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A Happy Medium

Madison Mid Cap takes a moderate approach to growth.

UNDISCOVERED MANAGER

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In every issue, Undiscovered Manager profiles a manager on the Morningstar Prospects list compiled by Morningstar Research Services' manager research group.

As comanager of Madison Mid Cap Fund GTSGX, Haruki Toyama is focused on investing in the sweet spot.

Toyama hunts for shares of fast-growing companies, but narrows his search to those stocks sporting relatively tame valuations, wide-moat business models and high-quality management. And with the strategy's mid-cap focus, Toyama believes investors are gaining exposure to a segment of the stock market that carries less risk than small companies but more growth potential than market behemoths.

"We're very risk-averse, but we want the upside," he says. "We find these wonderful companies with great track records. Their competitive advantages have been honed over multiple economic cycles. They're not yet so giant that they are slow and lumbering."

This investment process has led to strong long-term performance since Toyama's comanager Rich Eisinger started on the fund nearly 20 years ago. The fund's annualized return of 8.9% from the beginning of 1998 through June is well ahead of the mid-cap growth average of 7.1% and beats the Russell Mid Cap Growth Index's 7.9%. The fund's Morningstar risk-adjusted return over that time beats that of more than 80% of its peers.

While the fund's returns over the past 10 years are middling, its Morningstar risk score is Low over the three-, five, and 10-year periods. In the strong stock market rallies of 2009 and 2013, the fund landed in the bottom decile of the category. But in the years over the past decade with more moderate rallies or down markets, the fund has been comfortably in the top half.

Thanks in large part to its strong, long-term risk-adjusted performance, Madison Mid Cap is on the Morningstar Prospects list of under-the-radar or up-and-coming fund strategies.

"There's an appealing conservatism to their strategy—the focus on relatively higher-quality mid-caps, and holding an above-average stake in cash when opportunities are scarce," says Greg Carlson, a senior analyst at Morningstar Research Services who oversees the Prospects selection process. "Also, the lower-turnover approach, of course, leads to lower transaction costs. This fund could easily be someone's sole mid-cap holding."

Path to Madison

Madison Investments, based in Wisconsin's capital city, was founded in 1974 by Frank Burgess, who today serves as the firm's chairman. The independent, employee-owned company manages $16 billion. Madison's historical emphasis was on conservative bond strategies. But its U.S. equity team today manages $5.1 billion, of which $1.5 billion is in the mid-cap growth strategy, including just under $400 million in the fund. (Madison Funds carried the Mosiac Fund brand name until April 2013.)

Madison was still a small bond shop in 1990 when the firm's now chief investment officer, Jay Sekelsky, came over from Wellington Management in a move back to his home state of Wisconsin. Eisinger joined Madison in 1998. Toyama had met Eisinger in business school at Cornell University, and after a stint at MFS Investment Management, he joined Madison in 2002. He left in 2004 to help launch Marcus Asset Management in Milwaukee, where he ran a long/short hedge fund, but he returned to Madison in 2014.

Toyama, 46 years old, traces his path to Madison back to his awareness of the Japanese real estate bubble as the child of two Japanese doctors who had immigrated to the United States. He was born in Buffalo, N.Y., then spent his childhood in Miami before his family moved back to Japan for five years.

"By the time I was in college [at Brown University], Japan was booming, and you could see the bubble form," Toyama says. "Every year, I would go back to Japan, and I saw the bubble burst. That got me very interested in economics."

While at graduate school at Cornell, Toyama was introduced to the concept of classic value investing: "I was very interested in international politics, macro thinking. But it just clicked that instead of trying to speculate on what a stock price may be based on what other people think, I'm just buying a piece of a company. Why should the analysis be different than if I was buying the whole company?"

The Right Balance

Toyama, Eisinger, and the rest of the eight-person equity team are hunting for growth stocks, but there is a decided quality and value tilt to the approach.

"We think as 'value' investors because we are looking for value, but the word has certain connotations," Toyama says. "[Some] value guys are looking for beaten-up Kias that they can buy for $500 and flip for $1,000. Another definition of value is that you get more for the money with a BMW or Mercedes, but you still want to pay less than they are worth."

