Mitch on the Markets

Small-Caps or Large-Caps? There's Another Answer

By Mitch Zacks
Portfolio Manager

Investors often ask me which style and/or category of stocks they should favor in the current environment. Is now the time to own large-cap stocks? International? Maybe load up on value over growth? Small-cap?

In reality, a *broadly diversified equity portfolio* should probably have some level of exposure to each category, with some categories overweighted and underweighted depending on market conditions. Leadership in the equities markets changes hands often, and diversification across styles and sizes can ensure an investor has exposure to the best performing category each year, while also reducing the overall risk in a portfolio. In Zacks Investment Management's view, it's a commonsense approach to long-term investing.

In this week's Mitch on the Markets, though, I want to make a case for having mid-cap stocks be a part of that overall diversification, particularly in the current environment.

Taking Clues from the Economic Cycle

In the early stages of economic and bull market cycles, we generally tend to see small-cap stocks outperform. The logic behind this outperformance is fairly simple: new economic cycles generally bring fresh capital investment, more risk-taking, and faster rates of growth coming off a recession. All of these conditions favor small-cap stocks.

As the economic cycle ages, capital starts to dry up and investors – and businesses themselves – become more risk averse. They hire fewer people, spend less on fixed capital investment, and stockpile cash. These conditions tend to favor large-cap stocks, since they are more well-established, have more stable earnings, and are cash rich enough to weather downturns.

That's why I think mid-cap is very likable right now. I would argue that though we are approaching the later stages of this bull market and economic cycle, there is still some punch left in the U.S. economy. Our analysts here at Zacks still expect corporate earnings to pop nicely in the back half of 2017, and though we have grown more cautious about the expected boost from deregulation, tax reform, and fiscal stimulus, we see a "better than expected" outcome for the U.S. and the world. That could play well for growth-sensitive mid-cap stocks.

Case in point was the first quarter, where mid-cap stocks slightly underperformed large-cap stocks but outperformed small-cap stocks. Again, while the administration appears determined to make economic and job growth a priority, it remains to be seen what the follow-through will look like. Mid-cap stocks, in particular, could actually benefit in this environment, if investors don't feel confident enough to assume greater risks associated with small-cap stocks but are also optimistic that growth could be better than expected. In such an environment, investors may seek out the higher growth potential that mid-cap stocks offer over large-cap stocks.

How to Invest in Mid-Cap Stocks

A good starting point for investors is the Russell Mid-Cap Index, which lists 800 companies with market capitalizations generally in the range of $5 - $10 billion. The challenge for retail investors is then sifting through the 800 companies and deciding how to build a diversified portfolio of solid names. At Zacks Investment Management, we conduct all of our research independently and in-house, using research capabilities from our parent company, Zacks Investment Research. This gives us access of course to the highly regarded "Zacks Rank" stock selection technology along with earnings surprise and estimate revision factors.

Using these capabilities and quantitative screens, we then optimize our selections from a risk-adjusted return standpoint, landing on an average of 100 positions to make up our Mid-Cap strategy. The positions we own run across the style spectrum, including both growth and value stocks. We also rebalance the portfolio regularly, selling stocks with declining fundamentals that we no longer think add upside value to the portfolio.

Bottom Line for Investors

If the U.S. posts another year of economic growth with strong corporate earnings reports throughout the year, we expect mid-cap to benefit.

-Mitch

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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