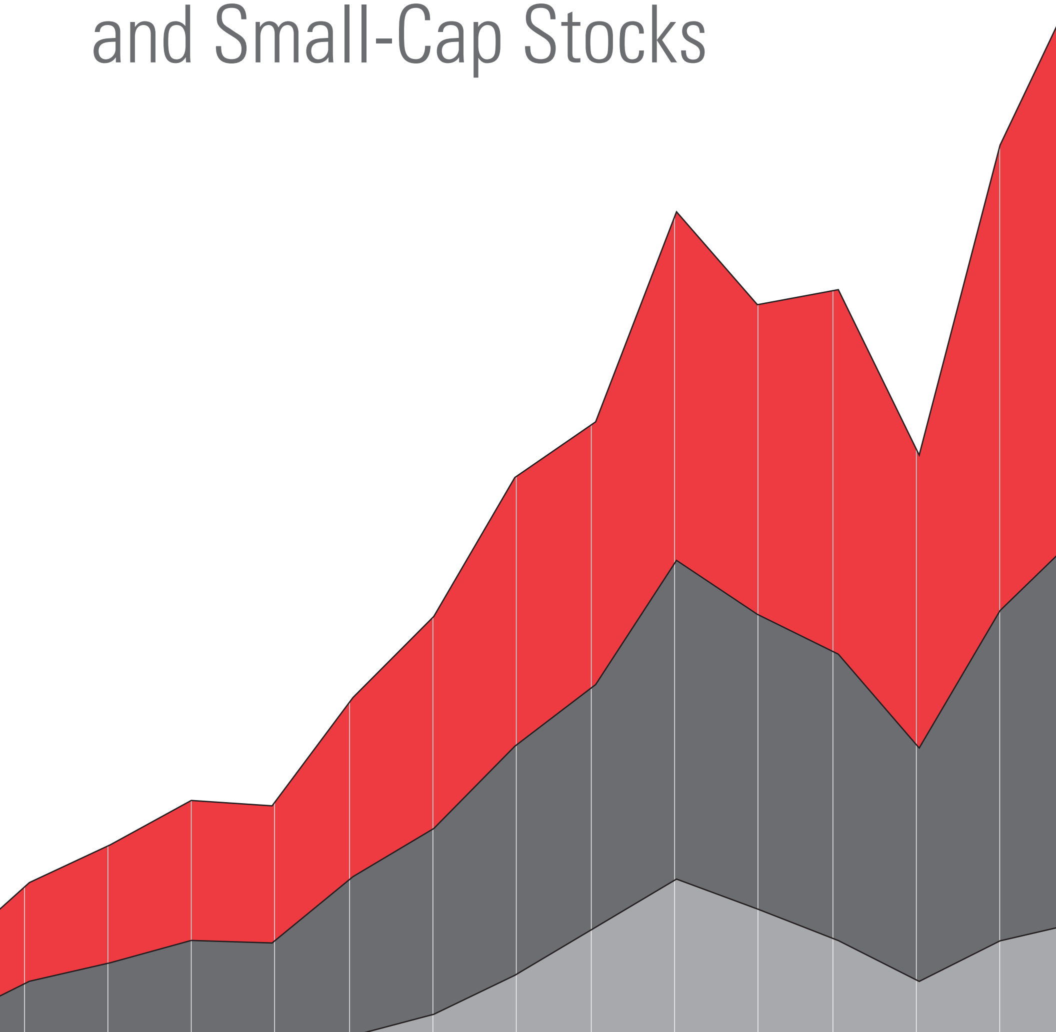
Morningstar Stock Research

The Perfect Mix of Large-, Mid-, and Small-Cap Stocks

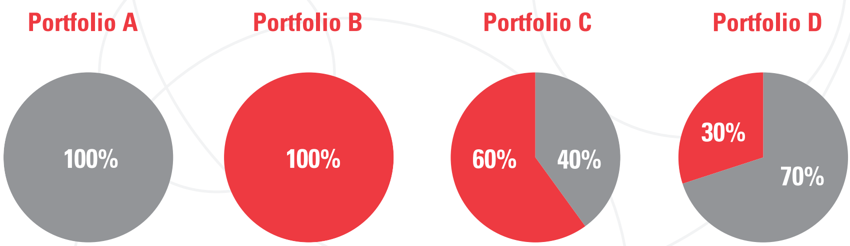


Consider Adding Mid-Cap and Small-Cap Stocks to Your Large-Cap Portfolio

Did you know that by adding mid- and small-cap stocks to your large-cap portfolio, it may be possible to improve return without necessarily increasing (and possibly even decreasing) the portfolio's risk?

While large-cap stocks are typically mature, established companies with market caps in excess of $5 billion, mid-cap stocks are typically companies that, although having successfully navigated their startup years, still have market caps between $1 and $5 billion. Small-cap companies, generally the youngest and least established of the three, have less than $1 billion in market capitalization.

