

Finding midcap, large-cap gems

Regular readers of the *Forecasts* probably know that the Quadrix® stock-rating system works well as a stock-picking tool. However, they may not realize that Quadrix works *differently* for different kinds of stocks.

The Overall score is among the variables with the highest predictive power for most groups of stocks. It works in all market-cap groups and most industry sectors. As the chart illustrates, the top one-fifth of large-cap stocks as measured by Overall score generated 12-month returns an average of 6.1% higher than those of the average large-cap stock since 1990.

For midcaps, the top scorers beat the average midcap by an average of 6%. On the surface, the performance is comparable. But look at the other scores. In many market-cap sectors and industry groups, Value is the most effective Quadrix category score.

But for large-caps, Performance has worked substantially better. All of the six Quadrix scores shown in the chart below have proven effective for finding superior stocks since 1990, but Momentum has been more useful in the midcap area, while Quality is more important for large-caps. Each Quadrix category score is derived from a series of individual statistical factors, and the effectiveness of those factors varies greatly between groups of stocks.

To harness the power of these

WHAT WORKS BEST FOR LARGE-CAPS AND MIDCAPS

Listed below are nine of the most effective individual factors for picking large-cap and midcap stocks, along with Quadrix® Overall and category scores. Outperformance represents the return advantage of the top one-fifth of stocks since 1990, with three-month returns annualized. Winning percentage measures how often the top one-fifth outperformed. For example; assuming average returns and three-month holding periods, the top 20% of large-cap stocks as measured by price/earnings ratio outperformed the average large-cap by an annualized 5.4%. Top scorers outperformed in 70% of the holding periods.

Note how results for a given statistic differ based on holding periods and market-cap sectors. Most statistics work better using average returns than using median returns. By definition, half of the values in data set are higher than the median, and half are lower. Average returns are a better measure of a portfolio's expected return. But medians are less likely to be affected by a few outsized returns, so they provide a useful check on whether a factor is truly effective.

	Based on Average (Mean) Returns				Based on Median Returns			
	3-Mo. Periods		12-Mo. Periods		3-Mo. Periods		12-Mo. Periods	
	Outper- formance	Winning %	Outper- formance	Winning %	Outper- formance	Winning %	Outper- formance	Winning %
Large-Cap Stocks								
Top individual factors								
6-month total return	4.0%	55%	5.1%	70%	2.2%	48%	1.9%	61%
12-month total return	7.1	65	4.3	69	5.5	61	1.6	62
Earnings predictability	2.9	63	2.4	73	2.9	64	2.0	67
EBIT margin	3.0	58	2.9	67	2.7	58	3.3	71
Enterprise value/EBITDA	4.4	63	4.0	68	3.4	62	3.8	66
EPS revisions – curr. qtr.	4.0	67	3.8	78	2.3	58	2.4	70
Price/earnings ratio	5.4	70	4.6	73	4.6	65	4.9	74
Price/free cash flow ratio	5.5	69	3.6	71	4.5	65	3.4	65
Price/cash flow ratio	3.8	57	3.0	58	2.7	55	3.2	57
Overall and category scores								
Overall	6.5	71	6.1	84	5.4	64	4.0	78
Performance	5.3	57	5.1	67	2.9	50	2.3	63
Value	4.5	64	3.4	68	4.4	61	4.2	67
Quality	3.6	61	2.9	66	2.8	56	0.5	52
Momentum	4.0	62	2.7	67	2.9	60	-0.3	49
Financial Strength	2.5	58	2.0	58	0.7	56	-0.2	49
Midcap Stocks								
Top individual factors								
6-month total return	3.9	54	5.0	68	-0.2	50	-0.4	54
EBIT margin	2.6	59	2.9	64	3.5	60	4.2	71
Enterprise value/EBITDA	7.1	67	5.7	79	5.7	68	5.5	83
EPS revisions – curr. qtr.	5.4	73	6.8	85	2.6	65	2.7	71
EPS revisions – next qtr.	4.4	66	5.1	78	2.3	60	1.9	61
Price/book ratio	3.2	57	3.9	67	3.3	60	4.8	80
Price/cash flow ratio	4.1	60	4.0	68	3.5	60	4.0	71
Price/earnings ratio	5.0	70	4.4	71	5.4	71	5.0	78
Price/free cash flow ratio	7.0	76	4.6	78	5.7	75	5.3	72
Overall and category scores								
Overall	5.9	72	6.0	82	4.7	67	4.5	76
Performance	4.8	59	5.2	70	1.2	51	0.4	63
Value	6.3	68	5.2	73	6.3	69	5.6	79
Quality	2.6	63	2.1	51	1.2	60	-0.6	46
Momentum	4.2	65	3.6	63	0.8	58	-1.3	50
Financial Strength	2.3	61	2.0	55	1.2	58	0.5	54

individual factors, we derived new rankings specific to market-cap sectors, using nine individual factors that work particularly well for stocks of a certain size. The table shows how well the most effective individual factors work for midcaps and large-caps.

Midcaps have market values between \$2 billion and \$8.6 billion. Stocks with market values of more than \$8.6 billion are classified as large-caps. The Quadrix universe contains 700 midcaps and 408 large-caps. For a table containing the top one-fifth of those midcaps and large-caps, visit dowtheory.com.

While *Dow Theory Forecasts* covers some midcap stocks, the newsletter tends to focus on larger companies. Small and midcap stocks are covered by the *Forecasts'* sister publication, *Upside*. For more information on the *Upside* newsletter, visit upsidestocks.com or call (800) 233-5922 for a free sample copy.

