

Substance Over Style: Mid-Cap Growth

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August 1, 2006 - Right now, it appears that many mid-cap growth managers are doing fairly well, according to a new *On Wall Street*-Morningstar ranking of separately managed accounts within this style box. And here's a big reason for their success: They're not pure mid-cap growth accounts at all.

In this latest installment of our series on top-performing SMAs, we looked at the top 60 retail accounts in Morningstar's database of 231 mid-cap growth strategies and found that a surprising number reached these heights in part by mixing and matching cap sizes. (See attached rankings)

Consider Lateef Management Associates, which ranked first in the *OWS*-Morningstar mid-cap growth rankings. Lateef, based in Greenbrae, Calif., came out on top thanks to a highly concentrated portfolio of approximately 20 mid- and large-cap stocks. (Our scoring system relies on a risk-adjusted measure of return, as explained in the "Understanding the Data Tables" sidebar below.) Lateef's Non-Taxable All-Cap Growth Equity composite turned in a 24.6% return in 2005. That's almost in line with its 15.26% five-year average annual return, which generated 11.26 percentage points more annually than the average annual S&P 500 return during the same period.

Ironically, the rankings' leader doesn't see itself as part of the mid-cap growth category at all. Like many managers in the arena, Lateef executives resist the label. "We don't really put ourselves in a box," says Ryan Willson, partner and director of marketing and client services at the \$3 billion-plus management firm. "Frankly, we think of ourselves as an absolute return manager."

Willson has a point. As of April 30, nearly 46% of the stocks in the nearly \$2.5 billion portfolio were mid-caps, according to the latest filings supplied by Lateef to Morningstar's Principia database. Almost the same amount--40.1%--is in large- and giant-cap stocks. Lateef's mid-cap favorites include Expeditors International of Washington, a global supply-chain advisory service that as of March 31 made up 14.16% of the portfolio, and C.H. Robinson Worldwide, a shipping company whose shares amounted to 9.91% of the total. Publishing giant McGraw-Hill was the favorite large-cap with a 7.27% share.

Such a blended approach isn't unusual for the category. Most leading mid-cap growth accounts are, in reality, blended strategies, with mid-caps often representing less than 60% of the mix. Steve Deutsch, director of the separate accounts business at Morningstar, says that a recent analysis of holdings in the top 10 accounts found that many had components reaching beyond the mid-cap box of fast-growing companies worth \$1 billion to \$8 billion. "They're picking up holdings all over the style charts," he says.

For Lateef, the results seem to have grown out of running a highly concentrated portfolio based on some old-fashioned stock picking. Willson says the manager looks for companies that have almost monopolistic market power, strong balance sheets, good return on capital and experienced management teams that have ownership stakes in the companies. Turnover is very low, particularly for a growth manager--only 25% annually, according to Morningstar.

Given Lateef's success, it is perhaps surprising that the firm's concentrated approach isn't emulated by other managers. But few make such concentrated bets. "Warren Buffett said it best: 'Diversification is a hedge against ignorance.'" quotes Willson. "We have high conviction in our companies and don't have the desire to dilute their impact on performance by overdiversifying."

Still, for the many managers in this world who are neither Buffett nor, for that matter, Lateef, hedging can be a good bet when it comes to choosing mid-cap growth stocks. The No. 3 account on the Morningstar list, Avenir Value Core Equity, holds a portfolio of approximately 60 stocks and returned a 20.17% annual average over the past five years, with 13.62% last year. The account, however, is quite concentrated, despite the large number of names. A Dec. 31, 2005 portfolio analysis--the latest supplied to Morningstar--revealed a large stake in American Tower (a firm that owns cell phone towers) that amounted to 15.81% of the portfolio, and a slightly smaller slice of AES (an electric company) that comprised 12.27% of the portfolio.

In fact, the Washington, D.C.-based portfolio manager's strategy may be slightly riskier than Lateef's. As of March 31, the former maintained a beta of 1.33 to the S&P 500, compared to 1.01 for Lateef, according to Morningstar.

A more extremely diversified strategy, the Cloud, Neff Management Russell Midcap Growth Style-Weighted Enhanced Index, showed similar characteristics. The composite account, run by Cloud, Neff & Associates, holds approximately 470 equally weighted stocks, yet returned a five-year average annual return of 12.60%--good enough to place it in the top 10 mid-caps. Actual performance would be even better because fees on the product are only 25 basis points annually, says portfolio manager Randy Cloud. That's substantially less than the 150-plus basis points he says most managers would charge.

