

Mid Cap Update

HIDING IN PLAIN SIGHT: MID CAP OPPORTUNITY

An Opportunity for Undiscovered Investment Opportunities

If an investor designed a portfolio starting with a blank canvas, would it be the same as their current portfolio? Often times the answer is no. One reason for this is inertia, the concept of doing nothing or continuing the old way of investing. An example is how many investors have designed U.S. equity portfolios in a barbell-like structure between large cap and small cap stocks. This has resulted in many investors being underallocated to mid cap stocks, which we believe has created opportunities for finding undiscovered investment opportunities.

Based on our observations, the practice of underallocating assets to U.S. mid cap stocks is common. Mid cap stocks represent about 20% of the overall U.S. equity market but only 11% of invested assets (see Figure 1).

Surprisingly, the strong absolute returns and risk-adjusted returns of mid cap stocks relative to large and small cap stocks during the last 30 years have failed to entice investors to adjust their underweighting to the asset class (see Figure 2 and Figure 3).

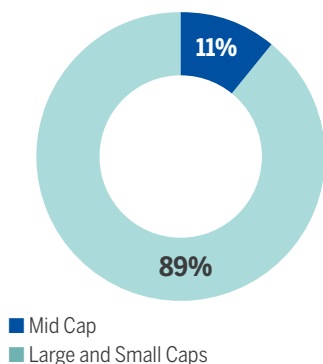
Given that U.S. mid cap stocks are often underweight within portfolios, they can potentially be an effective asset class for unlocking higher returns and harvesting alpha by using effective active management to find undiscovered opportunities. The following are four key considerations for mid cap stocks.



Brad Neuman, CFA

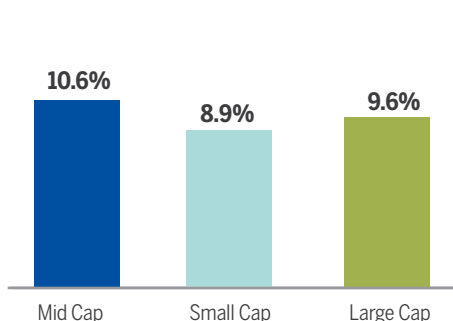
SENIOR VICE PRESIDENT
DIRECTOR OF MARKET STRATEGY

Figure 1:
Total Mutual Fund and ETF Assets



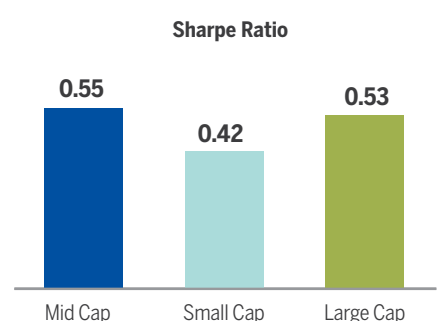
Source: Morningstar as of September 30, 2022.

Figure 2:
Annualized Total Returns



Source: FactSet for the 30-year period ended September 30, 2022. Mid Caps represented by the Russell Midcap Index; Small Caps represented by the Russell 2000; Large Caps represented by the S&P 500. Data from 1990–2020.

Figure 3:
Risk-Adjusted Return Metrics



Fewer Analysts Results in Hidden Gems

Market efficiency directly impacts the ability of active managers to outperform benchmarks and peers. Because there are fewer research analysts per U.S. mid cap stock relative to an average U.S. large cap stock, investment managers can more easily develop differentiated views on fundamental drivers of returns, such as sales, cash flows and ultimately value (see Figure 4).

