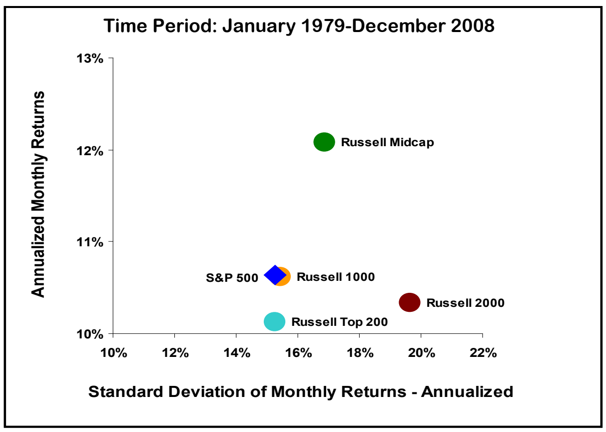
May 2009

“Middle Class”

Much recent discussion involves the middle class. One middle class remains relatively strong and perhaps deserves a bit of attention – middle capitalization stocks, typically referred to as ‘midcaps’. So what’s so attractive about midcaps?

Quite simply, midcaps have historically provided a better risk/return trade-off. The figure below plots risk and returns for various benchmarks over the last 20 year period. Midcap stocks over that time have generated 160 basis points of incremental annual performance over the often-touted Russell 2000 Small Cap Index*, but with less risk*. Compared against large cap indices (such as the Russell Top 200, Russell 1000, and the S&P 500) midcaps have proven over time to be higher risk. However, they have also posted at least 140 basis points annual relative outperformance.

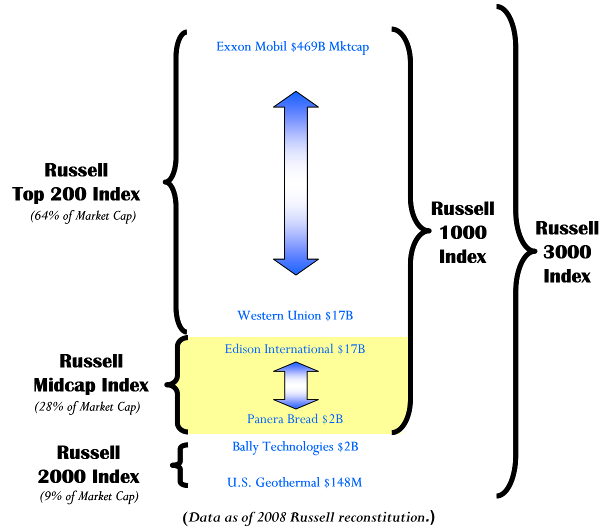


Source: StyleADVISOR

Conceptually, larger companies should provide lower risks than midcaps, and midcaps less risk than small caps. As a company grows, it builds controls and management infrastructure, allowing it to better anticipate and react to problems and competition. Customer loyalty and installed product bases expand over time, allowing recurring revenue streams and cross-selling opportunities to buffer downturns. Smaller companies, relying on a more narrow product line or customer base, are more exposed to economic cycles.

But what about the better performance? Shouldn’t small, rapidly growing companies with great new product ideas generate substantially better stock returns? We’ve tested various time periods and over the course of any cycle tested, the conclusion remains the same – midcaps win. The financial press loves to highlight short periods of time when small caps soar during the earliest portion of an economic recovery, but typically from a lower trough. Reality often sets in when earnings fail to meet investors’ excessive expectations.

So what exactly are these midcaps? Each year in June, Russell Investments ranks the largest 3000 domestic stocks by capitalization. The largest 1000 become the Russell 1000 and the next 2000 become the Russell 2000. The Russell 1000 is further split, with the Russell Midcap Index becoming the 201st through 1000th largest companies in the U.S. Once established, the constituents are set until the following year’s reconstitution. The following figure provides an indication of break points as of the 2008 reconstitution.



Source: Russell Investments

The simplicity of the Russell methodology is its beauty, with essentially no judgment, industry, or legacy concerns clouding the characteristics of the indices. It also may play into relative returns. In fact, we see three types of midcap stocks:

“Just passing through” – These are smaller companies with competitive advantages and strong earnings growth. Their midcap status is merely temporary, with continued success likely translating over time into graduation to large cap status.

“Skinned knees” – Some midcap companies used to be large cap companies, but have stumbled. Internal or external issues have caused these stocks to fall out of favor. Their midcap status is also temporary, as they will make the necessary changes to fix their issues, reinforce competitive advantages, and return to the glory of large-cap-land. Alternatively, they will continue to struggle and become a reduced weighting in whatever index they reside.

“Perpetuals” – Perpetuals are the midcap stocks that give midcaps a bad reputation. They have a limited ability to grow and will always remain midcaps. Perhaps the issue is heavy competition, complacency, product obsolescence, or insufficient market opportunity. Whatever the reason, a lack of growth makes perpetuals less attractive investment opportunities.

DHJA has historically invested 20-35% of its large cap Quality Growth Equity portfolios in attractive midcap stocks and manages a dedicated MidCap Growth product. We expect a recovering economy to provide the optimal tailwind for accelerating earnings growth at companies “Just Passing Through” while many companies with “Skinned Knees” will experience strong operating leverage following significant cost reduction actions. Our holdings in these areas should contribute meaningful portfolio performance as events unfold.

Let’s hear it for a strong “middle class”.

Curt Rohrman
Portfolio Manager
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For an electronic version of this newsletter, please email DHJA@dhja.com
Five Houston Center 1401 McKinney St., Suite 1600 Houston, Texas 77010 Phone: (713) 853-2322 Fax: (713) 853-2308