Cloud argues that indexing should be a much more popular strategy than it is, not only in a mid-cap growth account, but also for SMAs in general. One reason is because an index can be offered at a fraction of the 1.5% or more in annual costs generated by a typical account. (It's unclear as to what extent investors are actually taking advantage of the opportunity, as Cloud, Neff doesn't disclose the assets it runs in that strategy.)

"In today's age of technology, the tools are so powerful and so plentiful that this is just a better way of going," says the Tulsa, Okla., investment manager. Such tools are accessible, too--even for a smaller investment company. "Let's face it," Cloud continues. "Here I am, Rednecks-'R'-Us investment manager, and we've got 15 funds that anybody can buy for 25 basis points, and I'm making money on them at 25 basis points."

Even without that cost advantage, such strong performance might seem like a bad sign for the 50 active managers on the list that ranked lower than the Cloud, Neff index. Yet Cloud isn't running quite an old-fashioned, look-Ma-no-hands product. First, the firm combines two-thirds of the Russell Midcap Growth Index with one third of names that are listed on both growth and value. At the same time, to make sure those ratios don't move, Cloud rebalances occasionally--not on a schedule, but whenever those ratios change.

"When that mix is changed--when, for example, because of market performance, that ratio looks like 70/30 instead of 66/33--that's when we're going to start pulling the rebalance trigger," explains Cloud.

That might not be pure, classic indexing, but Cloud isn't too concerned. "If they want to call us active, we're OK with that," he says. In fact, keeping an eye on it may be a good idea: As of April 30, the account had a beta of 1.37 to the S&P 500, according to Morningstar.

Cloud, Neff may be wise to not have a 100% mid-cap growth account for another reason: The style isn't always stable. The five-year average annual return of the Russell Midcap Index is only 4.86%--a souvenir of the general drubbing mid-cap growth stocks took during the technology crash of half a decade ago.

Most other top accounts in Morningstar's list seem to have missed or overcome much of the dot-com damage. Some did it by investing in less volatile core mid-cap stocks instead of growth mid-caps. Others, like the tiny, \$12 million Northwest Investment Counselors Small Company strategy--No. 2 on Morningstar's list--did it in part by buying outside the mid-cap space.

Northwest had a nearly 16% drawdown in 2002. Since then, performance has been strong enough that the five-year average actually reached a 15.38% annual rate. Portfolio managers Mark Scarlett and Matthew Roehr achieved this by following the traditional investor buy-and-hold gospel. The managed account of the Lake Oswego, Ore., firm turned over only 13% last year on a concentrated portfolio of fewer than 40 stocks.

As it is with many mid-cap managers, Northwest holds diverse cap sizes. As of April 30, only 51.4% of the portfolio is in mid-caps, while the remainder includes creatures great and small: 15.4% large-caps and 26.5% small-caps. Northwest is not enthusiastic about manufacturing (which it underweights compared to the S&P: 8.2% versus 33.4%) or information (only 9.9% of the portfolio, compared to 20.3% of the S&P). But Northwest is sanguine when it comes to services, which make up 81.9% of the portfolio. Its current top holding, as of Feb. 28, is TALX Corp., a company that provides automated employment and income verification, employee tax management applications, as well as other services.

Joining the near-index managers and old-fashioned stock pickers at the upper reaches of the Morningstar list is one sector rotation player. The Leuthold Weeden Select Industries Portfolio, which ranked ninth, uses a quantitative system to track sector performance. Leuthold Weeden Capital Management's 28-factor system includes financial, sentiment and momentum factors, which then help the managers make sector weighting decisions. It's a hit-and-miss strategy, according to Morningstar's figures. In 2002, the account was down 29.27%, but in 2003, it bounced back greatly, with a dramatic rise of 60%. (Leuthold Weeden doesn't disclose asset levels.)

At press time, the Minneapolis-based managers were making their biggest sector bets on healthcare (32% of the portfolio) and software (an undisclosed portion of the second-largest share, which is mostly invested in companies that produce business applications). "Materials is what's driven performance over the last four years, but that's been coming down a bit," says Chuck Zender, a portfolio manager at Leuthold Weeden. At one point, 24% of the portfolio was in basic materials. Come late May, he says, that level stood at 17%.

