MID CAP STOCKS

March 1999

With the growth in demand for index funds, the mega-cap stocks (those companies with a market capitalization of $50 billion or above) have been the stars of this market cycle since 1994. With the exception of the Internet stocks, the broad stock market has been virtually ignored.

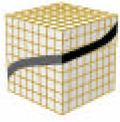
Notwithstanding the recent stellar performance of the mega-cap stocks, it is our contention that the population of mid-cap stocks represents the definitive arena for investors to exploit. Further, the market opportunity for today's investor lies squarely in these mid-cap stocks.

Let us define what we mean by mid-cap stocks. These are companies with multiple product lines and proven management. They have five or more years of history; many have far longer. They are financially strong. They range in market value from $500 million to $20 billion at the time of purchase. Often they are either not followed by Wall Street or the analytical coverage is spotty.

Mid-cap stocks offer two great attributes for the investor. Generally they are trust quality so they are usable for trust quality portfolios such as retirement funds. Second, they offer opportunities for the investor because the price of the stocks may differ widely from the intrinsic value of the companies.

Before we go further, we believe it is critically important that our readers understand why we make such a big point about being an "investor". To us, the investment world is broadly divided into two camps, investors and speculators. To define the difference, we have chosen to rely on the thoughts of Benjamin Graham. Mr. Graham is best known as the intellectual godfather of Warren Buffet and has been described as the most influential investor of all time. His two most well known books, Security Analysis (first published in 1934) and The Intelligent Investor (first published in 1949) still are among the best books ever written on common stock investing. They have withstood the test of time. In the very first page of The Intelligent Investor, Mr. Graham tackles the critical issue of investment versus speculation. He wrote, "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Mr. Graham recognized that this short definition needed to be expanded into a real world context. In The Intelligent Investor he explains, "In most periods the investor must recognize the existence of a *speculative factor* in his common stock holdings. It is his task to keep this component within minor limits, and to be prepared financially and psychologically for adverse results that may be of short or long duration."



He further adds, " Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook. More than that, some speculation is necessary and unavoidable, for in many common stock situations there are substantial possibilities of both profit and loss, and someone therein must assume the risks. There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously instead of as a pastime, when you lack proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose."

At the risk of putting you to sleep we need to fold in one more concept developed by Mr. Graham, i.e. the margin of safety. Mr. Graham believed, correctly, that bonds and stocks could exist under the same analytical framework. With bonds, the investor seeks to develop a margin of safety to account for the possibility that the bond issuer cannot meet the interest requirements. With stocks, Mr. Graham believed that the margin of safety was (and still is) the difference between the price of a stock and the appraised value of the underlying company under a reasonable set of assumptions. For Mr. Graham, "The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price." For Mr. Graham every stock could be highly valuable or outright speculative and that the primary determinate of that attraction was not the quality or size of the company itself but the relationship between the stock price and the appraised value of the company. Thus, for Mr. Graham virtually every company offered investment value at a certain stock price or lower and every company could be speculative if the stock price was high enough.

Clearly we would not be quoting Mr. Graham to you at length if not to reinforce two of our central beliefs. First, investors must continually measure the extent of speculative activity in their holdings and manage that speculation, even at the cost of underperformance. Second, investors should fish in that pond which offers the best chance to operate as an investor. Our choice is clearly the mid-cap stocks. In this "pond" we believe there is a consistently available opportunity for the investor to effect excellent research and to find a good list of stocks with an excellent margin of safety.

Let's examine the second precept first. It is our contention that the mid-cap stocks offer the most fertile ground for the investor.

Perhaps the best argument for mid-cap stocks is based on common sense. Today there are 75 companies with market values over $50 billion contained in a worldwide database of over 9100 companies. There are 2030 companies with market values between $500 million and $20 billion. The 75 largest companies enjoy intense analytical coverage (an average of 18 analysts have forecast 2000 earnings on each of these companies) whereas the 2030 mid-sized companies have less coverage (only 8 such forecasts per company). When we look further at these numbers we find that the median mega-cap stock enjoys coverage by 20 analysts, i.e. over half of these stocks are covered by more than 20 analysts.

The 2030 mid-cap companies have a median coverage of 7, i.e. over half these stocks have less than 7 analysts providing coverage. This means that the serious investor has a better chance to discover inefficiencies in market valuations.

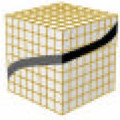
The second argument for mid-caps is even more simple and based on the law of size. A successful mid-cap company can increase in value from $5 billion to $50 billion more easily than a mega-cap company can increase its value from $200 billion to $2 trillion. We are not aware of this discussion taking place in any public forum. The question is when does a company's market value become too large?

