INVESTMENT INSIGHTS

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The Importance of a Midcap Allocation

As the forgotten middle child of investment strategies, midcap stocks often don't get the attention that they merit from institutional investors.

Many institutional investors expect exposure to midcap stocks through their large- and small-cap allocations, but the universe of midcap stocks is much broader than investors think, covering companies from $2.5 billion to $35 billion in market capitalization. Depending on the fringes of a large- or small-cap allocation doesn't assure exposure.

It's a missed opportunity, according to Eric Mintz, portfolio co-manager of the Mid Cap Growth Strategy at Eagle Asset Management, an affiliate of Carillon Tower Advisers. Having a dedicated midcap allocation can provide increased growth potential with a favorable risk-reward profile.

Since the Russell Midcap index started in 1979, midcaps have outperformed small-cap stocks on every rolling 10-year period, and they beat small- and midcap stocks combined 90% of the time. Midcap stocks outperform large stocks 73% of the time.

"Midcaps have built a pretty impressive track record of outperforming, and while they do succumb to corrections in a bear market, they're nowhere near as punitive as what we see in the small-cap universe," Mintz said.

Indeed, midcaps have outperformed all other stock classes for the majority of rolling one-, three- and five-year periods over the past four decades. So investors should consider them when they're searching for the higher returns they often look for in small caps.

Midcap stocks benefit from having more liquidity, typically, and the companies generally have stronger management teams than small-cap companies. Midcaps also have less volatility as they move beyond the startup phase of a business. When the stock market plunged at the end of 2018, small caps fell further than midcaps and ended the year in a weaker position.

'NEEDLE-MOVING EARNINGS GROWTH'

Mintz has a positive outlook for midcaps through the rest of 2019 amid low interest rates and moderate economic growth. The asset class has also benefited from merger-and-acquisition activity year-to-date. Some well-publicized recent examples of this include Ultimate Software, which was sold in February for $11 billion, and payments giant Worldpay, which sold for $35 billion in March.

"Those takeouts are just a nice kicker to performance that really helps," Mintz said. "Even in instances where the names are acquiring other names, they can be a pretty compelling source of needle-moving earnings growth. That's one of the interesting dynamics within the midcap space."

"The drawdowns of the fourth quarter probably tested people's convictions," he said. "Once you got the rally back, you had a combination of more willing sellers, given the temperament of the market, and a pretty good war chest of cash on the sidelines of corporate America."

In addition to merging with each other, midcaps make an attractive acquisition target for large caps looking to purchase a new technology or product line.

Several other trends make midcaps a smart strategy to consider now. After the volatility of the fourth quarter, midcap valuations are fairly attractive compared to large caps, and their earnings are rising faster.

The digital revolution across all industries also bodes well for midcaps. While midcaps may not be the most high-profile tech companies, they're helping fuel digitization of industries like health care and providing the components for a variety of innovations.

LOOKING AHEAD

While there's a pretty clear case for buying midcaps now, Mintz and his team tend to take a longer-term view when building their portfolio, preferring to look for stocks with potential for secular growth.

"You have a slowing global growth environment and pretty muted interest rates," he said. "So you're going to see that scarcity of growth get bid up and supported by the lower interest rates on the higher multiple. That is really the kind of environment in which those secular-growth names outperform."

Mintz conceded that, given the duration of the current economic expansion, the economy could slip into a recession sometime in the next year, which would hurt the prospects of midcap stocks, but perhaps not as much as the rest of the market.

"You have some factors that should be a little bit more supportive to the midcaps than the small-cap universe," Mintz said. "You have better liquidity, and the balance sheets tend to be stronger than [with] small caps. And the large-cap stocks are going to be hyper-sensitive to broader economic trends.

WHY MIDCAPS?
Here are the top three reasons institutional investors should consider an allocation to midcap stocks, according to Eric Mintz, portfolio co-manager for Eagle Asset Management's Mid Cap Growth Strategy.

- **Risk-adjusted returns:** Midcaps historically have provided attractive risk/return characteristics compared with their larger and smaller equity peers over time.
- **Growth potential:** Mid-sized companies may still have plenty of room to grow, and could give investors a way to gain an early position in companies that might become tomorrow's blue chips.
- **Consistency:** Many midcap companies tend to be more financially stable than their small-cap counterparts and have more experienced management teams. As they mature, some of these firms may become as stable as larger-cap companies.

Mintz's team focuses on fundamental research and looks for midcap companies that are poised to experience acceleration in their earnings growth rate. It's helpful, Mintz said, that the team has a successful small-cap strategy, so they're dialed in to what's happening with many emerging midcap stocks.

According to Mintz, looking for secular-growth stocks works best when an investor is able to spot the opportunities early and hold on to the stocks, giving them room to run.

"Our bias is to stick with our winners," he added. The team also seeks to have lower turnover, which was about 40% last year, he said.

The self-discipline to allow midcap stocks the room to grow has fueled Eagle's outperformance over time.

"With midcaps there's a consistency of outperformance versus small- and large-caps, based on a really sweet spot in the market," Mintz said. "Over time, they're going to attract increased investor awareness." •

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