Dave Hutchison, CERTIFIED FINANCIAL PLANNER™

1720 E Calle Santa Cruz
Phoenix Arizona 85022

HUTCHISON INVESTMENT ADVISORS
Registered Investment Advisor
Founded on a CPA Firm Background
(602) 955-7500

E-mail: dave@HutchisonRIA.com
website: www.HutchisonRIA.com
Fax (602) 955-1458

Why Mid-Cap Stocks Maybe More Prudent and Timelier than Large Caps

Fall 2019

Summary: Large caps have many risks today, and their growth potential may be limited. Small-caps have higher short-term risk but potentially greater long-term growth potential. Midcaps maybe should be the center of more attention and perhaps today's sweeter spot for diversified portfolios. Our action plan recommendations.

Large Caps Current Negative Outlook

High Valuation: Large caps as represented by the S&P500 index are seemingly defying gravity, with near all-time highs. More importantly, the price/earnings ratio valuation of the large-cap S&P500 index is near the 90th percentile. This means that over the past 15-years, the S&P500 P/E ratio has only been higher 10% of the time. In comparison, the S&P Midcap 400 index is only at the 26th percentile, relatively cheap historically. Even relatively cheaper is the S&P SmallCap 600 index at the 18th percentile[1].

Exposure to Foreign Markets: The S&P500 companies derive over 40% of their earnings from foreign markets, and are hurt by the stronger U.S. dollar. The dollar may hit an all-time high as investors seek the comparatively higher U.S. interest rates vs. negative rates in many foreign markets.

S&P500 companies with even more global exposure could see double-digit earnings declines, reports Factset.

While the US economy is probably slowing to about a 2% growth rate, this still is better than most foreign economies. Many European economies and Japan are in or near recession.

The 3-year fight over BREXIT in the U.K has been smoldering and may soon explode if there is a no-deal exit from the EU. This result could “ensure years of hideous negotiations with no leverage and little hope of clawing Europe back the benefits of membership. Any agreement would likely need to be ratified by the EU’s 27 parliaments, which may not be sympathetic after the U.K. has imposed such mayhem.” Bloomberg Opinion "What is Boris Doing."

China growth is slowing as it is walloped by the Trump Trade War, which also is hurting other Asian economies that sell to China.

There is now more than $17 trillion of negative-yielding debt – almost all in Europe and Japan - which limits further stimulus by more rate cuts by central banks. Thirty percent of all investment-grade securities have negative rates – so buyers will lose money on maturity. Bloomberg 8/31/2019.

Limited Organic Growth: Larger mature companies have limited organic growth rates because they already address a larger proportion of their target market. Any new product or service represents a smaller proportion of total revenue than the established product offering. For these reasons, earnings and cash flow growth in large-cap stocks can be limited.

Smaller Companies

Smaller and mid-caps often have much less analyst coverage and garner less attention from Wall Street. What this means to the individual investor is that, because many smaller cap companies are often under-reported or even undiscovered, there is a high probability that smaller cap stocks are improperly priced, offering an opportunity to profit from the inefficiencies caused by the lack of coverage. The fewer managers and analysts that do search for "hidden gems" can often find more growth opportunities or potentially profitable future mergers with smaller companies by larger companies.

While long-term smaller caps have outperformed large-caps, small caps are also more susceptible to volatility, simply due to their size; it takes less volume to move prices. There are limited institutional investments in small caps.

Mid-Caps: At the Center of Attention[2]

The mid-cap segment of the equity market is often overlooked, falling between headline-grabbing and widely followed large-caps and small-caps, known for their high growth potential. While mid-caps have historically outperformed *both* small- and large-cap stocks, they don't get much investor attention.

Mid-caps make up about 25% of the overall equity market, according to a breakdown of the Russell indexes, yet mid-caps only account for just over 12% of all invested assets, as represented by Morningstar asset flows.

Investors lacking a dedicated allocation to mid-caps may be missing exposure to a crucial market segment. Mid-cap stocks have proven to be a positive addition to a diversified portfolio of equities, both in terms of boosting portfolio return and lowering risk.

Large-cap companies may be well established and more likely to pay dividends but may have limited growth potential. Small companies offer the allure of outsized growth but may exhibit more volatility and greater dependence on debt. Mid-caps occupy a place squarely in between—small enough to experience relatively high growth rates, but mature enough to have proven business plans, greater stability, and more experienced management.

Mid-caps have exhibited better historical earnings-per-share growth than both large-caps and small-caps. Also, mid-cap companies have demonstrated more consistent profitability than small-caps, as measured by comparing earnings variance data.

Conclusion

Investors may be well served by including an allocation to mid-cap stocks as part of a diversified portfolio. The data show that mid-caps have historically outperformed large-caps and small-caps over the last 20 years. When mid-cap stocks are added to a portfolio of small-cap and large-cap stocks, the risk-return profile of the portfolio shows significant improvement. Based on this data, the conclusion is not whether to add mid-caps, but how best to achieve mid-cap exposure. Data supports the potential value of an actively managed mid-cap strategy over a passive, index-driven approach.

Action Plan Recommendations

I can discuss individually specific recommendations based on goals, objectives, and risk tolerance.

In general, I suggest investors reduce allocations in Europe and Japan and increase growth objective allocations to more U.S. equities. While U.S. growth is slowing, the U.S. has comparatively stronger economics than most global economies.

Consider more U.S. Small-Mid Caps, which overall are less dependent on European sales. With revenues more from within the U.S., they do not have the currency risk of a stronger dollar that reduces foreign earnings. Smaller companies also have the potential for faster growth, and with so many more smaller companies than large, good research can potentially find hidden gems. Smaller companies' stocks are often more volatile with less trading volume, but over the long term have rewarded investors.

Instead of "dumb" index funds with no stock selection based on individual company outlooks, or similar ETF's (only make sense for traders, not investors), I suggest managers with long-term track records of outperformance compared to the category they invest in and compared to the risk taken (Alpha vs. Beta in investment terms) – not just raw returns.

---

[1] Cetera Investment Management, Morningstar and Standard & Poor's Date as of 8/31/2019

[2] Highlights of article by Jon K. Christensen, CFA and Craig Stone, both Senior Research Analysts and Portfolio Managers at Virtus Investment Partners. Various charts and graphs supporting conclusions are omitted.