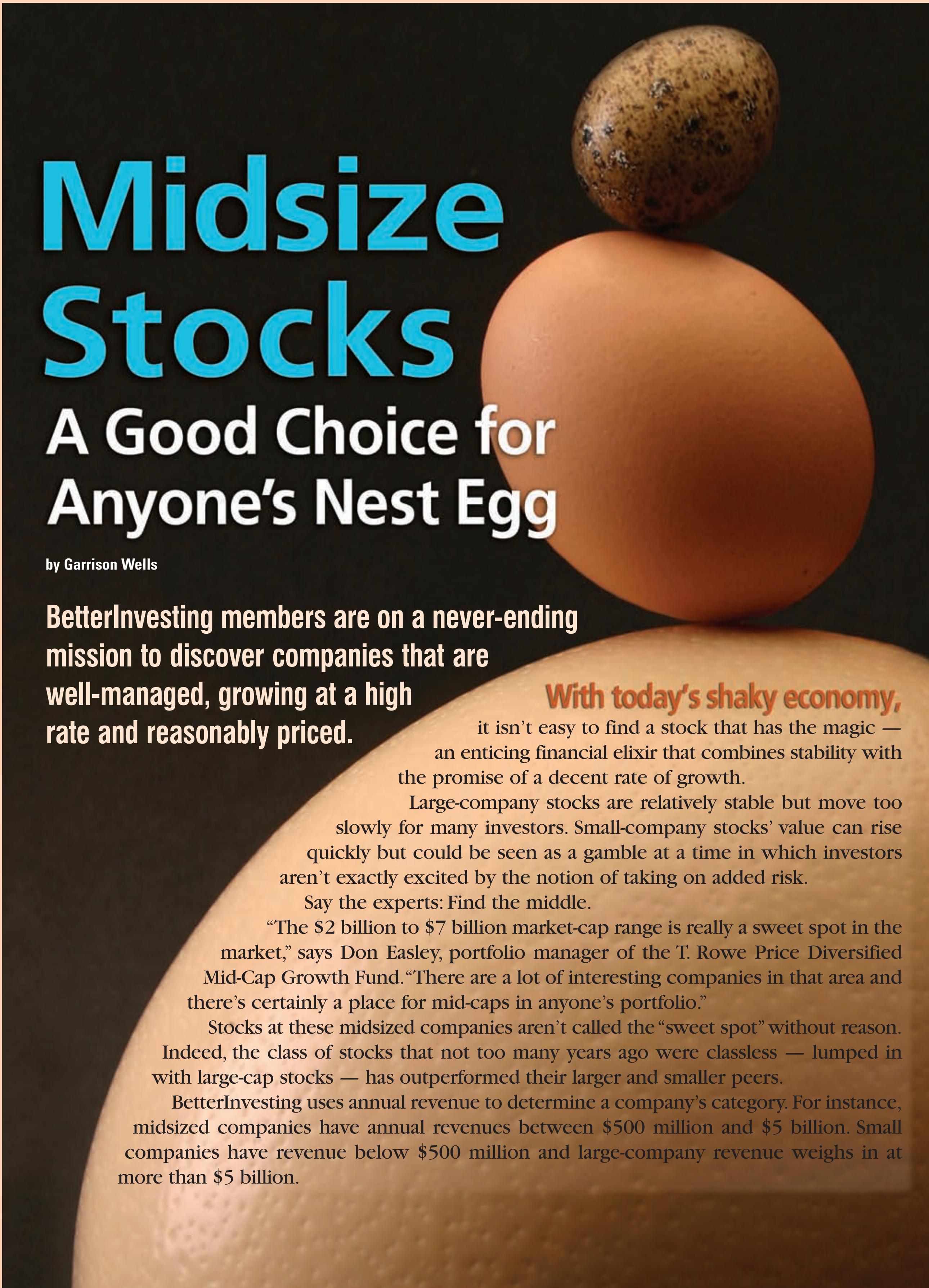

Midsize Stocks

A Good Choice for Anyone's Nest Egg

by Garrison Wells

BetterInvesting members are on a never-ending mission to discover companies that are well-managed, growing at a high rate and reasonably priced.

With today's shaky economy, it isn't easy to find a stock that has the magic — an enticing financial elixir that combines stability with the promise of a decent rate of growth.