Madison screens among stocks with a market cap between $500 million and $40 billion for those that meet a range of quality metrics. They include a strong balance sheet, high return on capital, high return on equity, earnings quality, and strong free cash flow generation.

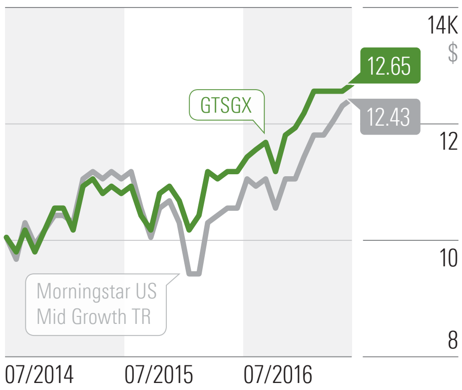
"The really important thing we want is for the company to have a sustainable competitive advantage," Toyama says. "We'd much prefer a company growing steadily and solidly at 8% to 12% for many, many years rather than something growing 20% to 30% for a year or two, but beyond that, we just don't know because the moat isn't strong enough."

Morningstar's stock analysts assign companies under coverage a Morningstar Economic Moat Rating. Some companies have no moats, others have wide or narrow moats providing a level of sustainable competitive advantage. Madison Mid Cap has 23% in companies designated by Morningstar as having

Haruki Toyama, director of U.S. equities and a portfolio manager at Madison Investments.

Madison Mid Cap Fund
GTSGX

Growth of $10K



Category	Mid-Cap Growth
Expense Ratio (%)	0.98
Morningstar Rating	★★★
3-Yr Annl Total Rtn (%)	18.2
3-Yr Annl Total Rtn % Rank	26

Source: Morningstar. Data as of 06/30/2017

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wide moats, compared with 16% for the category norm.

Assessing management is another important aspect of the investment process. They look at capital allocation decisions, including stock buybacks, debt repayment, and acquisitions. Companies that use aggressive assumptions in their earnings reporting, or try to spin away bad news, are shunned.

Also important is management's alignment with shareholder interests, such as high levels of inside ownership.

"We want to see management teams that are owner-operators," Toyama says. Take insurer Brown & Brown BRO, which was 3.7% of the portfolio as of the end of May. Brown's chairman—who Toyama says owns 15% of the stock—is the son of one of the founders, and the current CEO is the third generation of the family to lead the company. Madison first bought shares in the second quarter of 2007 in the mid-$20 range, and it was trading in the mid-$40s in June.

Long-Term Outlook

As a result of the emphasis on wide-moat stocks, there are some sectors of the stock market where the Madison fund managers say it's harder to find names that can make it into the portfolio. That tends to include consumer-facing technology where demand can be fickle, or healthcare, where government regulation is a constant uncertainty. The fund's stakes in technology and health are both below the mid-cap growth category norms.

Animal-pharmaceutical company Zoetis ZTS, added to the portfolio in February, is one standout in healthcare. As Toyama and Eisinger said in the fund's first-quarter report—a frank and illustrative discussion of both successes and disappointments—the animal health industry is still largely private pay, and less vulnerable to generic competition than human pharmaceuticals.

An exception in technology is enterprise software. Hardware reseller CDW CDW, which sells products from different manufacturers, is a stock they have owned for three years. At more than 4% of assets, it was one of the top five holdings in the fund at the end of May.

"With software, we feel like we can understand the stickiness of a customer or revenues," Toyama says. "We feel we can be agnostic about which may be winning in the marketplace as long as CDW does a good job being a consultant." Madison bought CDW for the fund in the second quarter of 2014 in the high $20 range and it was at more than $60 in June.

On the valuation side, Madison puts to work a variety of different valuation models depending on the company and the industry, and goes beyond reported numbers, adjusting for cyclicality, for example, or unsustainable profitability.

An example of the legwork that Madison puts into its fundamental research can be seen through its stake in Copart CPRT, a stock the fund has owned since 2008. Copart is in the business of auctioning off damaged or wrecked cars on behalf of insurance companies. It's an industry that is essentially a duopoly, Toyama says, with Copart and another company each having about 35% market share.