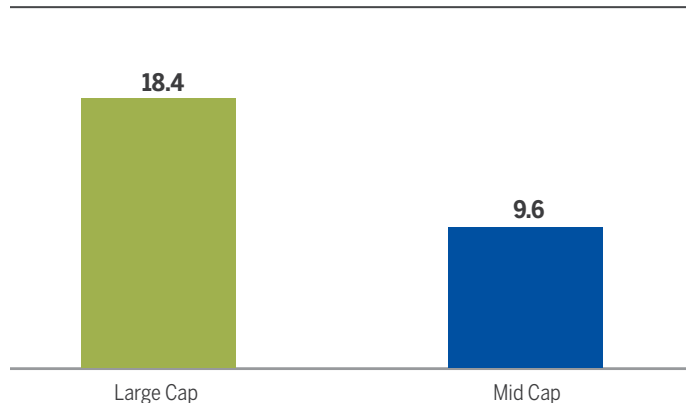
Attractive Relative Valuation

Given underperformance during the past few years, overall U.S. mid cap valuation has compressed relative to U.S. large caps. Mid cap stocks have historically traded at a 1% premium to large cap stocks when measured by P/E. Today, mid cap stocks are trading at a 28% discount (see Figure 5). We believe the relative valuation of the asset class should be a key consideration when evaluating an asset class.

Defining Mid Cap Companies by Growth Potential

How should an investor define a mid cap stock? For the S&P MidCap 400 Index, a U.S. mid cap company is defined as

Figure 4: Average Number of Analysts Per Stock



Source: FactSet based on data as of September 30, 2022. Large cap is the S&P 500 and mid cap is the S&P MidCap 400.

having a market capitalization between \$3.7 billion and \$14.6 billion. This range is driven by the distribution of market capitalizations of publicly traded U.S. firms, so using this framework creates a moving target that also fails to account for each company's underlying business dynamics.

Perhaps a more thoughtful approach is to use bottom-up research to identify companies that have survived the

Figure 5: Price-to-Earnings S&P MidCap 400 / S&P 500



Source: FactSet as of September 30, 2022. P/E is price divided by earnings per share over next 12-months.

perils of the earlier phases of their lifecycles yet still have significant growth opportunities ahead of them based on revenue relative to their total addressable market. Using company fundamentals rather than market capitalization may help identify midsize companies with strong growth prospects to potentially generate alpha.

Structural Growth Engine and High Earnings Forecast

Often a stock's market capitalization corresponds to its underlying company's business lifecycle. Young companies with limited earnings often begin as small cap companies. As some companies successfully grow their business and earnings, they become mid caps and transition to another growth phase of their lifecycle. Over the last 30 years, the earnings per share (EPS) growth rate for the S&P MidCap 400 Index has been over 290 basis points (bps) per year greater than the S&P 500 index. This has resulted in S&P MidCap 400 Index earnings increasing 2,750% during this time period compared to 1,200% for the S&P 500 Index. The U.S. mid cap asset class can potentially offer a sweet spot for investors seeking high-growth companies that are between their start-up and mature lifecycle phases.

In addition to a structural growth advantage evidenced by historical data, mid cap stocks are forecast to grow their earnings much faster than large cap stocks (see Figure 6).

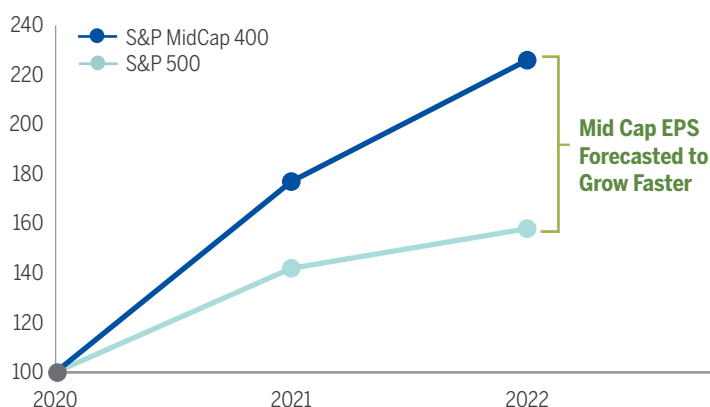
The Opportunity Ahead

The attractive growth rate and risk-adjusted return characteristics presented by U.S. mid caps offer investors a compelling asset class to potentially generate higher returns. In today's world of increased complex asset allocations, sometimes the best opportunities to potentially generate higher returns and alpha are hiding in plain sight.



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Senior Vice President
Director of Market Strategy

Figure 6: **Estimated Earnings Per Share Trajectory**



Source: FactSet as of September 30, 2022. Estimated EPS trajectory based on consensus estimates from FactSet.

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