Mid Cap: Another Look at the Sweet Spot of Investing

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Mid cap stocks typically represent companies with market capitalizations between $2 billion and $10 billion (though with the multi-year rise in the overall market, when the Russell Mid Cap index was last reconstituted the largest mid cap stock was over $50 billion[1]). Over the years, this market cap niche has demonstrated attractive characteristics, however, it tends to be under-allocated. With its appealing risk/return characteristics along with a nice blend of growth and quality, we believe this space presents a compelling investment case and merits consideration for investors' portfolio allocation.

"Not too big, not too small, but just right"

The Goldilocks principle refers to the concept of achieving the "just right" amount by avoiding extremes. As investors search for "just right" opportunities with not too much volatility and not too little return, mid cap has a history of being a happy medium. A quick comparison of Russell 1000, Russell Mid Cap, and Russell 2000 indices over the last 20 years[2] indicates that the Russell Mid Cap index offers higher return potential with just slightly more volatility than the large cap index.

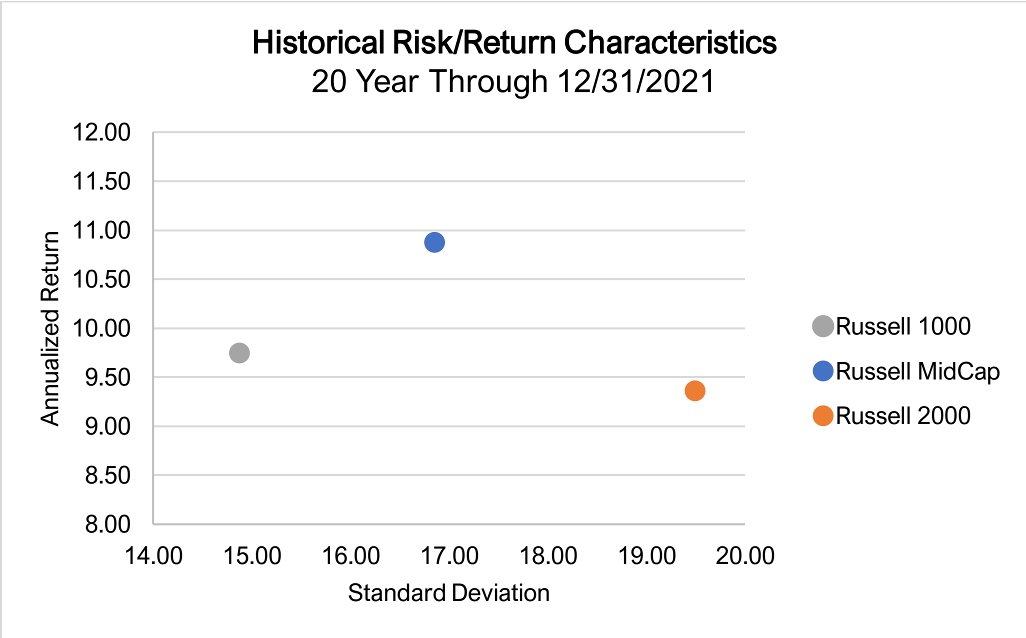

Figure 1 - Historical Risk Return Characteristics 1/1/2002 – 12/31/2021

[1] Source: Jefferies
[2] Data Source: eVestment, FTSE Russell

To illustrate how an additional mid cap allocation could be advantageous to existing portfolios, we compared two blended options. Portfolio 1 follows a simplistic large-plus-small approach with 70% Russell 1000 and 30% Russell 2000. Portfolio 2 adds a mid cap component with 60% Russell 1000, 20% Russell Mid Cap, and 20% Russell 2000. Over the last 20 years, Portfolio 2 not only offered superior return but also lower volatility.