As part of the initial research, Madison had visited a number of the auction sites, talked to the firm's primary competitor and vendors. Then in late 2014, shares took a hit on a weak earnings report, which the company in part blamed on high tow-truck prices. "I wondered if that was true, so we talked to a bunch of tow-truck companies," Toyama says.

It turned out that the towing industry had just gone through a wave of consolidation that resulted in a sudden jump in towing prices. "We got comfortable that the effect was short-term, and we bought more," he says. Overall, Copart shares have more than quadrupled since Madison took a stake.

Top holding Markel MKL also exemplifies Madison's strategy. In the portfolio since 2000, Markel is a specialty insurer that focuses on niche markets, such as insuring summer camps. "A lot of companies won't [take on that business], but that means there is less competition and more pricing strength," Toyama says.

A second attribute Madison likes about Markel is management's focus on maintaining profit margins, Toyama says. "There's a lot of term mentality in insurance," he says. Markel, however, "will pass on business if the price isn't good even if means volume drops." The firm has beaten industry profit margin averages for the past 23 years, he says.

And third, at the management level, the family that founded Markel is still actively involved, Toyama says, and compensation is tied to long-term targets. Since Madison bought the stock in late 2000, it has risen from around $150 to $990.

This all comes together in a portfolio of 25 to 40 stocks that the firm aims to hold for five to 10 years. At last count, the fund's annual turnover was 27%. That's relatively low for a growth-oriented strategy; the mid-cap growth category averaged 67%.

Index-Agnostic

Based on its overall portfolio profile, Morningstar classifies the fund as mid-cap growth and benchmarks that category against the Russell Mid Cap Growth Index. The fund's prospectus benchmark is the Russell Mid Cap Index.

By either measure, the fund's sector exposure is distinctive; its technology exposure, for example, is low relative to both, and its financials stake is relatively high. Toyama and the team have found consumer discretionary stocks (such as Liberty Broadband LBRDA) to be fertile ground, and the fund had 23% of equity assets in the sector at the end of May, on the high side for both mid-cap blend and growth funds.

Over the long term, Toyama says, cash levels tend to be in the mid-single-digit percentage range. When they believe stocks with attractive valuations are rare, Madison's managers will hold more cash. That is the case today.

At the end of May, the fund had nearly 10% in cash, while its average mid-cap growth peer had less than 3% in cash. That stake has contributed to the fund's lagging performance so far in 2017: The fund's 5.7% return through June was less than half the category average. Over the trailing three years through June, however, it ranked in the 26th percentile of the category, owing to relatively strong performance in both 2015's tough market and 2016's rebound. While outperformance in rallies hasn't been the norm for the fund, its low risk profile has been a constant.

Madison Mid Cap is "truly index-agnostic," says Julius Ridgway, a financial advisor at Medley & Brown in Jackson, Miss., which has placed clients in Madison Mid Cap for about 15 years. Ridgway describes the strategy as "participate and protect," and he says that "their emphasis on capital preservation and good balance sheets are the things that give you comfort in uncomfortable markets."

Over the long term, the fund has earned a decent return in up markets, while holding up relatively well in down markets: Over the past five years, Madison Mid Cap has captured 86% of the Russell Midcap Growth's upside but only 81% of its downside.

Toyama says that kind of performance is more than just a reflection of the fund strategy, it's a reflection of Madison Investment in general.

"A lot is probably rooted in the culture of fixed income, where we care more about protecting against downside first," he says. "And we're very grounded, almost Midwestern in some ways in terms of our temperament. We work really hard to understand the companies and not get too caught up in the latest fad." M

Tom Lauricella is the editor of Morningstar Direct.

Disclosures

Average Annual Total Returns (%) as of 6/30/2017

	1 Yr	3 Yr	5 Yr	10 yr
Class Y	13.31	8.16	12.67	6.82
Russell Midcap® Index	16.48	7.69	14.72	7.67
Russell Midcap® Growth Index	17.05	7.83	14.19	7.87

Fund Ticker	Inception Date	Expense Ratio
GTSGX	7/21/83	0.98%

Average annual total returns assume all distributions are reinvested and reflect applicable fees and expenses. Index returns reflect broad measures of market performance compared the fund and reflect no deduction for sales charges, account fees, expenses or taxes. You cannot invest directly in an index. Past performance is no guarantee of future results.

