The Search for Value in Turbulent Markets: The Case for Mid Caps

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Executive Summary

Despite the fact that U.S. mid cap stocks have outperformed their large and small cap counterparts over the last 5-, 10-, 15-, 20- and 25-year time periods, many institutional portfolios still maintain a relatively low allocation to the asset class.[1] We believe that long-term investors should reconsider the role of mid cap stocks in a well diversified portfolio because they may offer distinctive features large caps and small caps do not. For example, on a historical basis the U.S. mid cap universe has offered meaningfully higher excess return potential than the extensively researched world of U.S. large caps. At the same time, mid caps have historically exhibited less volatility than their small cap counterparts. The following discussion looks at the historical performance of mid caps compared with that of other capitalization ranges and why current valuations might make this an attractive time to consider including more exposure to mid cap stocks.

U.S. Mid Cap Stocks as an Investment Sweet Spot

We believe U.S. mid cap stocks and their associated companies offer distinctive features that set them apart from other capitalization ranges, including:

- Better diversification of business operations relative to smaller companies
- Deeper management resources than U.S. small cap companies
- Less volatility and more moderate downside risk than small cap stocks
- More operational experience than many younger, small cap companies
- Potentially more apt to benefit from new product growth and market share gains than larger cap companies
- More nimble than large cap companies, with greater flexibility to remedy problematic divisions
- Outsourcing allows mid cap companies to “punch above their weight”
- Since 2001, mid cap companies have shown better margin performance than small companies along with faster earnings growth than large companies

1 Russell, ZEPHYR Style Advisor. Since January 1, 1979 inception. **Past performance is no guarantee of future results.** Investors cannot invest directly in an index. Actual results would vary. For purposes of this paper, the Russell Mid Cap (Mid Cap), Russell 2000 (Small Cap), and Russell 1000 (Large Cap) indices are used for the analysis. See Appendix for more details.

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The U.S. mid cap universe remains an inefficient and under-researched sector, since Wall Street coverage is far more limited for U.S. mid caps than for U.S. large caps. Investment management firms often specialize in U.S. large cap or U.S. small cap equities, with minimal emphasis on expertise in the U.S. mid cap asset class. Amid this limited analyst coverage, we find greater market inefficiencies exist in the valuations of the U.S. mid cap universe than for other market cap ranges. We believe this helps explain the outperformance illustrated in Exhibit 1. Note that even after the recent U.S. equity market volatility and the strong performance run of large cap stocks, mid caps have remained the long-term return leader. Indeed, mid caps have outperformed small caps by 186 basis points since the launch of the Russell indices 33 years ago.

Strong Performance in Both Up and Down Markets

Critical to the strong, long-term returns of mid cap stocks has been their ability to provide solid relative performance in up and down market environments. As shown in the following chart, mid caps have delivered competitive returns in rising markets, but more importantly, declined only slightly more than large cap equities in down periods and not nearly as dramatically as small caps.

Exhibit 1 – U.S. Mid Cap Stocks Have Historically Outperformed U.S. Large and Small Caps

Annualized Returns
Periods Ended
December 31, 2011

	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years	Since Inception*
Mid Cap	-1.55%	20.17%	1.41%	6.99%	8.44%	10.24%	10.92%	13.09%
Small Cap	-4.18%	15.63%	0.15%	5.62%	6.25%	8.52%	8.67%	11.23%
Large Cap	1.50%	14.81%	-0.02%	3.34%	5.68%	7.99%	9.35%	11.31%

*January 1, 1979 inception date for each index.

Source: TBCAM, using Russell, ZEPHYR Style Advisor data. **Past performance is no guarantee of future results.**
Investors cannot invest directly in any index.

For many investors, the excess return generated by mid caps over large caps may be an acceptable trade-off for higher volatility.

