INVESTING IN THE SWEET SPOT

Mid Cap Equities
Executive Summary

Mid cap companies tend to live in the “sweet spot” of the business cycle—they offer the stability of more mature firms, but retain the high-growth potential of younger firms.

The characteristics inherent in mid capitalization U.S. equities have led to over 35 years of consistent and meaningful outperformance relative to small and large cap equities. Indeed, this asset class is ripe with opportunities to invest in high-quality, established organizations with substantial growth potential. Mid cap companies tend to live in the “sweet spot” of the business life cycle—they offer the stability of more mature firms (having surpassed the high-risk, early development stage associated with start-ups), but retain the high-growth potential of younger firms (which generally abates as firms mature and grow). In this paper, we provide an overview of the mid cap equity asset class and explore the unique balance of fundamental strength, profitability and other advantages that the mid cap asset class offers to institutional investors.
Defining Mid Cap Equities

The Investment Universe

The mid cap equity universe generally consists of companies with market capitalizations ranging from $2 billion to $20 billion. The Russell Midcap Index, a subset of the Russell 1000 Index and a commonly used benchmark for measuring mid cap equity performance, consists of approximately 800 stocks and amounts to approximately 27% of total investable U.S. equities as defined by the Russell 3000 Index. In contrast, the Russell Top 200 Index represents the 200 largest companies in the Russell 1000 Index and approximately 7% of total U.S. equities. The Russell 2000 Index represents the 2000 smallest companies and approximately 66% of total U.S. equities, as shown in Exhibit 1.

Fundamental Characteristics

Stability, Agility and Growth Potential

Unlike small cap companies, most of which are highly focused and in early development stages, mid cap companies tend to be more mature and have established business infrastructures. With strong management teams and proven product strategies in place, mid cap companies are often able to avoid the earnings volatility commonly associated with small, highly-concentrated organizations.

In general, mid cap companies are in the business life cycle stage at which they begin to exhibit sales and earnings stability resembling that of mature and diversified large cap firms. As illustrated in Exhibit 2, mid cap companies retain the focus and agility that seldom accompany larger companies, which often manage highly diverse and competing interests.
Although mid and large cap companies have similar stability, mid cap companies are less constrained by their scale and therefore have more growth potential. All else equal, a company’s ability to consistently grow earnings becomes substantially more challenging as the company’s market capitalization grows. For example, to generate an earnings growth rate of 10%, the median large cap company would require nearly ten times the aggregate increase in earnings required by the median mid cap company. Simply put, mid cap companies have upside potential that larger companies—subject to the economic realities of growth rates and capitalization ranges—do not.

Profitability

Many mid cap companies are at a stage of growth where they have developed meaningful competitive advantages, cost efficiencies and product strategies poised to catalyze future earnings growth. Accordingly, mid cap companies tend to maintain the earnings growth potential associated with many smaller companies while exhibiting a profitability profile that more closely resembles larger companies.

The profitability of mid cap companies, measured in return on assets (ROA) and rolling 5-year return on equity (ROE) as shown in Exhibits 3A and 3B, respectively, was consistent and at times as much as double that of smaller companies. Further, mid caps were more stable than small caps and nearly as stable as large caps: the average annual change in ROA for mid caps was approximately 11%, in contrast to the nearly 30% change for small caps and close to the 10% change for large caps. As measured by 5-year ROE, mid and large caps have similarly stable profitability, with a change from peaks to troughs of approximately 40%—less than half of the almost 95% peak-to-trough change posted by small caps.

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1 As of 9.30.16, the median market cap of the Russell Top 200 Index was $46.9 billion and the median market cap of the Russell Midcap Index was $6.4 billion.
**Investing in the Sweet Spot: Mid Cap Equities**

**Exhibit 4A**
Annualized Returns by Capitalization Segment
(January 1979 - September 2016)

Mid cap equities have long represented a sweet spot in the U.S. equity market, exhibiting over 35 years of consistent outperformance relative to large and small cap equities. As Exhibit 4A demonstrates, the Russell Midcap Index produced an annualized return of 13.3% in this period, outperforming large caps and small caps by 213 and 182 basis points, respectively.

A similar trend is apparent in Exhibit 4B, which uses rolling 10-year returns to illustrate the consistency of long-term performance over time. Once again, mid caps provided the highest long-term returns with less variability than large caps. The consistency of long-term returns for mid and small caps is primarily the result of their nimbler business models and focus on market niches, while large caps typically take longer to recover from recessions because of their reliance on the overall economy.

Mid and small cap equities exhibited positive absolute returns in all 10-year periods calculated quarterly from 1988 through March 2015. In contrast, large cap equities posted negative returns in eight consecutive periods. All three market cap segments hit their low 10-year return in Q1 2009. By Q1 2013, mid and small caps returned to their long-term average while large caps lagged their average 10-year return by 3.35%.

**Exhibit 4B**
Rolling 10-Year Returns Calculated Quarterly by Market Capitalization Segment (December 1988 - September 2016)
Volatility of Returns

Interestingly, mid cap equities have provided this long-term outperformance versus small and large cap stocks without an equivalent increase in risk. As we established in the previous section, mid cap equities offered 186 basis points in excess returns over small cap equities during the 37 years ending September 30, 2016. From the risk/return comparison in Exhibit 5, we can see that the mid cap asset class outperformed with less volatility and lower risk than small caps, which despite their higher risk profile, delivered less than a market-level return.

Upside/Downside Capture

Delving further into the history of the capitalization segments, we found that mid caps advanced more than the market during times of broad market strength. As shown in Exhibit 6, the Russell Midcap Index captured nearly as much of the market’s “upside,” or positive performance, as small caps (the Russell 2000 Index), but captured substantially less of the “downside.” Compared to large cap equities, mid caps offer considerably higher upside potential with only a moderate increase in downside risk.

Sources: FactSet, Russell
Analyst Coverage

Beyond the strong fundamental characteristics and attractive risk/return profile already discussed, limited research coverage further contributes to the relative attractiveness of the mid cap asset class when compared to large cap companies. Sell-side analyst coverage declines significantly as market cap decreases. The Russell Midcap Index has, on average, just 15 analysts covering each company. In contrast, an average of 24 analysts cover each company in the Russell Top 200 Index. Limited research coverage opens the door for informational inefficiencies in the mid cap range, thus amplifying potential alpha generation for investors with the resources and expertise to diligently research this segment of the market.

On the buy side, research coverage is driven by the products offered by investment managers. Since mid cap products account for just over 15% of the 2200+ products in the eVestment U.S. equity investment universe, mid cap equities are out of the spotlight in buy side research. Dedicated large cap products are more than half of the universe at 54%, while small cap products account for just over 30% as indicated in Exhibit 8.

Conclusion

The mid cap equity market offers abundant opportunities to institutional investors seeking to invest in profitable companies with strong fundamental characteristics and proven track records. This asset class has not only provided strong long-term absolute and relative returns as a result of its high-quality constituents, but has done so without substantially increasing volatility. Indeed, from profitability, resource and risk standpoints, mid cap companies are on par with large cap firms while balancing the focus, agility and excess returns of small cap companies. By drawing the most compelling attributes from either end of the capitalization spectrum, the mid cap equity asset class is fertile ground for institutional investors seeking to boost their return potential with an allocation to high-quality U.S. equities.