Arnerich Massena
Building Better Portfolios

Mid Cap: The Goldilocks Asset Class

Arnerich Massena, Inc.

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Domestic mid cap stocks may be on their way to being dubbed "the Goldilocks asset class." Long-term risk and return analysis demonstrates that mid cap stocks historically fit into a "sweet spot" of higher return for lower risk. In this paper, we'll look at why U.S. mid cap stocks hit this sweet spot, examining factors such as business cycle and earnings growth, and suggest how investors can take advantage of the opportunities mid cap has to offer.

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Mid Cap: The Goldilocks Asset Class

"Not too high and not too low. Not too hot and not too cold. Not too big and not too small. Just right." Goldilocks' famous line applies well in today's investment world. If you can imagine Goldilocks reviewing the asset allocation of her portfolio, she might look at her U.S. mid cap stocks and say the same thing: "Not too big and not too small, but juuuust right."

Over the past 36-year period, domestic mid cap stocks have outperformed both large and small cap stocks, with lower long-term volatility than small cap stocks. It must be emphasized that we don't view investing in mid cap as a short-term tactical opportunity, but rather as a potential source of long-term value creation. For long-term investors, mid cap stocks may indeed be the Goldilocks asset class.

Figure 1: The Universe of Global Equity

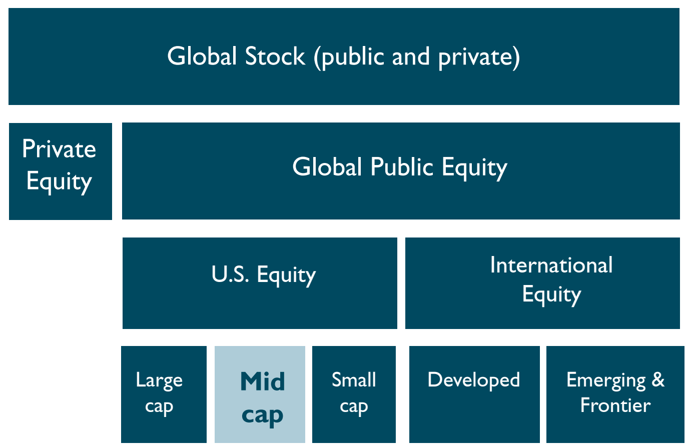
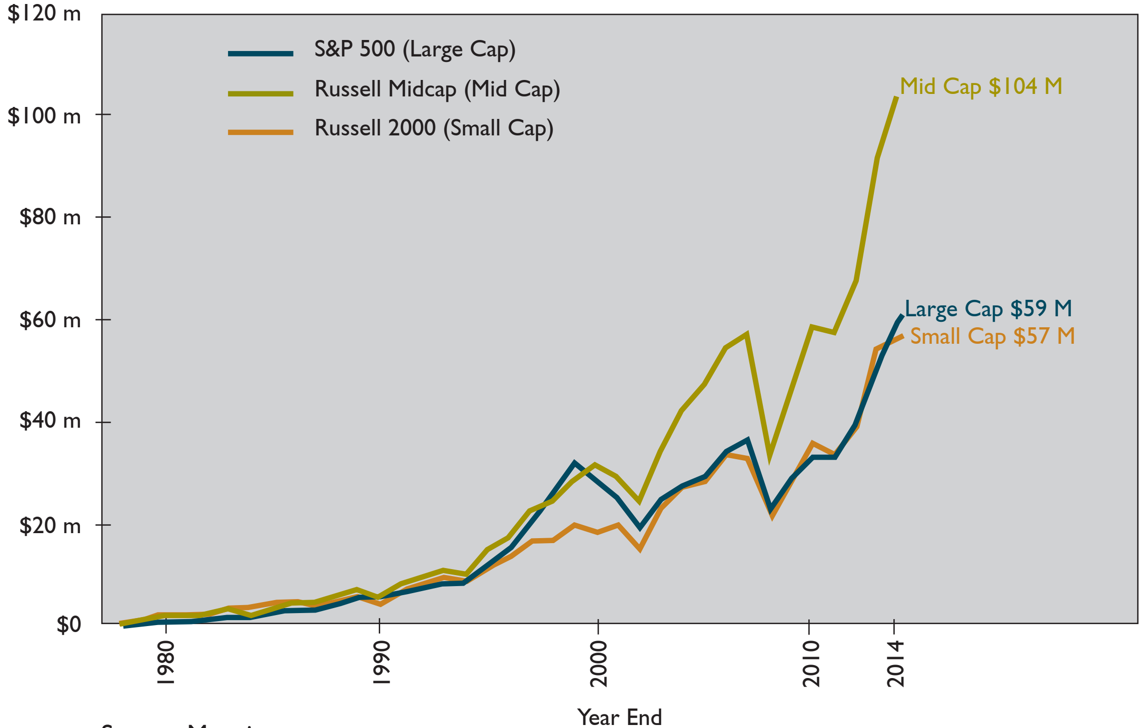