Looking ahead, Leuthold Weeden sounds as ecumenical about styles as it does about sectors. Zender sees the account creeping north to large-caps now, as he sees opportunity growing at that end of the market. "From a valuation standpoint, our work shows that large-cap growth, relative to its history, is probably the most relatively undervalued area," he says.

Still, some managers retain a strong commitment to mid-caps. For example, Stacey Thomas, co-manager of the nearly \$1.5 billion Eagle Asset Management Small Mid-Cap Core Retail account in St. Petersburg, Fla., says the style box has some special advantages. For one thing, it's easier for a mid-cap company to defend its market position. "In large-cap, you certainly find those situations of market dominance," she says. "But the size of the markets are so much bigger, you're constantly trying to fend off competition."

In addition, because of the law of large numbers, it's difficult for large-caps to keep showing the kind of dramatic increase in profitability that clients are seeking. The small scale also benefits mid-cap investors, Thomas says, because missing a single small- or mid-cap stock in a portfolio can't have the same kind of impact as missing a market giant such as Microsoft Corp., or Cisco Systems. It's also easier to diversify away from unattractive sectors, she says.

Tempting though that might be, it's a privilege Thomas isn't exercising at the moment. Holdings by sector in the account at press time don't differ substantially from the weightings in the S&P 500, according to Morningstar. As of March 31 (the latest available portfolio analysis), Eagle's portfolio of 50 stocks included 3.51% in NII Holdings, the parent company of Nextel, and 3.27% in Affiliated Managers Group, an asset management company. Like many in the space, Eagle favors companies that have strong franchises and solid, stable cash flow--though judging from its 61% turnover rate, such companies may be hard to find.

For the style box as a whole, performance has trended upward the past few years. Whether their success was the result of careful stock picking or sector picking or just blind luck, many mid-cap managers appear to be doing better and better--particularly now that the Nasdaq crash is receding into history. Yet despite the opportunity, mid-caps tend to be less popular than large-caps, says Morningstar's Deutsch. "People are just oriented toward the familiar names, and you don't get as many familiar names in a mid-cap management style," he says.

But will mid-caps provide good investment opportunities if stocks keep declining as they did in May? Eagle's Thomas thinks some will. "Looking within the asset class, the most attractive place to be in a slowing economic environment is stable, cash-flow-rich companies," she says. "What we tend to find is that typically, those types of companies tend to outperform when earnings growth starts to decelerate."

UNDERSTANDING THE DATA TABLES

A SMA's **total score** is a rough indication of overall performance, developed by *On Wall Street*. It is derived from the Treynor ratios of each SMA, a measure of risk-adjusted return. A higher Treynor ratio indicates a higher level of return per unit of risk. The total score is weighted toward longer-term performance. Forty percent of the total score comes from the SMA's five-year Treynor ratio, 35% from its three-year Treynor and 25% from its one-year Treynor.

Total scores are expressed on a scale of one to 10. The numbers are ordinal, so a SMA with a total score of eight is not necessarily four times better than one with a score of two.

SMA assets under management (millions) are as of the most current dates provided to Morningstar.

Latest gross return (three months rolling) % reflects the percentage performance of each SMA in the three months ended for a specific period. For this issue, the returns for the three-month periods ended either March 31, April 30 or May 31, 2006, are shown for various SMAs--the latest information reported to Morningstar. Gross returns for separate accounts are before money manager and administrative fees. Net returns, after management fees, would be lower.

Since *OWS* allows a window of return dates in calculating the score, money managers that have not updated their performance numbers to May 31, 2006 would probably have reduced total scores from *OWS* now because of the general market declines through May's end.

Date of latest gross return represents the date on which the latest gross return (three months rolling) percentage was effective.

The Morningstar Flexibility Measure--provided as high, medium or low--is an indication of the manager's ability to customize assets in a SMA portfolio to meet an individual investor's needs and to employ practices that make a portfolio more tax-efficient.

Compliance refers to whether a manager follows the old voluntary performance-reporting guidelines (Performance Presentation Standards or PPS) set by the CFA Institute (formerly known as the Association for Investment Management and Research or AIMR) or the new ones, called the Global Investment Performance Standards (GIPS).

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