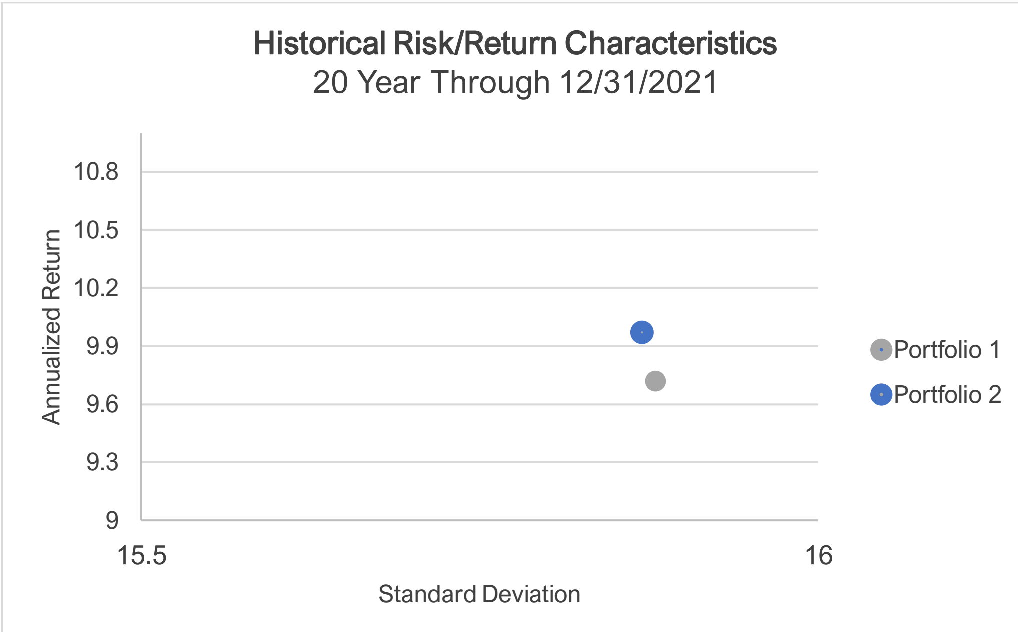

Figure 2 – Blended Portfolio Historical Risk Return Characteristics 1/1/2002 – 12/31/2021[3]

Market Inefficiency: Analyst Coverage Matters

As market cap declines, so does analyst coverage. At first glance, the difference in average analyst coverage between Russell 1000 and Russell Mid Cap might seem negligible, which is understandable because the Russell Mid Cap index are the 201-1000 stocks in the Russell 1000. However, evidence shows there are significantly more analysts covering the largest companies versus the rest of the investment universe. As illustrated in the chart below, the average number of analysts covering Russell Top 200 (the 200 largest names) is almost double that of Russell Mid Cap. Less analyst coverage leads to market inefficiency, which presents opportunities for active investors. With a double-digit analyst coverage, the mid cap space has just "enough" coverage to be robust but not quite enough to drive out all market inefficiency. This is a key reason we find that mid cap space is "just right" for active investment management.

[3] Portfolio 1 = 70% Russell 1000 Index + 30% Russell 2000 Index; Portfolio 2 = 60% Russell 1000 Index + 20% Russell Mid Cap Index + 20% Russell 2000 Index; Rebalanced monthly. Data Source: eVestment, FTSE Russell

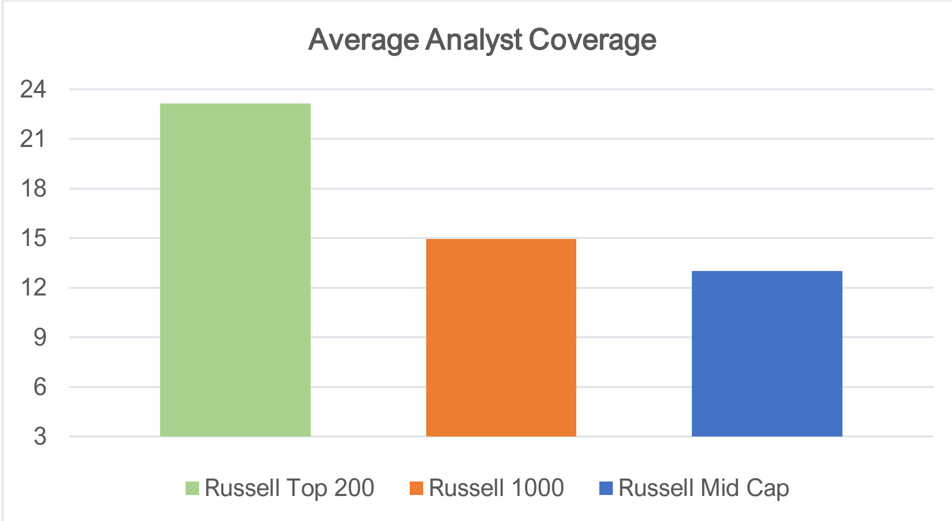

Figure 3 - Average Analyst Coverage 12/31/2021[4]

Quality and Growth

On the two ends of the market cap spectrum, small cap stocks are well known to offer significant growth potential while large cap stocks offer more stability to a well-diversified portfolio. Meanwhile, mid cap companies are in an early enough stage of their life cycle to generate above average earnings growth yet are mature enough to reduce the business risk associated with younger, smaller companies. Mid Cap company managements also tend to be more seasoned and thus more capable of navigating in fluctuating economic environments. As such, mid cap companies offer attractive quality profiles as measured by Return-on-Equity and Return-on-Assets.