Figure 2: Market Capitalization Ranges

Definitions of market capitalization ranges corresponding to "large cap," "mid cap," and "small cap" can vary widely across investment firms, investment styles, and market conditions. The table below provides a guide to both Morningstar's and Arnerich Massena's definitions of these terms.

Market Cap	Morningstar Definition	Arnerich Massena Definition
U.S. Large Cap	Largest 70% of U.S. Stocks in each style category (i.e. growth, value, and blend)	Large cap stocks generally have market capitalizations greater than $25 billion.
U.S. Mid Cap	Next 20% of U.S. stocks in each style category	Mid cap stocks generally have market capitalizations between $2.5 billion and $25 billion.
Small Cap	Smallest 10% of U.S. stocks in each style category	Small cap stocks generally have market capitalizations less than $2.5 billion.

FIGURE 3: HYPOTHETICAL GROWTH OF $1 MILLION INVESTED DECEMBER 31, 1978 THROUGH DECEMBER 31, 2014



Source: Morningstar

Figure 1 above shows the growth over time of mid cap stocks relative to large and small cap stocks. (Throughout the paper, asset classes are represented by indexes.) Over the past 36-year period, you can see that the long-term growth differential is significant: a $1 million initial investment grew to $104 million for mid cap stocks, versus $59 and $57 million for large and small cap stocks respectively.

With mid cap's long-term returns outpacing large and small cap stocks, one would normally expect higher volatility to accompany that growth, particularly if we work under the assumption that higher risk typically results in higher long-term returns. But mid cap stocks have been an anomaly from that assumption, demonstrating volatility over time that has been much closer to that of large cap stocks, and considerably lower than the volatility of small cap stocks. In Figure 4, you can see the annualized standard deviation of all three asset classes from 1979 to 2014.

Let's take a deeper dive into this asset class and explore possible reasons why mid cap stocks seem to hit the sweet spot when it comes to the risk/return tradeoff.

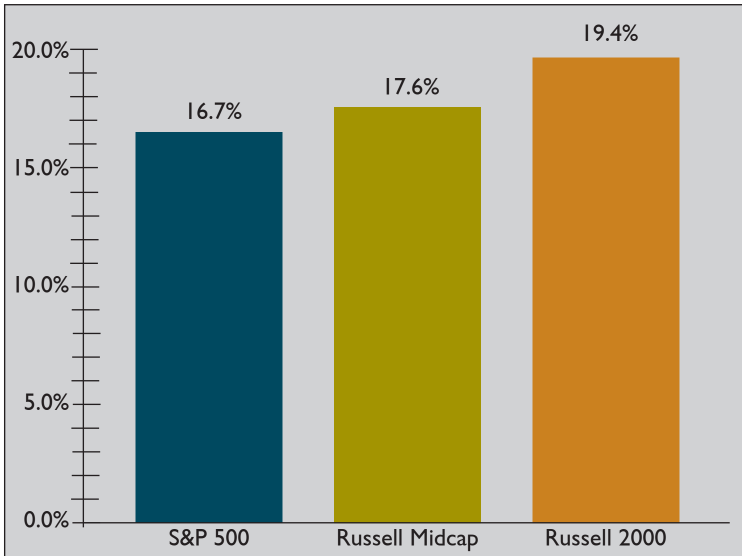
> "MID CAP companies have typically been seasoned, managements have been battle-tested, and the business models have been tested as well."
>
> ~ TimesSquare Capital Management, 2005

WHY DO MID CAP STOCKS HIT THE SWEET SPOT?

