

THE MID-CAP *WAY*

Investing in a medium-sized, European company

Pointing at the wide dispersion of returns between top and bottom quartile managers, Yale University's endowment fund star manager David Swensen shows that mid-cap stocks constitute an inherently inefficient market. The inefficiency

of mid-cap stocks comes from many well-known factors: relatively reduced scrutiny from investors and brokers, less readily available information and the more fragmented nature of the market itself. Over the last few years however, you did not need to beat the index to do very well. Just buying it would have generated very hefty profits for your portfolio. Not unlike early 2005, many strategists were quite pessimistic in early 2006 about the prospects for mid-cap European stocks. They have been proven wrong again, and 2007 could well be a replay of 2006.

We are now in a continuing six-year cycle of out-performance relative to European large caps. According to the Euro STOXX Mid 200 Index, the returns on European mid-caps in 2006 outperformed the Euro STOXX Large 200 Index by about 11%, with returns rising by 24%, and despite a sharp correction in May. Valuations are

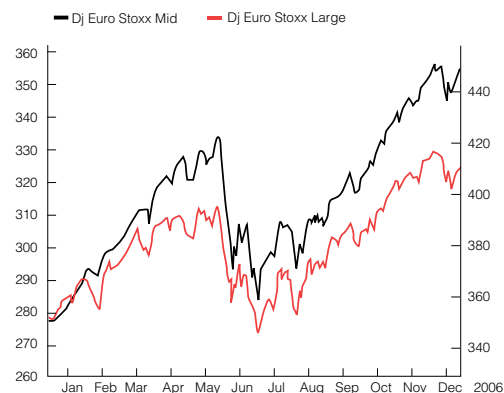
becoming somewhat rich: in the UK, the FTSE 250 is trading on prospective p/e of 13.9 times 2007 earnings while the FTSE

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100 is rated at 11.8 times. Despite relatively high valuations, large institutional investors, including pension funds, have been increasingly interested in raising their exposure to mid-cap stocks in order to generate additional alpha from equities markets. Should they do it themselves by buying direct holdings or via a specialized fund is they key question. Because mid-caps are inherently a specialist's market, in which you typically want to spread your risk across many positions rather than concentrate it on just a few bets, most investors usually decide to use pooled investment vehicles rather than pick individual securities directly.

The secular case for mid-cap investing is clear: there are over 1,000 mid-cap companies in Europe, so it is always possible for managers to find the diamond in the rough. Ignoring that segment of the market may result more risky than not ignoring it. Most mid-cap companies are only in one business so an investment in their stock is quite pure. Also, several emerging businesses such as renewable energy can only be found in mid-cap land. In general, stock pickers point out that mid-sized companies can grow as quickly as small ones and faster than big ones. Unlike small companies however, mid-size outfits tend to have established products and proven track records of generating earnings. These last two attributes can make mid-size companies "prime" candidates to be acquired by big ones. Managers also like the fact that mid-size companies' top executives make themselves more accessible.

There are many reasons to believe that mid-cap stocks could continue to do very well in 2007: 1) it is a class with higher expected returns (and risk) compared to large caps, 2) investors continue to have a big appetite for risk as witnessed by the current tight credit spreads, 3) M&A activity has been and is forecast to remain very strong, 4) the current economic



cycle has proven its resilience and its longevity is not in doubt for the moment, and 5) mid-size businesses tend to be more domestic so they are hurt less by a weaker dollar.

Another supporting factor put forward by mid-cap bulls is simply demand. It could continue to be very strong as many investors have missed the rally because the large investment firms advising them have in general a poor mid-cap product offering. Indeed, large firms looking after vast pools of money typically do not find it economical to focus on a market which is relatively small compared to the assets they manage. Boutique investment firms and their clients have profited the most from the boom in mid-cap stocks and they are now attracting the interest of large institutional investors, no longer just private money. Most importantly maybe,

private equity sponsors are raising records amount of cash and, as can be seen by the record level of transactions, it is becoming more and more appealing for many public companies to be owned by focused, professional investors with a long-term industrial view rather than see their stock go up or down according to next quarter's earnings or the unpredictable and volatile mood of stock market investors.

The fact that the ECB is raising rates at a reasonable pace could be interpreted as a positive sign for mid-caps since it signals confidence about economic growth. The risk of course is that monetary policy becomes too aggressive and that growth slows abruptly in 2007; that would be particularly bad for mid-cap companies indeed as they have fewer different revenue streams than large caps.

It is not certain either that the mid-cap sector will continue to be a happy hunting ground for managers: valuation anomalies are becoming harder and harder to unearth as the mid-cap space attracts every-increasing attention. The days of finding a dull but worthy industrial company that is deeply undervalued are waning. It is difficult to imagine a mid-cap stock that has not been sized up by hedge funds, private equity houses, trade buyers and a rising number of more active, traditional fund managers. Almost all carry out computerized, quantitative screening of stocks to seek out bargains on the basis of financial ratios and earnings performance. Many also employ the tactics of traditional stock pickers to seek out primary information such as scouring trade publications and talking to suppliers. Finally, another risk for investors is to invest in large-cap managers disguised as mid-cap ones. Indeed, many mid-cap managers have seen massive asset inflows of late, triggered by their recent historical success. They could slowly be tempted to drift towards investing in large-cap stocks for liquidity reasons and there is a risk that their performance could become more index-like, which would mean of course that their management fees would no longer be justified (a little like beta managers pretending to be providers of alpha, in order to charge higher fees). Investors beware!

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