Madison

EXCELLENCE IN INVESTMENT MANAGEMENT

BLUE-CHIP STOCKS

What they are and why we like them.

The term “blue-chip” may sound like an odd term to define the most sound and secure companies in America. Especially when it turns out the term actually comes from poker, where blue chips are traditionally the most valuable of the various colored chips. But the irony of the nomenclature is that these high-quality companies are often the most secure segment of the inherently risky stock market.

There is no “blue chip” directory, or set rules for inclusion in this category. As a result, no one actually publishes a list of companies which are blue chip. Instead, the term is a general one, subject to interpretation. For instance, one attribute often associated with the term is a long history of successful operation, yet some market commentators may include particularly successful technology companies that are relatively new to the scene.

Rather than quibble over definition, we prefer to think of blue chips as synonymous with our definition of high quality: companies which have a proven record of profitability, have strong balance sheets, accomplished management and a business model which shows the promise of continued success in the future. These are generally the sort of companies we like to own across our portfolios, particularly when valuations are attractive.Madison Funds’ senior portfolio manager, Jay Sekelsky explains there has long been an association between the firm’s holdings and stocks which are characterized as blue chips. “But this isn’t because we shop on a blue-chip shelf. It’s because stocks which are considered blue chip are usually the higher quality stocks we find attractive. They have stronger balance sheets and higher credit ratings, which tends to provide more stability through difficult times.”

“It was a dark and stormy market, but then the Dow rallied and the blue chips began to rise…”

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One quality that is often associated with blue-chip status is size. This is only natural, since a large total corporate valuation can be a sign of success, and could suggest the company might provide superior stability. But as Rich Eisinger, Madison Funds’ lead mid-cap manager, explains, these same qualities can be found in mid-sized companies as well.

“In my mind a blue chip is a high quality business with a strong competitive advantage. There are certainly blue chip mid-cap stocks – established, high-quality businesses with strong sustainable competitive advantages. It’s quite possible that a great company can exist in a niche or industry that just doesn’t support huge market capitalization.”

The same standards apply to companies outside of the U.S. as well. Ray Vars, a portfolio manager on Madison’s NorthRoad International portfolios: “I equate blue chip with high-quality companies, and such businesses exist in almost every country and every sector. The key is not the location of a company, but the returns on capital and growth that it can generate over time.”

While there is always a case for owning high-quality, blue-chip stocks, they are especially appealing when they are being overlooked by the market. We saw a particularly dramatic example of this during the final months of the technology stock bubble in 1999 and 2000, when we began to see increasing valuation advantages for great, but “boring” blue-chip companies. Investors who focused on these companies suffered little damage over the ensuing years, which saw devastating losses for the most speculative technology companies.

High-Quality Stocks Can Provide Downside Protection
1997-2011 Losing Years for the S&P 500

Investment	2000 Return	2001 Return	2002 Return	2008 Return
S&P 500 Index	-9.10	-11.89	-22.10	-37.00
S&P 500 High Quality Index	15.20	0.82	-9.96	-32.84

Source: Standard & Poor's

The S&P 500 and S&P 500 High Quality Indices are unmanaged indices and cannot be invested in directly. This table is for illustrative purposes only and does not represent the performance of any Madison Funds mutual fund.

One aspect that is not typically considered in identifying blue-chip stocks is absolute and relative stock price. This, however, is an important aspect of stock selection across all of Madison's stock portfolios. We not only want to own great companies, we want to pay fair valuation for them. This is one of the reasons that, as stock pickers, we can often find a silver lining in market volatility and corrections: companies we admire may reach our valuation targets.

David Hottmann heads Madison's worldwide asset allocation strategies and has been favoring large, high-quality companies. "It begins with some of the basic qualities of blue-chip companies," he explains. "Most blue-chip companies enjoy a truly diverse, multinational and scalable revenue base with supporting overseas operations. The ability to globally leverage their products and services provides attractive access to faster growing regions of the global economy, such as emerging markets. This unique global footprint is often a key distinction for many blue-chip companies. When the valuation story lines up with the quality story, it seems to us to be one of these rare opportunities where you can have your cake and eat it too."

In the end, blue chip is like many other nontechnical terms – subject to the eye of the beholder. But it's a useful shorthand for many of the qualities that your portfolio managers tend to like in companies. Investors who are attracted to blue chips; who find the concept of owning the best companies in the world when they are attractively priced should find a comfortable match in their Madison Funds stock portfolios.