Business cycle bulls-eye

Mid-sized companies are often in the perfect stage of a business's life cycle. They have progressed enough to have achieved a proven business model and economies of scale, but remain nimble enough to compete effectively. Mid-sized companies tend to have better access to capital and an improved capital structure relative to smaller companies, while being more flexible and better able to adjust to changing market conditions than larger companies. Because mid-sized companies are usually fairly well established, they expose investors to less business risk than smaller companies. Despite this lower risk, mid-sized companies are often still on a strong growth trajectory, as opposed to larger companies, which are better known for slow and steady growth.

FIGURE 4: ANNUAL STANDARD DEVIATION 1979-2014



Source: Morningstar, Arnerich Massena

Note: Standard deviation is based on annual observations.

Strong earnings growth

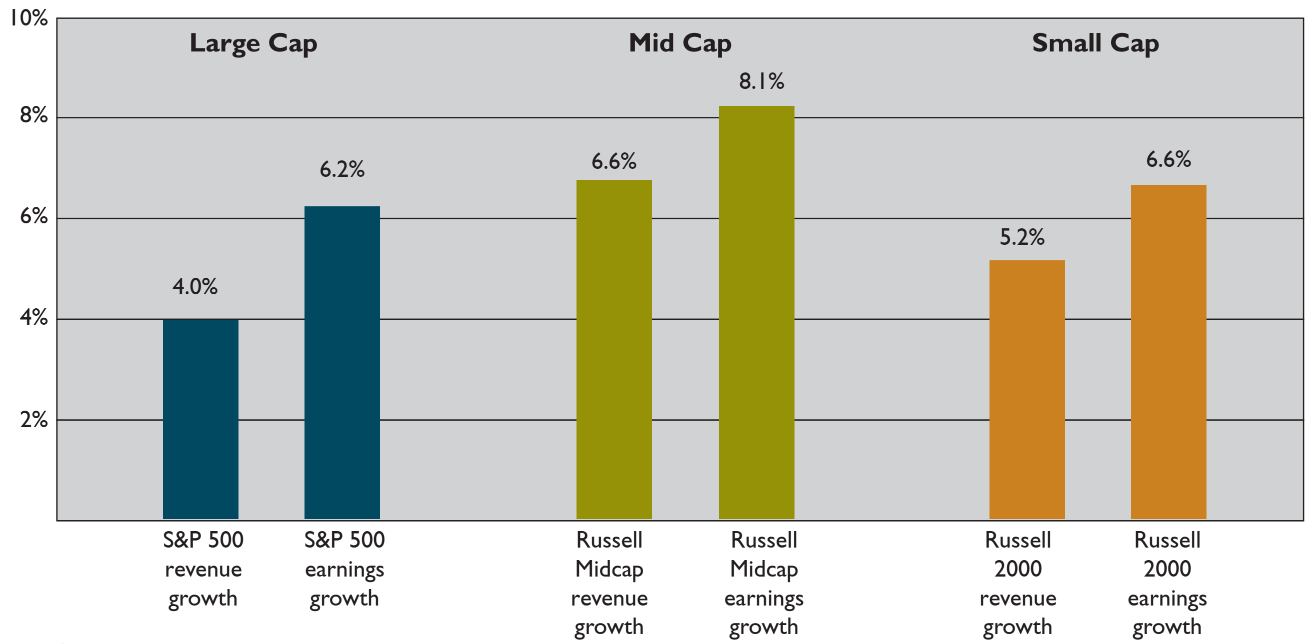
Mid cap stocks' positioning in the center of the business cycle bulls-eye shows in their long-term revenue and earnings growth. In Figure 5, you can see that over the past 19 years (the longest time period for which common data is available), mid cap companies have experienced higher earnings and revenue growth than both large and small cap stocks. If mid cap earnings growth continues to outpace other asset classes and all other factors remain the same, it is not unreasonable to expect mid cap stocks to continue to outperform in the future.