Performance data shown represents past performance. Investment returns and principal value will fluctuate, so that fund shares, when redeemed, may be worth more or less than the original cost. Past performance does not guarantee future results and current performance may be lower or higher than the performance data shown. Visit madisonfunds.com or call 800.877.6089 to obtain performance data current to the most recent month-end.

Madison Mid Cap fund, Class Y, received a Morningstar Rating of four stars for the 3-year period, three stars for the 5-year period and four stars for the 10-year period, rated against 576, 502 and 370 US OE Mid-Cap Growth Funds, respectively. Performance results represent past performance and are no guarantee of future results.

During the management tenure of Rich Eisinger, Director of U.S. Equities and Portfolio Manager, who began managing the Madison Mid Cap fund in January 1998, the Madison Mid Cap Fund Class Y Shares ranked 48 out of 313 in the Morningstar Mid-Cap Growth Equity peer group.

Morningstar ratings are based on risk-adjusted total return, are determined monthly and are subject to change. A Fund's Overall Morningstar Rating is derived from a weighted average of the performance figures associated with its 3-year, 5-year and 10-year (if applicable) Morningstar Rating metrics.

For each fund with at least a 3-year history, Morningstar calculates a Morningstar RatingTM based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Rating for a fund is derived from a weighted-average of the performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar Rating metrics.

Morningstar Ratings are for the share class cited only; other classes may have different ratings. The fund on the previous pages offer multiple classes of shares, each with a different combination of sales charges, ongoing fees and other features. These different share classes are invested in a common portfolio. Institutional R6 shares are sold to a limited group of eligible investors, including certain retirement plans and investment programs.

Fees referred to are fees for Class Y Shares. Class A, B and R6 shares, which were incepted on 9/23/13, 4/19/13 and 2/29/12, respectively, have separate fee structures.

Portfolio holdings as a percentage of net assets as of June 30, 2017 for securities mentioned are as follows: **Markel Corporation** - 4.9%; **CDW Corporation** - 4.4%; **Liberty Broadband** - 4.4%; **Copart** - 4.0%; **Brown & Brown Incorporated** - 3.7%; **Zoetis Incorporated** - 2.7%. Holdings may change over time.

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DEFINITIONS

Downside Capture Ratio: a fund's performance in down markets relative to its benchmark. The security's downside capture return is divided it by the benchmark's downside capture return over the time period.

Economic Moat is a proprietary Morningstar data point. The idea of an economic moat refers to how likely a company is to keep competitors at bay for an extended period.

Morningstar Risk: An assessment of the variations in a fund's monthly returns in comparison to similar funds, with an emphasis on downward variation. The greater the variation, the larger the risk score. If two funds have the exact same return, the one with greater variations in its return is given the larger risk score. In each Morningstar Category, the 10% of funds with the lowest measured risk are described as Low Risk, the next 22.5% Below Average, the middle 35% Average, the next 22.5% Above Average, and the top 10% High. Morningstar Risk is measured for up to three time periods (three-, five-, and 10-years). These separate measures are then weighted and averaged to produce an overall measure for the fund. Funds with less than three years of performance history are not rated.

Participate and Protect Philosophy: Madison's expectation is that investors will participate in market appreciation during bull markets and be protected during bear markets compared with investors in portfolios holding more speculative and volatile securities. There is no assurance that Madison's expectations will be realized.

Portfolio Turnover: a measure of the trading activity in an investment portfolio—how often securities are bought and sold by a portfolio.

Russell MidCap Index: The Fund's Index, is a market-capitalization-weighted index representing the smallest 800 companies in the Russell 1000 Index. The average Russell MidCap Index member has a market cap of $8 billion to $10 billion, with a median value of $4 billion to $5 billion.

Russell MidCap Growth Index is designed to track those securities within the broader Russell MidCap Index that FTSE Russell has determined exhibit growth characteristics.

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Upside Capture Ratio: a fund's performance in up markets relative to its benchmark. The security's upside capture return is divided by the benchmark's upside capture return over the time period.