Exhibit 2 – Mid Caps Have Achieved Strong Relative Performance Results in Both Up and Down Months

January 1, 1979, through December 31, 2011

	Average Return Up	Number of Months	Average Return Down	Number of Months
Mid Cap	4.1%	247	-3.8%	149
Small Cap	4.7%	242	-4.6%	154
Large Cap	3.6%	253	-3.6%	143

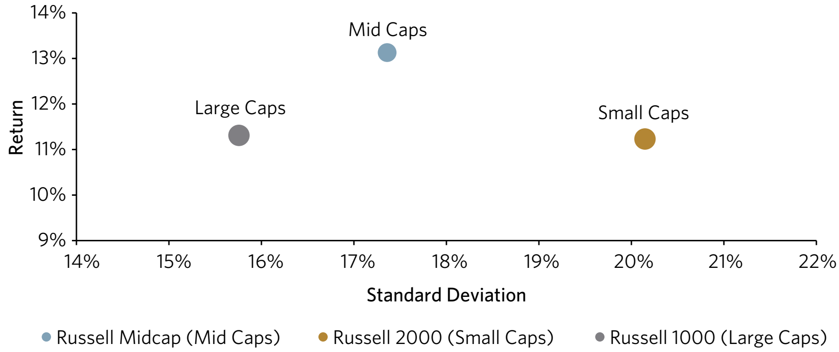
Source: TBCAM, using Russell, ZEPHYR Style Advisor data. **Past performance is no guarantee of future results.** Investors cannot invest directly in any index.

Risk/Return Trade-Off

For many investors, the excess return generated by mid caps over large caps may be an acceptable trade-off for higher volatility. It is also important to note that part of the increase in standard deviation (a measure of volatility of the return stream) is also a function of the higher excess returns delivered over the represented time period.

Exhibit 3 – Mid Caps Have Historically Achieved Higher Returns With Only Modestly Higher Standard Deviation Versus Large Caps

January 1979 – December 2011 (Single Computation)



Source: TBCAM, using Russell, ZEPHYR Style Advisor data. **Past performance is no guarantee of future results.** Investors cannot invest directly in any index. **Standard Deviation** is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk. In mutual funds, the standard deviation tells us how much the return on the fund is deviating from the expected normal returns.

The Emergence of New Levels of Margin Performance and Earnings Growth for Mid Cap Companies

The 2001 to 2003 time period appears to have laid the foundation for mid cap companies to achieve new levels of margin performance and earnings growth. Responding to the challenges of the recessionary environment, mid cap companies expanded the use of outsourcing to cut production costs without the expense of large capital spending programs to gain scale. The deflationary impact of the Internet revolution, the plunge in technology hardware costs caused by Y2K over investment and the productivity enhancements driven by continuing technological advancements had an immediate and long-lasting effect on mid cap profit margins. Scalability, increased product diversity and broader exposure to global markets have also enabled mid cap companies to deliver higher pre- and after-tax margins than their small cap competitors. Note the margin difference in Exhibit 4:

Exhibit 4

	Mid Cap	Small Cap
Operating Margin	17.3%	13.8%
Net Margin	8.67%	6.0%

Source: FactSet, 12/31/01 - 12/31/11.

Large cap companies had already attained benefits of scale, technological advancements, geographic expansion, market share penetration and attention to costs, so progress from already high levels was more difficult. In addition, large companies offer more mature products and face the challenge of demonstrating meaningful growth off a much bigger operating base. Even though large companies demonstrated 16.4% earnings-per-share growth over the past 10 years, the combination of limited margin expansion and mature products produced a growth rate that meaningfully lagged mid cap results. Note that mid cap companies delivered an EPS growth rate 680 basis points higher than large caps.

Exhibit 5

	Mid Cap	Large Cap
EPS Growth	23.2%	16.4%

Source: FactSet, 12/31/01 - 12/31/11.

We believe these trends might continue into the future and offer another potential driver of strong performance for mid caps in the latter part of recessionary cycles.

After the recent market turbulence, we believe valuations for small, mid and large cap domestic asset classes have become quite compelling.

Mid Cap Valuations Currently Compelling Across the Board

After the recent market turbulence, we believe valuations for small, mid and large cap domestic asset classes have become quite compelling. The more stable valuation metrics, such as price-to-sales and price-to-book ratios, indicate attractive opportunities for most U.S. equities. On a price-to-sales basis, each asset class is generally valued around one-time sales. The price-to-book ratio is also attractive for each class.

We believe whether domestic equities will be attractive on the more volatile P/E and P/E-to-growth metrics hinges on the status of the U.S. economy in 2012. Assuming the U.S. does not experience a recession in 2012, in our view all equity classes appear to be undervalued on 2012 P/Es and their respective P/E-to-growth ratios.