Large-company stocks are relatively stable but move too slowly for many investors. Small-company stocks' value can rise quickly but could be seen as a gamble at a time in which investors aren't exactly excited by the notion of taking on added risk.

Say the experts: Find the middle.

"The $2 billion to $7 billion market-cap range is really a sweet spot in the market," says Don Easley, portfolio manager of the T. Rowe Price Diversified Mid-Cap Growth Fund. "There are a lot of interesting companies in that area and there's certainly a place for mid-caps in anyone's portfolio."

Stocks at these midsized companies aren't called the "sweet spot" without reason. Indeed, the class of stocks that not too many years ago were classless — lumped in with large-cap stocks — has outperformed their larger and smaller peers.

BetterInvesting uses annual revenue to determine a company's category. For instance, midsized companies have annual revenues between $500 million and $5 billion. Small companies have revenue below $500 million and large-company revenue weighs in at more than $5 billion.

Others in the industry, including many funds, use market capitalization to determine company size, but mid-cap funds such as the Standard & Poor's MidCap 400 are medium-sized companies. Considered a benchmark for medium-sized companies, the MidCap 400 covers more than 7 percent of the equity market in the United States.

Sam Stovall

"S&P came out with its S&P MidCap 400 index in the '90s," says Sam Stovall, chief equity strategist for S&P Capital IQ. Russell already had its 2000 and S&P had its large-cap. I guess you could call it a doughnut hole because the area that was being overlooked was the mid-cap space. And the result is that they have done exceptionally well."

Indeed, Stovall says that stocks at those midsized companies on the 400 from 1995 through 2010 have beaten their large-cap brethren 63 percent of the time with the average price change at 12.8 percent per year for MidCap 400 equities, compared with 8.6 percent for the S&P 500.

Stocks in the MidCap 400 have also performed better during downturns, Stovall says. In 2000, 2001 and 2002, the S&P 500 fell 10 percent, 13 percent and 23 percent, respectively. During that same time frame, the MidCap 400 was up 16 percent, down 2 percent and down 15 percent.

"I think it's because of the small-cap effect," Stovall says. "In general, small-caps beat large-caps, and people are more willing to move into the mid-cap space than actually going to the small-cap area. In a positive economic environment, mid-caps and small-caps do better than large-caps, but what is interesting is that mid- and small-caps didn't get crushed during the tech bubble and the most recent financial meltdown."

Indeed, those stocks at midsized companies suffered less than large-cap stocks during the last two meltdowns of 40 percent or more bear market declines, he says.

A Lighter Shade of Blue

What makes the middle so attractive? Midsized companies have made it past the risky, early stages of growth. This makes them less of a gamble than stocks at smaller firms, while they generally have more promise of growth than large companies.

"People say, 'I don't mind looking at smaller companies, but I'm not brave enough to go to the very small companies, so let me go to those companies that are almost blue chip,'" Stovall says. "I guess you could call them light-blue chips, instead of very small companies that are not frequently covered by analysts and that are more of a gamble. This is all speculation on my part. I don't really have anecdotal evidence that proves it, but it's what I am thinking."

Indeed, it's among those midsized companies that investors just might find the next rising large-cap star, Stovall adds.

"Everyone is looking for the next IBM, and very small companies take a long time to become large companies," he says. "There's not a lot of patience on Wall Street, and they say: 'Why don't I search for the next IBM in the mid-cap arena rather than search for them in the small-cap arena.'"

Takeover Targets

Medium-sized companies are also prime candidates for acquisition by larger companies looking to bolster their bottom lines and boost stock prices.

"I think that is part of the reason why they (midsized equities) are so attractive," says Easley. "You look at a sector like technology, where you have a lot of emerging software companies that are, in a lot of ways, creating new markets and growing very fast. Then you have larger-cap companies that have a lot of cash on the balance sheet that are earning, say, 1 percent. I think you are going to continue to see acquisitions and I think you will see at least one a week in technology. For these large companies with a lot of cash, they can afford to make a $4 billion to $5 billion acquisition because cash on the balance sheet is just not earning very much."

One recent deal: SAP subsidiary SAP America announced on Dec. 3 its merger agreement with SuccessFactors, set at $40 a share — a 52 percent premium. The deal was valued at $3.4 billion.

