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Mid-Cap Stocks Offer Portfolio Security and Diversification Potential

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The tech sphere's dominance of the S&P 500 has been one of the defining market trends of the last year. Following a rocky few years marked by volatility, rising interest rates and inflation, investors have been eager for any sign of stability, with many taking refuge in the impressive numbers emanating from the information technology sector. The so-called Magnificent Seven stocks—Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla—have captured as much as one-third of the market value at their peak, in turn turbo-boosting investors' enthusiasm for large caps.

Given these companies' outsized success, investors' yearning for a return to the strong and steady upward growth of the pre-pandemic market, and advisors' understandable desire to provide stability for their clients, a perfect storm of circumstances has culminated in the prevalence tech is enjoying in the current marketplace.

However, we think that the present situation has also produced an extreme level of concentration in the S&P 500, and with it, a plethora of risks for investors who may be neglecting to diversify their portfolios. In addition to the degree of exposure this reliance on large-cap tech assets brings, we believe it also carries the concurrent repercussion of blinding a great deal of investors to other areas of opportunity.

One latent avenue for non-tech-oriented growth can be found in the mid-cap space. While prominent companies aided by name recognition and industry dominance may presently be generating the lion's share of headlines, we see several advantages to mid-cap assets—based on both their structure and scale as well as their historic performance—that many investors are neglecting to factor into their portfolio considerations.

Over the last 20 years, the mid-cap index has delivered returns comparable to those of large caps. Although popular thinking may obscure this, the leadership of large caps has been a relatively recent phenomenon, having only exceeded mid-caps in performance across the last decade. Between 2004 and 2009, the S&P 500's cumulative returns lagged the mid-cap as well as small-cap indices. We believe much of this change has been animated by macro market forces. This includes periods of slowed overall economic growth, along with more and more sectors coming to be driven by large companies that are limited in number but near unchallenged in market dominance within their respective industries.

From our perspective, these historical size-informed shifts speak to why we think now is an important time for investors to explore mid-cap assets further. With more and more people doubling down on the major players, we believe it's imperative that investors further diversify their portfolios and explore areas of potential growth rather than relying solely on the gains of well-worn territory. While we don't think this requires foregoing tech stocks or large caps entirely, it does mean exploring alternative avenues that may provide more modest returns in the short-term but potentially stronger, more consistent income streams in the future. As the last few years have vividly illustrated, the market is capricious and can turn on a dime; with large-cap assets dominating so much of the current economic landscape, we believe it pays to be prepared for a tectonic shift when it inevitably arrives. Tech and accompanying speculation-friendly innovations may be here to stay, but there's no telling if the sector's current dominance is the new natural order of things or a temporary moment of fleeting prosperity.

Looking beyond, the swift growth experienced by the Magnificent Seven stocks and comparable large caps is the very thing that may limit their potential in the long term. Considering these companies' primacy, substantial user bases, and the enthusiasm surrounding them from investors, we think ascendent trajectories of this sort can only offer so much space for continual expansion. By contrast, we believe incorporating mid-cap asset classes allow investors to arrange their portfolios in a more appropriately risk-adjusted manner while simultaneously diversifying their holdings and charting a pathway for potentially durable returns. Investors seeking to identify these kinds of mid-cap opportunities should look for companies that are "old enough to know, young enough to grow." In our experience, this means singling out businesses that have accrued considerable experience, a solid consumer base and success within their field, but that still have room to expand their operations and reach a wider audience. Mid-cap entities that have realized consistent profitability while remaining under the radar are assets we believe bring the most value to a portfolio across longer periods.

Although we understand it's enticing to get swept up in the excitement surrounding large-cap assets, we also think investors should be mindful of both mid and large-cap assets' historical performance when considering their personal long-term financial goals. With interest rates finally lowering after an elevated period, we believe businesses that are more modest in size stand to gain the most and demonstrate durability in any market, regardless of whether conditions are bearish or bullish. Unlike the Magnificent Seven and assets of their ilk, we see the range of opportunities within the mid-cap space as expansive and diversified. In our view, the advisors and investors who can identify and fully leverage the possibilities of the mid-cap space are those who may be best poised to thrive in the future. While there are undoubtedly gains to be taken advantage of while large-cap assets and tech companies enjoy their current moment in the sun, we believe the risk of it all tumbling as swiftly as it's risen is too great to stake the well-being of a portfolio on.

Opinions and estimates contained in this article are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This article originally appeared on *Financial Advisor* magazine's website on February 21, 2025.

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