> "With respect to outpacing Large Caps, one key reason this occurs is mathematics — it is simply easier to grow from a smaller base than a larger one. Also consider that Mid Cap companies tend to have greater exposure to developing opportunities or markets with lower penetration."
>
> ~Baird Investment Management, 2014

Less market demand

Investing is about finding opportunity. Because large institutional investors usually target large cap and often target small cap in their portfolios, but only sometimes target mid cap, the mid

FIGURE 5: REVENUE AND EARNINGS PER SHARE GROWTH
MARCH 31, 1995 TO SEPTEMBER 30, 2014



Source: Bloomberg

cap universe may be an under-invested market, a factor that theoretically may contribute to mid cap's attractiveness. "The less coverage a particular segment receives, the more likely there are market inefficiencies to exploit," notes Ridgeworth Investments in regard to active mid cap investing. In other words, the mid cap market is a rich field for active managers to mine.

> "For mid cap managers, less Wall Street research translates into more opportunities to uncover value."
>
> ~ Hotchkis & Wiley, 2014

Investor Perceptions

There is another possible reason why mid cap deserves its Goldilocks title. For individual investors, investing may be a rational process, but markets are still driven largely by fear and greed. Large and small cap stocks fit neatly into the fear and greed pathology: small cap stocks appeal to investors' greed with a perceived high risk/high return profile. Investors who are seeking the higher potential returns of small cap stocks may be willing to pay more for it, creating a tendency to slightly overvalue small cap stocks. On the other side of the coin, large cap stocks appeal to fear, being perceived as a safe choice. For this perceived safety, again, investors might be willing to pay a premium, thus potentially overvaluing large cap stocks. Mid cap stocks, however, don't appeal as directly to either fear or greed, falling as they do into the center of the spectrum. Mid cap equities, as a result, should be more reasonably valued, with valuations based on fundamentals rather than a perceived emotional value.