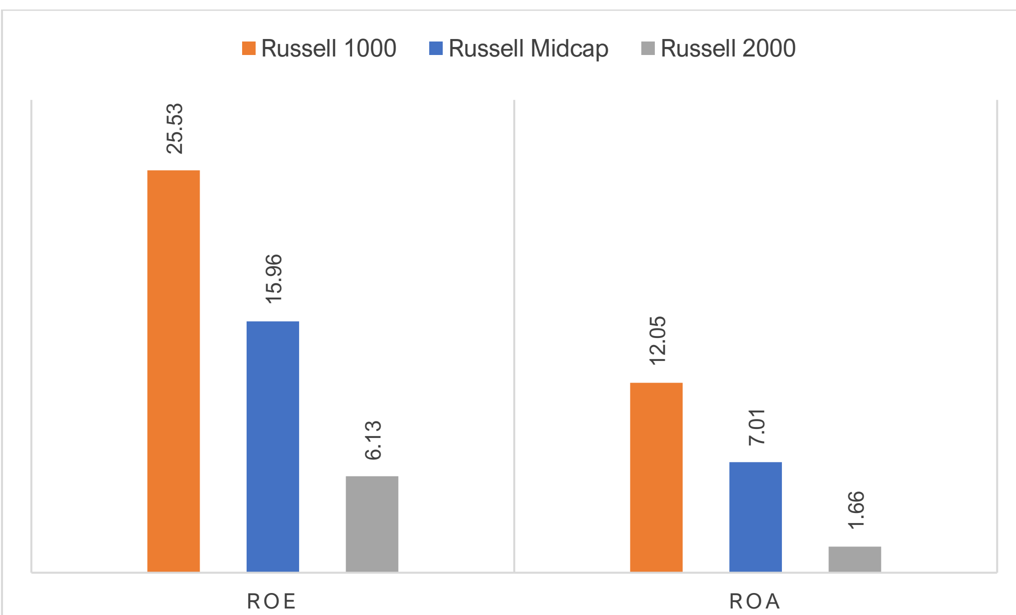

Figure 4 - ROE & ROA 12/31/2021[5]

[4] Data Source: FactSet

[5] Data Source: FactSet, FTSE Russell

Within the growth space that TimesSquare focuses on for our mid cap strategy, and in comparison to the small cap universe, there is no shortage of top and bottom-line growers among mid cap companies.