The following illustrations show the risk and return for four hypothetical portfolios over the time period 1976–2005.



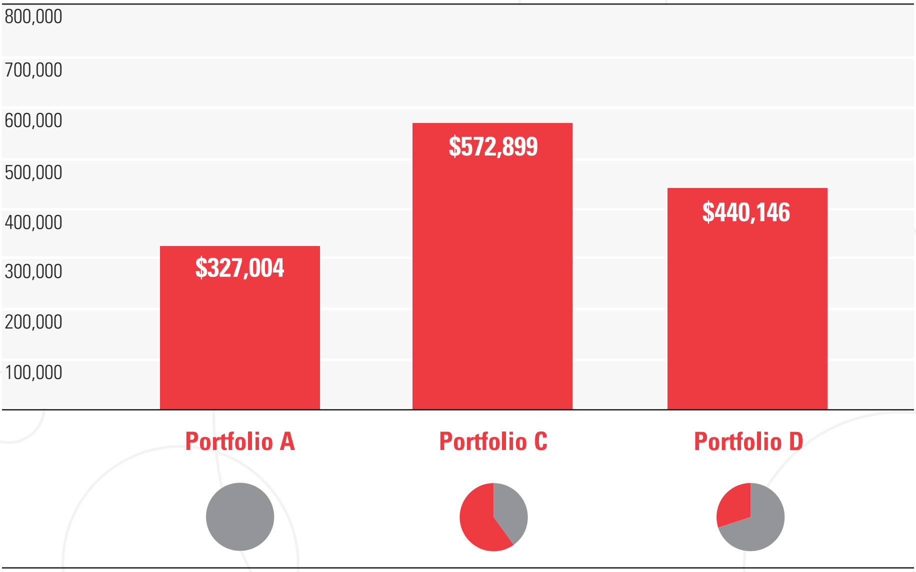
	Portfolio A	Portfolio B	Portfolio C	Portfolio D
Risk:	16.2	18.0	16.2	15.8
Return:	12.3	15.6	14.4	13.4

■ Large-cap stocks ■ Even mix of small- and mid-cap stocks

Adding Mid- and Small-Cap Stocks May Increase Return Without Increasing Risk

The illustration above demonstrates that adding a mix of mid-cap and small-cap stocks to a large-cap portfolio may increase return without necessarily increasing risk. The return of hypothetical Portfolio C is 2.1 percentage points higher than the return of Portfolio A, and risk did not increase. How much is that extra return worth?

Growth of $10,000: Portfolio Performance ($)