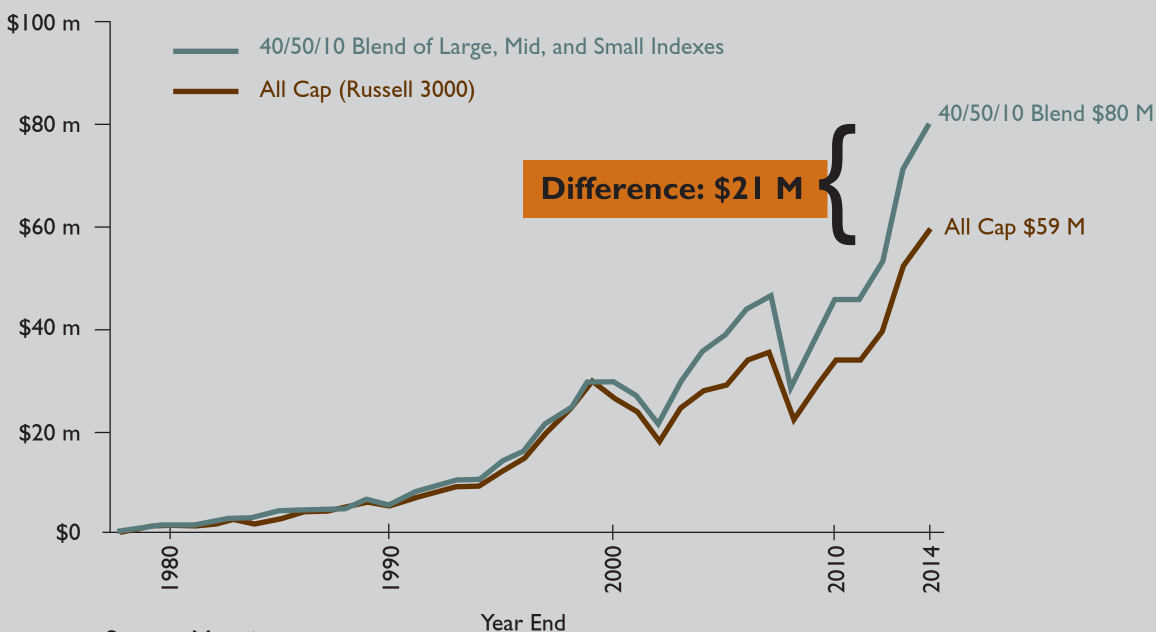
A THOUGHT EXPERIMENT

To analyze how an allocation to mid cap stocks might affect a U.S. equity portfolio, we compared the long-term risk and return of a "normally-weighted all-cap U.S. equity portfolio" — as represented by the Russell 3000 Index — to a portfolio with an overweight to mid cap stocks, represented by a mix of 40% S&P 500/50% Russell Mid Cap Index/10% Russell Small Cap Index. While we don't necessarily recommend this particular allocation or weighting, this hypothetical example does help demonstrate how mid cap stocks might benefit a portfolio.

Over a 36-year period, the hypothetical portfolio overweighted to mid cap outperformed the "normally-weighted" Russell 3000 by 0.9% with no added volatility.

If you invested $1 million in 1978, the mid cap overweight blend grew to $80 million by 2014, versus $59 million in the all-cap portfolio, a difference of $21 million.

FIGURE 6: HYPOTHETICAL GROWTH OF $1 MILLION: ALL CAP (RUSSELL 3000 INDEX)* VS. MID CAP OVERWEIGHT BLEND** INVESTED DECEMBER 31, 1978 THROUGH DECEMBER 31, 2014



Source: Morningstar

*The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. According to Morningstar, as of December 31, 2014, the Russell 3000 index was composed of 72.6% large cap, 18.8% mid cap, and 8.6% small cap.

**The "Mid Cap Overweight Blend" is comprised of 40% S&P 500 Index, 50% Russell Mid Cap Index, and 10% Russell Small Cap Index and assumes annual rebalancing.

How do you capture the mid cap potential?

> "Mid cap companies combine some of the best attributes of larger and smaller companies. They are generally able to grow sales at a much faster pace than larger companies and are established enough to have critical mass and deeper balance sheets for stability."
>
> ~ Eagle Asset Management, 2012

Why are we pointing out the particular potential of mid cap stocks? How can you best take advantage of this potential? When creating a portfolio's equity allocation, we think it's important for investors to be aware of mid cap as a sub-asset class within the greater global equity asset class — in fact, as an essential component of a broad global equity allocation. As pointed out, many investors' allocations will include large and small cap and overlook mid cap, or include it only haphazardly through large or small cap managers with some mid cap overlap. We believe that including an allocation targeting the mid cap market can have a significant long-term positive effect on a portfolio. In other words, to capture the benefits of this asset class, the most important thing is to "just show up," so to speak.

At Arnerich Massena, while we encourage investors to maintain broad asset classes in their policies to facilitate flexibility (i.e. specifying targets for an equity allocation, but not necessarily detailing large, mid, and small cap), we also see mid cap as a very important piece of the equity allocation for long-term investors. Emerging new investment strategies in equity markets are leaning toward the attractive opportunities in mid cap stocks.

> "If you look at the overall mid-cap portion of the domestic market, it constitutes roughly 25% of the U.S. domestic market in market capitalization...but I believe that most people probably have very little allocated to mid-caps. Most investors start with large, then perhaps go to international, perhaps they go to small-cap domestic, but mid-cap is just not even carved out as an asset class, and my sense is that it probably should be."
>
> ~ Munder Capital Management, 2006

For Goldilocks, her adventures ended with the bears kicking her out of their home, so that her perfect bed, chair, and porridge were lost to her. Fortunately for us, there is no one to chase us away from investing in mid cap stocks. There is no such thing as a perfect asset class, but for long-term investors, mid-cap stocks certainly hit the sweet spot.

Endnotes

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