The examples of Microsoft and General Electric may be illustrative. Microsoft is without question the greatest success story in the history of capitalism. In the span of less than 20 years (a brief period in economic terms) Microsoft has become the most valued company in the world, with a market cap (before employee stock options) of $437 billion. If stock options are included, the market value of the company could be considered to exceed $500 billion.

Microsoft has earned a premium valuation to other companies based on its phenomenal business model. Bill Gates has built the most profitable business model since IBM dominated the mainframe computer industry. Gates has gone even further. He has built a business model based on selling intellectual property at virtually no production costs. Microsoft has gained a monopoly on the desktop PC with its Windows operating system.

After celebrating the success of Microsoft as an American icon, the investor must ask whether Microsoft stock represents a great investment today. The company must overcome the law of large numbers. If Microsoft stock were to grow at 20% per year, the company would have to create $100 billion of wealth next year and over $120 billion in 2001. Could Microsoft do this? Of course! Is it prudent to assume they can? Consider the following. Every year Microsoft must now create value equal to a new mega-cap stock. Having become a mega-cap stock, Microsoft must now create a mega-cap stock every year in order to achieve growth rates far less than its past growth.

Microsoft must also create a mega-cap stock every year in the face of dramatic technological changes. It is our contention that the growth of the web is changing the face of computing in a manner as sweeping as the advent of the PC. It is our radical view that Wintel (Windows and Intel) has become a monopoly in search of a market. There is a new emerging nexus, involving
Sun Microsystems (market cap $40 billion), AOL (market cap $110 billion), and Oracle (market cap $40 billion) which is offering open, network-based computing. These companies are leaders in solving the technical and commercial issues necessary to further develop the web. Sun is putting heavy pressure on Microsoft's Windows operating system via a combination of superior technical progress (Java and Jini) and aggressive moves to introduce these technologies to the marketplace. Java will not replace Windows but is increasingly likely to circumvent Microsoft's operating system by residing on non-PC microprocessors. Last week, for example, Symbian, a consortium of leading wireless phone manufacturers (Ericsson, Motorola, Nokia) announced a preliminary agreement to utilize Java as its language for next-generation cellular phones, a potential market of 60 million phones per year.



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Finally, Microsoft must create a mega-cap company every year while battling the U.S. justice department.

General Electric faces the same law of large numbers. GE now enjoys a market cap of $375 billion. GE's management is superb, lead by Jack Welch. If GE is to grow at 20% the company must create $75 billion of wealth this year and $90 billion next year. Can this happen? Of course! Is it prudent to invest as though it will happen? Of course not!

Let's combine the market cap of Microsoft and General Electric. Microsoft is $500 billion (including options) GE is $375 billion, this makes a combined total of $875 billion. If we rank the market cap of all countries stock markets the combination of Microsoft and GE would rank sixth:

Country	Market Cap (US$ Billions)
United States	$12,256
Japan	2,616
United Kingdom	2,306
Germany	1,029
France	929
Microsoft & GE	**875**
Netherlands	566
Switzerland	503
Canada	494
Italy	492

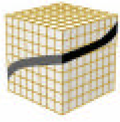
Source: IBES

By comparison, Hong Kong's stock market capitalization is $276 billion and Korea's stock market capitalization is $116 billion.

While it is proper to celebrate the incredible success of Microsoft and GE, it makes far less sense to own the stocks. Rather, it seems prudent to understand that there is today an opportunity to discover other companies which might duplicate (even partially) that success. And invest in those companies at a valuation that minimizes the speculative element in that activity.

With the foregoing we hoped to have convinced you that the mid-cap stocks offer the most fertile ground for the investor. Not only does this area offer the continual opportunity to find stocks offering a true margin of safety, but the visionary investor also has the chance to invest in companies which can migrate from mid-cap to mega-cap with commensurate rewards for the patient investor.

Now we would like to shift your attention to a more tactical basis. It is our strong contention that the mega-cap stocks have become speculative investments. While the underlying companies are sound, their stock valuations have badly eroded the margin of safety so clearly treasured by Mr. Graham and his disciple Mr. Warren Buffet. To repeat Mr. Graham's words, "The margin of safety is always dependent upon the price paid.



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It will be large at one price, small at some higher price, and non-existent at some still higher price." Further, we will attempt to prove that in contrast to the mega-cap stocks, there are lots of mid-cap stocks offering an excellent margin of safety plus outstanding chances to become mega-cap stocks.