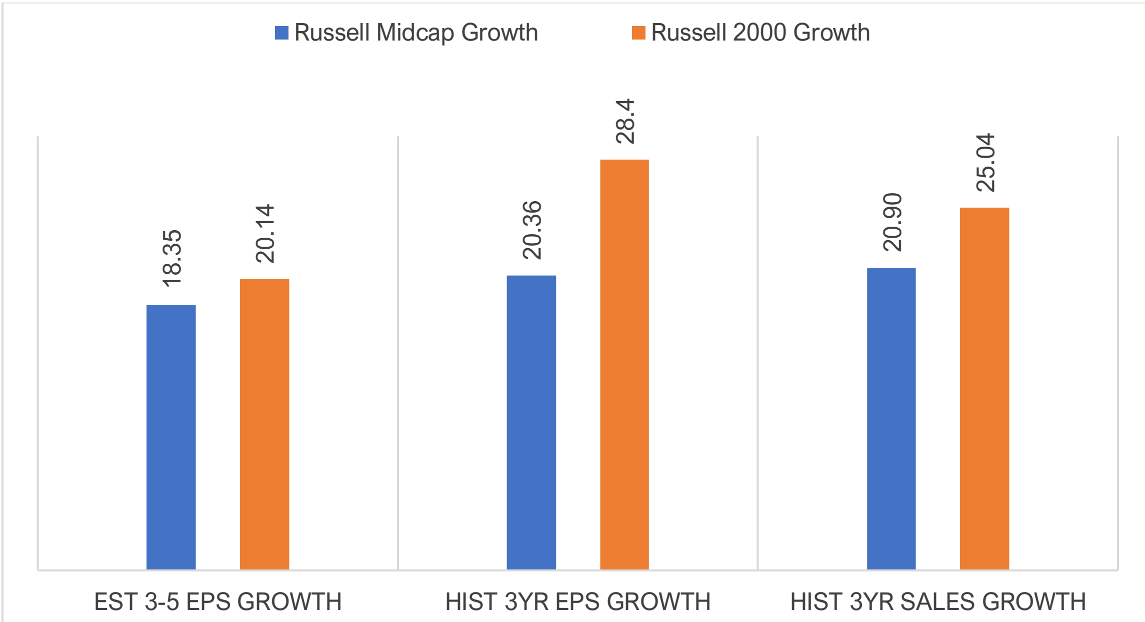

Figure 5 – Top and bottom-line growth as of 12/31/2021[6]

The technology sector comprises the largest component of the Russell Mid Cap Growth index with an over 30% weight. For TimesSquare, mid cap represents a sweet spot for technology, as the companies here offer compelling investment opportunities for innovations, robust growth, free cash flow generation. Within our Mid Cap Growth strategy, a good example is the portfolio's top holding, Palo Alto Networks.

Palo Alto Networks (PANW) / Information Technology

Founded in 2005, Palo Alto Networks (Palo Alto) is a leading global cyber security company. The company set its sights on improving network security and shipped its first enterprise firewall product "PA-4000 Series" in 2007. Differing from more traditional firewalls at the time, Palo Alto's product built what many call a "next-gen" firewall and was distinguished by a range of functionality including its unique ability to filter web traffic by specific web applications.

In the last 10-15 years the security landscape has materially evolved with the shift to cloud environments, virtual appliances, cloud-delivered security, a shift to "Zero Trust" architecture (which assumes breaches are inevitable), and the rise of security analytics and automation. Palo Alto has developed a diversified cybersecurity product portfolio across 3 categories: 1) network security (includes virtual and cloud-delivered services), 2) cloud security, and 3) SOC (security operations control) security.

Currently, Palo Alto holds the #1 market share in network security and fast-growing share in cloud & SOC segments. The continued innovation efforts have driven Palo Alto's revenue growth and margin expansion.

[6] Data Source: FactSet, FTSE Russell

TimesSquare's investment process focuses on identifying quality growth companies with sustainable competitive advantage, the well-balanced mid cap growth universe offers an attractive opportunity set for our investment style.

Staying Private for Longer

As Figure 6 suggests, many companies, especially within the technology sector, choose to stay private longer[7]. This trend has led to an increasing number of companies going public in the mid cap range. In the above example, Palo Alto Networks went public in 2012 with a market capitalization of $2.66 billion. As companies stay private for longer, public information also becomes scarcer. As a result, continuous coverage, and in-depth knowledge of these companies while they are still private becomes essential.