Year-end 1975 through 2005

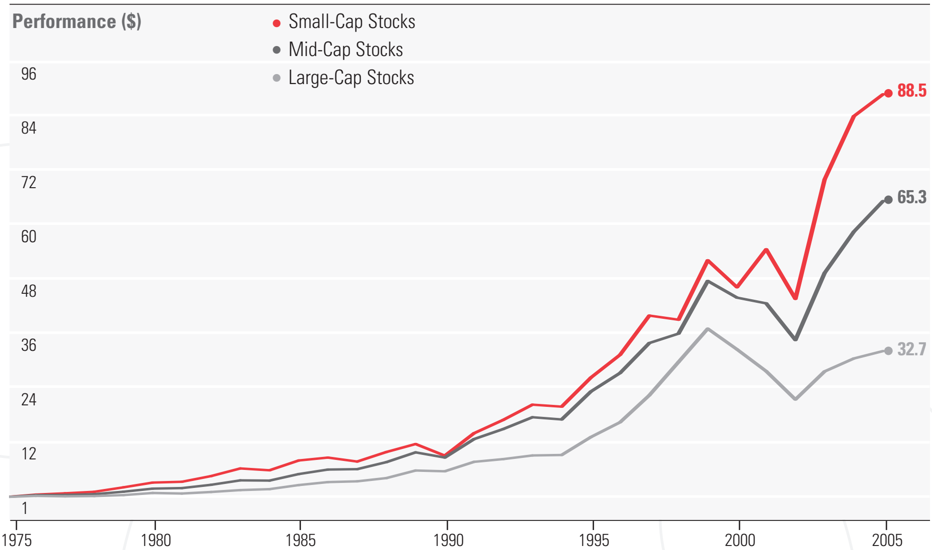
Made at the end of 1975, an investment of $10,000 in large stocks alone (Portfolio A) would have grown to $327,004 by year-end 2005, while the same $10,000 invested in a hypothetical portfolio composed of a 40% large / 60% mid- and small-cap stocks (Portfolio C) would have grown to $572,899, a difference of $245,895!

Even a Smaller Change Can Have a Dramatic Effect

In the example above, we allocated 60% of our hypothetical portfolio to mid- and small-cap stocks, but even smaller changes can potentially increase return and/or reduce risk. Let's look at an example (Portfolio D) that allocates 30% to mid- and small-cap stocks. The return of Portfolio D is 1.1 percentage points higher than the return of Portfolio A, and in this case risk actually decreased by 0.4 percentage points!

How much is that extra return worth? Again, let's say that in December 1975 you had invested $10,000 in large-cap stocks alone. Based on historical data, this investment would have grown to $327,004 over a period of 30 years. The same $10,000 invested in a hypothetical 70% large / 30% small- and mid-cap portfolio would have grown to $440,146, a difference of $113,142!

Growth of $1: Performance of Small-, Mid-, and Large-Cap Stocks ($)



Year-end 1975 through 2005

The chart above illustrates the performance of $1 invested in the three major asset classes from year-end 1975 through year-end 2005. Over the 30-year time horizon, small-cap stocks were the big winners, followed by mid-cap and large-cap stocks. Although a stock's volatility generally increases as its market capitalization decreases, adding these riskier assets to a portfolio may actually lessen the overall risk and/or increase the overall return.

Order *Morningstar GrowthInvestor* and learn how small- and mid-cap stocks can help you grow your portfolio.

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Risk and return are based on annual data from year-end 1975 through 2005. Risk and return are measured by standard deviation and compound annual returns, respectively. Standard deviation measures the fluctuation of returns around the arithmetic average return of the investment. The higher the standard deviation, the greater the variability (and thus risk) of the investment returns. The portfolios shown were rebalanced annually. Diversification does not eliminate the risk of experiencing investment losses.

Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Small- and mid-cap stocks are subject to more price volatility, have lower trading volume, and are less liquid than large-cap stocks. The data assume reinvestment of all income and do not account for taxes or transaction costs.

Source: Large Stocks—NYSE/AMEX/NM Deciles 1-2, CRSP Cap-Based Indices™, Center for Research in Security Prices at the University of Chicago's Graduate School of Business. Mid-Cap Stocks—NYSE/AMEX/NM Deciles 3-5, CRSP Cap-Based Indices™, Center for Research in Security Prices at the University of Chicago's Graduate School of Business. Small Stocks—NYSE/AMEX/NM Deciles 6-10, CRSP Cap-Based Indices™, Center for Research in Security Prices at the University of Chicago's Graduate School of Business.

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