All readers should understand that we are not interested in spreading doom and gloom, but rather to make a careful analysis of the investment environment.

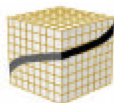
Interested readers will note that we detailed the overvaluation of the S&P 500 nine months ago; in that study ("Surviving the Next Five Years") we concluded that the overvaluation of the S&P 500 was attributable to the excessive valuation of the largest stocks. In this study we would like to add some additional updated analysis with a slightly sharper focus on the 75 largest cap companies. These 75 companies average a market cap of $105.5 billion. They sell on average at 5.2x current revenues, which grew at 15% over the past twelve months. They sell at 27x-enterprise value to EBITDA (earnings before interest, taxes, depreciation, and amortization).

A prudent investor would ask how this valuation would compare to prior periods. These mega-cap stocks sell at an average price-to-book value today that is 1.7x their average price-to-book of the last five years. The stocks sell at a P/E ratio equal to 1.7x their five-year average. The stocks sell at a price to sales equal to 2.1x their five-year average. The stocks sell at a price to cash flow equal to 1.8x their five-year average. During the past twelve months the stocks have increased by 45% on average.

It is our contention that a prudent investor would evaluate that the mega-cap stock valuations are at least 33-50% above reasonable appraised values. For the investor who operates under the requirement that a reasonable margin of safety must be maintained, the mega-cap stocks (which dominate the S&P 500) offer speculative, as opposed to investment appeal. The mega-cap stocks offer the investor great companies at inflated prices.

From a tactical viewpoint, the mid-cap stocks offer a fertile ground for investment. These 2030 companies have an average market cap of $3.2 billion. They sell at 3.5x revenues, which grew at 27% average rate during the last twelve months. They sell at 5.6x enterprise value to EBITDA.

These stocks also offer excellent value when compared against earlier periods. Today they sell at a price-to-book value that is 1.1x their five-year average. Price-to-sales and price-to-cash flow are also at a modest 1.1x their five-year average. These stocks increased by an average of 3.0% over the past twelve months.



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Perhaps the reader will find it helpful if we bring the analysis to some individual stocks. Eaton and Honeywell are two outstanding mid-cap companies in the capital goods area. Let's compare their fundamental performance and stock valuation versus General Electric. Here are the numbers:

	General Electric	Honeywell	Eaton
Trailing P/E	38.1x	16.2x	12.4x
P/E 2000 Est.	30.0x	13.0x	10.0x
Price/Book	9.4x	3.3x	2.4x
Price/Sales	3.5x	1.1x	0.7x
Price/Cash Flow	26.0x	10.0x	7.0x
Div. Yield	1.3%	1.6%	2.6%
Past EPS Growth	12.0%	19.0%	10.0%
EPS Growth in 2000	13.0%	12.0%	14.0%
ROE	26.0%	22.0%	21.0%

We believe the numbers speak volumes. All three are excellent companies. General Electric sells at a valuation substantially above Honeywell and Eaton, despite similar fundamental characteristics. Perhaps it is because General Electric has a market cap of $375 billion while Honeywell has a market cap of $9 billion and Eaton, $6 billion.

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Summary

We believe that mid-cap stocks offer the most fertile ground for investors on a long-term basis. There are many of these stocks and they are less efficiently researched than the mega-cap stocks.

Mega-cap stocks have performed very well over the past four years. The stocks have now become speculative, because their current valuations they offer only speculative appeal. Mega-cap stocks offer great companies at inflated prices.

The serious investor can learn from the example set by Microsoft and other great corporate success stories. While Microsoft may not be a good investment today, the serious investor should seek to find other mid-cap companies which could emulate (even partially) the success of Microsoft.

Mid-cap stocks have largely been ignored during the last four years. Careful analysis in this market segment can yield companies having excellent growth potential as well as an acceptable margin of safety.

To receive a complete list and description of Disciplined Growth Investors, Inc.'s composites and/or a presentation that adheres to the AIMR-PPS Standards, contact Cynthia Lennie at Disciplined Growth Investors, Inc., 100 South Fifth Street, Suite 2100, Minneapolis, MN 55402; telephone: 612-317-4108; fax: 612-904-2546; e-mail: cindyl@dginv.com. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities and analyses described in this article. The information contained herein has been obtained from sources that we believe to be reliable, but its accuracy and completeness are not guaranteed. DGI reserves the right at anytime and without notice, to change, amend, or cease publication of the information. The web site has been prepared solely for informative purposes. It is made available on an 'as is' basis. DGI does not make any warranty or representation regarding the information