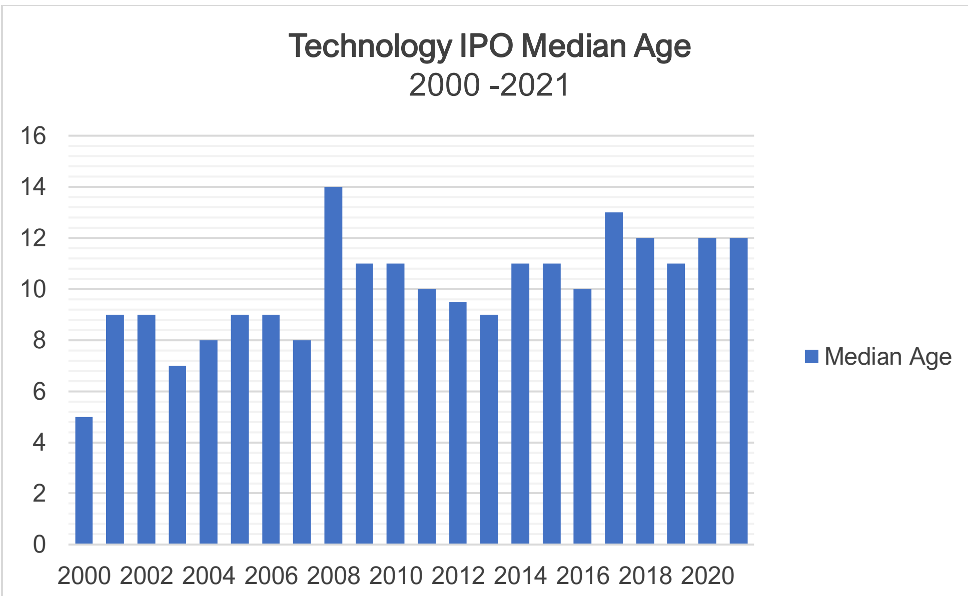

Figure 6 - Technology IPO Median Age

2021's deal activities were record shattering, with over 59% of the new listings presented by SPACs[8]. Meanwhile, traditional Initial Public Offering (IPO) activities remained robust. The top 25 companies that went public in 2021, many of which are household names, accounted for more than half of the amount raised, with all of them placed well within the mid cap range.

[7] "Initial Public Offerings: Median Age of IPOs Through 2021", Jay R. Ritter, University of Florida, https://site.warrington.ufl.edu/ritter/files/IPOs-Age.pdf

[8] "A Record Pace for SPACs in 2021", https://www.nasdaq.com/articles/a-record-pace-for-spacs-in-2021

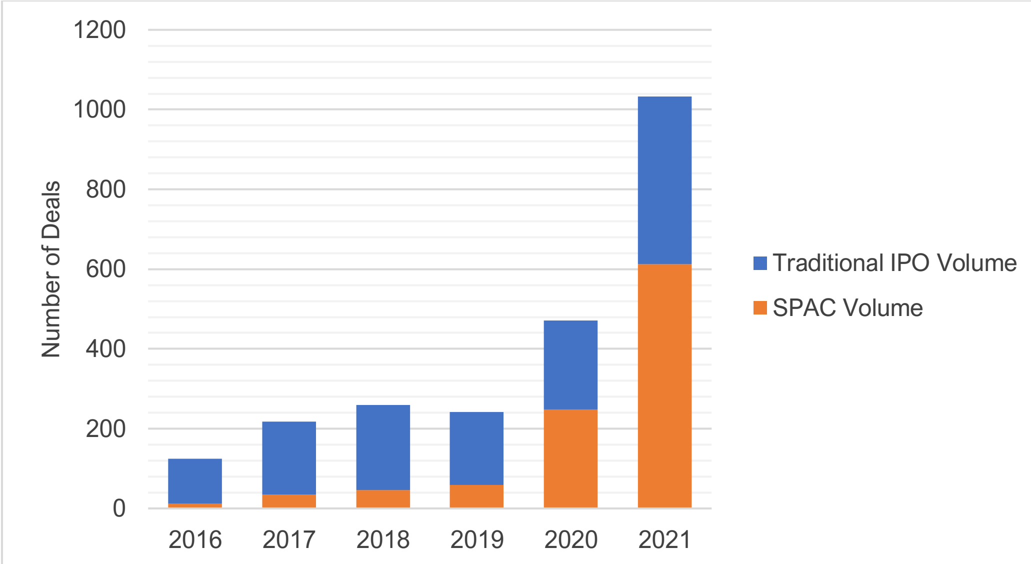

Figure 7 - Traditional IPO Volume and SPAC Volume 2016 - 2021

During the drastic market rotation away from high growth stocks in late 2021 and into 2022, many big IPO names were punished. Some companies that were originally scheduled to go public are pushing out their IPOs due to the current environment. Meanwhile, private markets remain abundant with cash, which provides life support to companies as they wait out the latest volatility. However, there is still a healthy pipeline of companies looking to go public. In the current market environment, bankers and investors turned their attention from “growth at all costs” to high quality, profitable, and “must-own” names in their industries[9].

As TimesSquare continues to comb through the mid cap universe for well-run quality growth companies that possess sustainable competitive advantage, we are encouraged to see the return of fundamentals and the renewed focus on profits and stability.

Conclusion

Mid cap has historically demonstrated an attractive risk/return profile against its larger and smaller peers. This asset class also houses companies that offer a good balance of growth and profitability. As companies stay private for longer, many house-hold names become public in the mid cap range. An allocation to mid cap could provide early access to tomorrow’s blue-chip companies. As a result, mid cap deserves consideration within the context of an asset allocation framework.

The market remains turbulent with geopolitical challenges and macroeconomic headwinds. As such, it is important to focus on company fundamentals while recognizing how the investment terrain constantly evolves. We believe significant potential exists in the mid cap universe, while these significant market movements could offer greater opportunities.

[9] “Behind the Scenes, the IPO Playbook is Changing”, The Wall Street Journal, March 25, 2022

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