"I think that, at a really high level, mid-caps are a really interesting and attractive area of the market," Easley says. "You have companies that are sufficiently seasoned. They have kind of made it through the small-company range into larger-company status, but in most cases they are still small enough so that they could grow."

Equities at midsized companies over the past three- and five-year basis have "outperformed just about every asset class," he adds. "We're believers."

Training First in the Minor Leagues

From the perspective of Standard & Poor's, there's another advantage to buying stocks in midsized companies. Those in the S&P MidCap 400 are likely the next generation of S&P 500 index companies, Stovall says.

"It's almost like a AAA baseball league where, if you're going to be promoted to the Majors, sort of like the S&P 500, that's the pool from which a company is selected," he says. "It doesn't always happen, but it's usually the case."

Stovall adds that a midsized company that's been bumped up to the S&P 500 isn't included in the index until a week after the announcement, sparking fund managers who replicate the 500 index or closet indexers to add the midsized company. This drives up the price in the short term.

"The benefit of being selected occurs while the company is still in the 400," Stovall says.

What many S&P 500 investors may not know is that they probably are already investing in midsized firms, says Mark Litzerman, CFA, manager of equity research with Wells Fargo.

"One thing that is intriguing, that not every investor knows, is that even if you invest in the S&P 500, you are investing in mid-caps. As of today, about 43 or 44 percent of stocks in the S&P could technically be classified as mid-caps," he says.


Mark Litzerman

Medium-sized companies' equities also play in a different revenue arena, which can actually make them safer in some sectors than large corporations, Litzerman says.

"If you look at components of a mid-cap market — the Russell, S&P — look at what is driving the sector returns," he says. "In financials, you are depending on the big banks. There are volatile issues there. Mid-cap financials are more dependent on smaller, regional banks."

Medium-sized companies, he adds, "are the sweet spot relative to large-cap and in fact on par with small-cap returns with a little bit lower risk."

Still, mid-caps this year underperformed, he notes. Wells' recommendation currently is overweight in large-caps and neutral weight in mid-caps on growth value.

Midsized companies "underperformed a bit this year, but typically they offer a couple of attractions," he says. "Historically, a lot of people look at mid-caps and consider it the stepchild of the large-cap area. But if you look at those companies, and we define those as being between $2 billion and $10 billion, you have a better growth opportunity there and they are more mature than small-cap stocks."

Those medium-sized companies, Litzerman adds, "are an attractive area to look at as a distinct asset class," a step that Wells took a couple of years ago.

"If you want to invest in the mid-cap space, there are a number of ways to do it, but do your homework so you know what you are investing in," he says.


David Kathman

Investing Via a Fund

One way to step into middle-sized company equities is through mid-cap funds, says David Kathman, senior mutual funds analyst and ad analyst for Morningstar's mid-cap growth category.

"Right now, this year has been a very volatile market," he says. People are very jittery and large-caps have done fairly well this year — large growth (stocks), for example, except ones with lots of financials.

"On the other hand, when things are going better and you have a rally like you had in 2009, the smaller stocks will tend to do better and larger stocks will lag behind."

Over the past five years, including the downturn in 2008-2009, middle-sized company equities outperformed, while large value stocks were the worst performing, he says. Next year, in the mid-sized company equity arena, Kathman says he expects that growth funds will probably do well.

For investors who might be more comfortable investing in mutual funds than individual stocks (a mid-cap screen is on the opposite page), Kathman suggests they study *(funds and stocks in this article are mentioned only for educational purposes; no recommendations are intended)*:

- **PrimeCap Odyssey Aggressive Growth Fund (POAGX).** The fund is fairly aggressive, but the managers are also focused on quality, Kathman says. The fund tends to favor holdings that have fallen out of favor, with the managers willing to wait for these stocks to turn around. Sometimes that leads to trouble, but the long-term record and fundamentals are strong.
- **T. Rowe Price Mid-Cap Growth (RPMGX).** It's a huge fund but has low expenses, Kathman says.
- **Vanguard Mid-Cap Growth Index (VMGIX).** It's an index fund, but it's very cheap and from a respected fund family, Kathman says.
- **Osterweis Fund (OSTFX).** This fund is more conservative and holdings tend to emphasize relative value, he says.