Exhibit 6 – Valuation Comparisons Between Asset Classes

	Price/ Sales	Price/ Book	P/E 2011 EPS	P/E 2012 EPS	Estimated 3-5 year EPS Growth	2012 P/E to Growth Ratio
Mid Cap	1.0X	1.9X	14.1X	12.6X	13.3%	1.0X
Small Cap	0.9	1.7	15.3	13.1	15.1%	0.9X
Large Cap	1.2	2.0	12.3	11.5	12.1%	1.0X

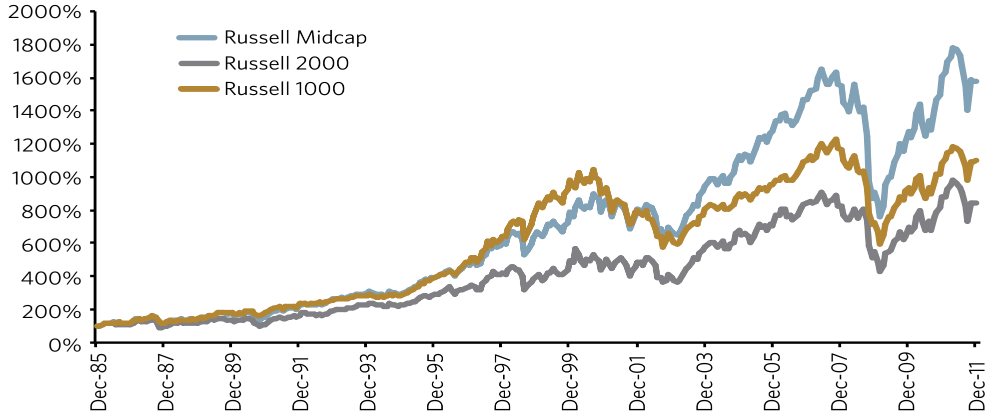
Source: FactSet, as of December 31, 2011.

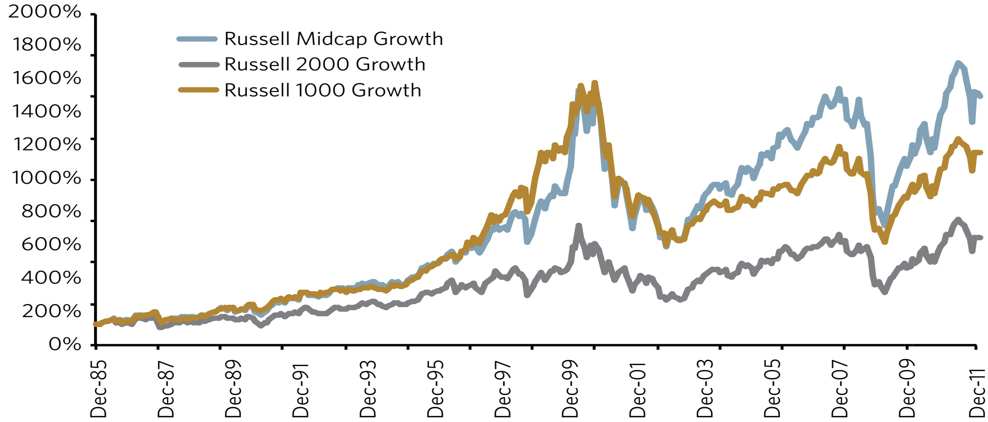
However, with valuation metrics so close across each asset class, and the 2012 outlook somewhat uncertain, we believe it makes sense to consider mid caps and the higher reward-to-risk ratio they have demonstrated over time.

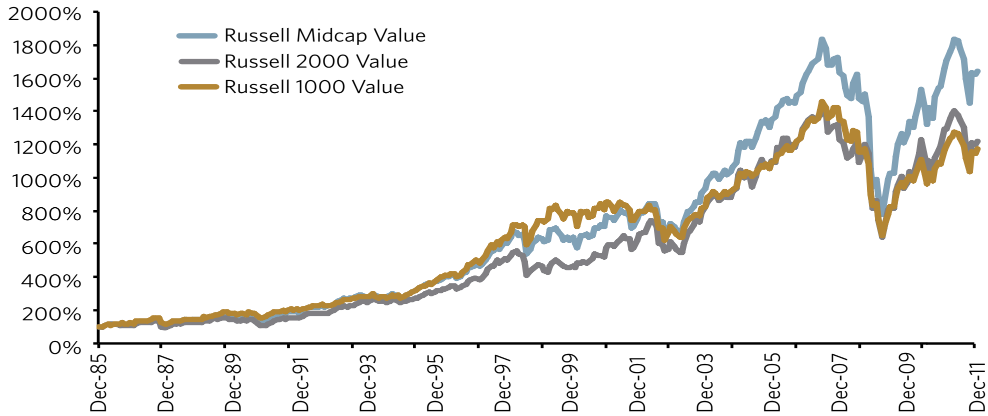
Clean Sweep: Each Mid Cap Style Has Historically Outperformed Its Small and Large Cap Counterparts

Another consideration for mid caps is the historical performance of each mid cap style category relative to its large and small cap counterparts. As the cumulative return graphs on the next page demonstrate, mid cap has outperformed its small and large cap siblings in the core, value and growth styles.

