Why We're Taking a Long-Term View of UK Mid-Cap Valuations

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UK-listed mid-capitalisation (mid-cap) stocks appear no longer to be the darling of the investment world; a double whammy of full valuations and uncertain economic sentiment has led some investors in this part of the market to rush for the door. Here, Paul Spencer flies the flag for mid-caps and argues that investors willing to take the long view should find value there.

We would be the first to acknowledge that valuations in UK-listed mid-capitalisation (mid-cap) stocks look a little full at the moment. The price-to- earnings (P/E) ratio for the FTSE 250 Index is currently around 15 times, which is around 10% above long-term averages.[1]

In our eyes, valuations around that level suggest a degree of profit recovery for mid-caps that might be a little difficult to achieve in the short term.

But then again, the entire market appears to be fully valued, in our view. For instance, the large-cap FTSE 100 Index is on about the same rating as the FTSE 250 for the first time in quite a while.

Now, of course these are very different indexes, but traditionally the FTSE 100 Index has traded on a slight discount because of the modest valuations of some of the big sectors that dominate its make-up, such as banks, miners, and oil and gas stocks.[2]

Recently however, these particular sectors have been rerated upwards to reflect an expected recovery cycle in profitability in those areas.

However, we think it takes a longer-term view—probably at least three years—to make sense of the some of the current mid-cap valuations.

That’s why we’re drawn to look at the one area of the market that appears to be contrarian at the moment—domestic cyclical stocks which tend to follow the peaks and troughs of the economic cycle.

Most of these domestic cyclical mid-caps are not yet at a level at which we’d want to invest, but we are interested in doing the groundwork now that would enable us to move quickly if we decided that there was an opportunity in the future.

Notwithstanding these reservations, we think there are genuine structural reasons to believe that some of these sectors—notably house builders—should be well set in terms of volume growth over the next three-to-five years.

Overall, we’re certainly not pessimistic. If the equity market can generate 7%-8% earnings growth and grow into the rating, we think it could make sense to own not only equities, but mid-caps in particular.

And we’re certainly not going to be put off by short-term volatility.

When the market has seen a broad decline, retail investors in small- and mid-cap stocks tend to become overly pessimistic, but in our view that's exactly the time to consider buying opportunities.

As a general asset allocation area, small- and mid-cap stocks seem to have been suffering net outflows for 12 months or so.

In particular, UK mid-caps were very weak in the immediate aftermath of the Brexit vote, but from an investor's perspective it offered us an opportunity to buy stocks that we'd had our eye on, at valuations we hadn't seen for a couple of years.

These occasional reversals can create value opportunities that short-term or passive investors might not otherwise get.

If a long-term investor can look beyond the short-term volatility and see attractive compound growth over the longer term, then these shake-outs shouldn't prove too alarming.

For example, even in the last 10 years we've seen a number of significant market corrections but we've still ended up with index levels at historic high levels. If you look at the very long term, these corrections have been blips on an otherwise upward graph.

In the last few months, the general direction of investor sentiment seems to be away from UK small- and mid-cap stocks, but it's worth remembering that mid-caps account for around 16% of the UK All-Share Index, so an investor benchmarking returns against a broad equity UK portfolio might expect to hold around 16% in mid-caps just to have a neutral weighting.

Over the long-term UK mid-caps have offered attractive returns, and despite our reservations about current valuations, we think mid-caps offer the potential to generate strong returns from here for investors with longer-term time horizons.[3]

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1. The price-to-earnings (P/E) ratio for an individual stock compares the stock price to the company's earnings per share. The P/E ratio for an index is the weighted average of the price/earnings ratios of the stocks in the index. The FTSE 250 Index represents the largest 250 companies listed on the London Stock Exchange. Indexes are unmanaged, and one cannot directly invest in them. They do not include any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

2. The FTSE 100 Index represents the largest 100 companies listed on the London Stock Exchange. Indexes are unmanaged, and one cannot directly invest in them. They do not include any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

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