"It's always a good idea to look at a given fund's track record, and especially its expenses," Kathman says. "That's one thing you can control. You should also look at the fund's current manager."

Garrison Wells is an award-winning freelance business writer based in Colorado Springs, Colo.

Company	Ticker	Trailing-12-month revenues ($ millions)	5-yr sales growth (%)	5-yr EPS growth (%)	Proj sales growth (%)	Proj EPS growth rate (%)	Proj 3-5 yr annual total return (%)	Value Line Financial Strength	Value Line Earnings Predictability
Akamai Technologies	AKAM	1,119.5	25.5	36.0	12.5	13.5	24.0	A	75
Coach	COH	4,158.5	22.0	19.5	14.0	14.5	12.0	A	90
Fossil	FOSL	2,437.7	14.5	21.0	20.0	22.0	16.0	A	65
Netflix	NFLX	2,924.9	28.5	58.5	28.0	25.0	31.0	A	75
ResMed	RMD	1,275.9	17.5	19.5	14.0	15.0	20.0	A	95
Urban Outfitters	URBN	2,411.6	19.0	20.0	14.0	14.0	23.0	A	80
Celgene	CELG	4,587.3	39.0	72.5	18.0	20.5	17.0	A+	50
Tempur-Pedic	TPX	1,343.8	13.0	13.0	18.0	25.5	13.0	B	60
Agnico-Eagle Mines	AEM	1,801.5	19.0	30.0	28.0	35.5	30.0	B+	40
Alliance Resource	ARLP	1,787.5	14.0	17.5	13.0	14.0	14.0	B+	70
Amphenol	APH	3,940.9	16.0	21.0	12.0	13.5	17.0	B+	80
Catalyst Health Solutions	CHSI	4,901.5	37.0	28.0	13.0	17.0	12.0	B+	90
Copa Holdings	CPA	1,739.9	21.0	21.0	12.0	17.0	20.0	B+	75
Green Mountain Coffee Roasters	GMCR	2,651.8	37.5	38.0	44.0	53.0	32.0	B+	65
II-VI	IIVI	521.1	14.5	16.0	12.5	16.5	13.0	B+	55
Plexus	PLXS	2,231.2	13.0	49.5	15.0	14.5	26.0	B+	55
Wright Express	WXS	528.2	12.5	21.5	12.5	15.0	19.0	B+	65
F5 Networks	FFIV	1,151.8	27.5	26.5	20.5	31.0	12.0	B++	80
FTI Consulting	FCN	1,532.3	21.0	12.5	12.5	13.5	18.0	B++	80
Gildan Activewear	GIL	1,726.1	16.5	16.5	15.5	18.5	32.0	B++	65
Informatica	INFA	754.6	17.0	27.0	13.0	22.0	14.0	B++	55
Juniper Networks	JNPR	4,517.9	21.5	17.5	16.5	16.5	25.0	B++	75
priceline.com	PCLN	4,096.1	17.5	73.0	22.5	25.5	15.0	B++	55
Red Hat	RHT	1,026.4	29.5	13.5	17.0	28.0	16.0	B++	80
RPC	RES	1,655.2	19.5	14.5	17.5	32.0	19.0	B++	25
Silver Wheaton	SLW	687.9	32.0	44.0	21.0	27.0	15.0	B++	55
Sohu.com	SOHU	779.2	41.0	37.0	16.5	14.0	24.0	B++	45
Stantec	STN	1,341.2	18.0	19.5	12.5	13.5	24.0	B++	95
Ultra Petroleum	UPL	1,068.5	25.0	23.0	18.5	18.5	34.0	B++	65
United Therapeutics	UTHR	714.2	33.5	25.5	20.5	29.0	36.0	B++	40

Screening for Midsize Companies

The list above details companies that passed the following conditions using Value Line's premium stock screening tool on Dec. 13: trailing-12-month revenues of between $500 million and $5 billion; five-year sales and earnings growth of at least 12 percent; forecasted five-year annual earnings and sales growth of 12 percent; and a projected annual total return for the next three to five years of at least 12 percent. We also included Value Line ratings for Financial Strength and Earnings Predictability. As with any stock screen, this is just a starting point for research; no investment recommendations are intended. You'll want to make sure any company of interest looks suitable on a Stock Selection Guide using your own judgments.