Exhibit 7 – Over a 25 Year Period, Each Mid Cap Style Achieved Higher Relative Cumulative Returns







Source: ZEPHYR Style Advisor, as of December 31, 2011. **Past performance is no guarantee of future results.** Investors cannot invest directly in any index.

We believe mid cap stocks are an important component for long-term investors seeking diversification and attractive risk-adjusted returns.

Why Mid Caps, Why Now?

We believe mid cap stocks are an important component for long-term investors seeking diversification and attractive risk-adjusted returns. As we have shown, mid cap stocks have historically outperformed their large and small cap counterparts. We believe this is a positive reflection of the stocks and companies that comprise this universe, and reflects the inefficiencies in this space that can be exploited by skillful managers. In the current low growth environment with potentially modest market returns, we believe mid caps could provide the additional capital appreciation many investors seek.

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Michael is a Portfolio Strategist supporting the U.S. Opportunistic Value strategies. Michael joined The Boston Company and the Opportunistic Value Team in 2008. Prior to joining the company, Michael's experience included positions first in equity research, later in portfolio management and most recently in client service and product management. His background includes various equity responsibilities at Kemper Financial Services, Phoenix Investments and Putnam Investments.

Michael earned his BBA from Southern Methodist University and his MBA from Indiana University. Michael is a CFA charter holder.

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Joe is a Senior Product Specialist at The Boston Company. He is responsible for positioning and communicating the firm's products in the marketplace.

Previously at The Boston Company, Joe was a Product Manager where he provided market research, analysis and project support to successfully enhance the development and promotion of the firm's products and services. Prior to his role as a Product Manager, he was a Client Service Analyst where he was responsible for generating a diverse range of analytical data and creating performance attribution reporting materials. Prior to joining The Boston Company, Joe worked as a Senior Portfolio Accountant at Standish/Mellon Asset Management where he was responsible for account maintenance, trade processing, cash and asset reconciliations. Previous to that role, Joe served as a Trust Specialist within the firm's parent company, Mellon Financial Corporation.

Joe received a BA in Finance from Bryant University and an MBA from Bentley University.

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David is a Client Service Analyst at The Boston Company working with BNY Mellon's internal distribution channels such as Dreyfus, Private Wealth Management, Taft-Hartley, Mellon Pension Services and BNYM Asset Management International.

Prior to joining The Boston Company, David served as an Accounting and Reporting Specialist within the firm's parent company, BNY Mellon. He was responsible for account maintenance, trade processing and cash and asset reconciliations for a corporate trust. Previously, David was an Investment Analyst at Sentinel Financial Group, an independent employee benefits firm, where he worked with the Chief Investment Officer and Executive Director of Wealth Management, drafting retirement plan proposals and analyzing the investment models that were offered to plan participants.

David graduated Magna cum Laude with a BS in Economics and Finance from Bentley University and is completing his MBA at Babson College. David is a Level I Candidate in the CFA Program and a member of the Bentley Honor Society and the International Economics Honor Society.

Index Definitions

The **Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values, and the Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values, and the Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies. The Russell Midcap Value Index measures the performance of those mid-cap companies with lower price-to-book ratios and lower forecasted growth values, and the Russell Midcap Growth Index measures the performance of those mid-cap companies with higher price-to-book ratios and higher forecasted growth values.

Each of these Russell indices is constructed to provide a comprehensive and unbiased barometer of their respective market. The Indexes are completely reconstituted annually to ensure stocks do not distort the performance and characteristics of their true respective market.

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The following are some **principal risks** associated with mutual funds that may engage in investments or strategies related to the topic of this white paper:

Equity funds are subject generally to market, market sector, market liquidity, issuer and investment style risks, among other factors, to varying degrees.

Small and midsize companies carry additional risks because their earnings and revenues tend to be less predictable, and their share prices more volatile than those of larger, more established companies. They also tend to be less liquid than larger company stocks.

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