Mid Cap Investing

Executive Summary

- We view mid cap stocks as a distinct segment of the U.S. equity landscape and believe there are key attributes that separate them from their small and large cap brethren. The mid cap universe is large and diverse; making up 22% of US securities listed on stock exchanges[1]
- Mid cap companies can be growing yet established – combining the growth opportunities of smaller firms with the financial stability of larger businesses
- Mid cap has been under allocated and is often overlooked by investors and Wall Street analysts[2]
- The mid cap universe has historically provided both positive and consistent returns—outperforming both large and small cap stocks[3]
- Mid cap offers a favorable risk-reward relationship (as measured by Sharpe Ratio[4]) compared to all other market capitalizations[5]

At Anchor, we have a thirty-year plus history of thoroughly researching and investing in mid cap stocks. While there is no universally accepted definition of mid cap, we currently define the asset class as U.S. publicly traded companies with a market capitalization between $2 billion and $20 billion. By comparison, the Russell Mid Cap Index, which tracks 800[6] companies as a baseline for performance, has holdings with market capitalizations ranging from $1.7 billion to $37 billion.[7]

Through our experience, we have witnessed first-hand some of the benefits that an allocation to mid cap stocks can make to a diversified portfolio, which we will discuss. We believe mid cap stocks are in the sweet spot between small and large cap stocks and offer a number of potential benefits when compared to securities of different capitalizations and styles. In our opinion, these include:

Large and Diverse Universe

In the U.S. there are over 6,822 listed securities[8] on stock exchanges, which provide a wide breadth of companies to research and include in portfolios. A segment of the stock market that we feel to be overlooked while constructing portfolios is mid cap stocks. Currently, there are 2,147 publicly listed companies[9] that fit that description of mid cap, and the representative Russell Mid Cap Index tracks 800[10] of those companies as a baseline for performance.

Using the Global Industry Classification Standard (GICS), publicly traded companies are categorized into 11 universally excepted industry sectors: Communication Services, Consumer Discretionary, Consumer Staples, Energy, Financials, Healthcare, Industrials, Information Technology, Materials, Real Estate, and Utilities.[11]

These categories capture both the breadth and depth of global investible opportunities. A number of mid cap companies can be found within each of the listed GICS categories, with individual sector weightings ranging from 2.5% to 18.5%,[12] clearly illustrating that the mid cap category is both large (1,497 listed securities) and diverse (securities in all GICS Industry Sectors).

Growing, But Stable

For large cap companies, according to the law of large numbers,[13] there is a challenge to maintain a high growth rate. As the rate of growth slows company management's focus then typically shifts to new avenues for growth, improving profitability and returning excess cash to shareholders. On the opposite end of the spectrum, small cap companies are usually in emerging areas or niche industries where growth can be much higher but also more unpredictable, as many small cap companies tend to be in the pre-earnings stage. For small cap companies, we believe there is also much less emphasis on returning cash to shareholders. Mid cap companies can fill the spot in between, where growth is still accelerating, earnings are stable and predictable, and the companies are established in their respective markets – they can often be growing yet established. For perspective, the average 10 year historical sales growth has been 7.3% for the S&P 500, 9.9% for the Russell Mid Cap Index and 16.8% for the Russell 2000 Index (small cap).[14] Mid cap companies tend to be mature enough to have strong brands, professional management teams and we believe years of continued growth ahead of them.

Company Management

In our opinion, management is critically important to the success of any company. With mid cap companies senior executives may have significant ownership, which can more closely align their actions with shareholder interests.

As long-term investors, it is vital for us to build a relationship and trust with the leadership of a business. With a smaller shareholder base, we find mid cap management teams are willing to meet with investors allowing us to evaluate the company's outlook, opportunities, challenges, and prospects.

Underrepresented in Indices, ETFs and Investor Portfolios

Most broad market indices and ETFs are market capitalization weighted—meaning individual components are weighted according to their total market capitalization.[15] More specifically, the larger capitalized components carry higher percentage weighting; while the smaller capitalized components have lower weights. As a result, large companies have higher weights in broad market indices and ETFs than small and mid-sized companies do. In our opinion, because mid cap companies are not as prevalent in broad market indices or ETFs mid cap stock prices are less effected by passive buying and selling activity. With less passive noise, we believe clearer fundamentally based investment opportunities could exist in the mid cap segment of the market.

We have also found that the average investor has a smaller allocation to mid cap, at 13%, than is found in the universe of U.S. securities listed on stock exchanges, 22%, and within broad market-weighted indices, 19%.[16] In our opinion, the average investor is underweighting mid caps, because they feel they can adequately cover the asset class through the fringes of investments into large and small caps or the mid cap names are less well known than their large cap counterparts are. In both instances, we feel the relative underweight in mid caps presents an opportunity to find strong, well-run, underinvested businesses at potentially attractive valuations.

Underfollowed by the Street

We believe opportunity exists for fundamental investors if they are able to identify companies that are not broadly covered by sell-side analysts where in-depth research can help unearth prospects or issues that might be ignored by the broader market. The mid cap sector remains inefficient and under researched relative to the large cap universe because mid cap companies tend to have a minimal number of Wall Street analysts following the stock. The average number of analyst coverage for mid cap securities ($2–20B capitalization) within the Russell Mid Cap Index is 15. Where, by comparison, the average number of analyst coverage of large cap securities (>$20B capitalization) within the S&P 500 is 25.[17] For those stocks in the Russell Mid Cap index, analyst coverage ranges from 0 to 39 as compared to 9 to 53 for the large caps in the S&P 500.[18] We believe the true value is finding industry-leading companies that are overlooked because of size and lack of research coverage. In our opinion, having less, and, in some cases, no analyst coverage presents greater opportunity to exploit inefficiencies within the asset class.

Performance

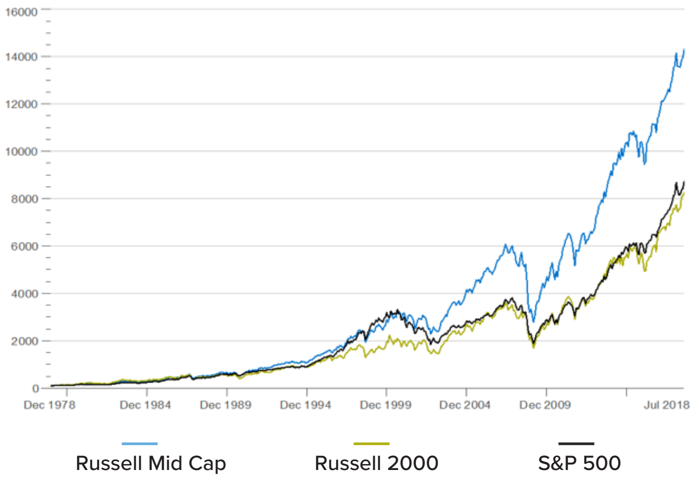
Over the past 40 years,[19] which represents the largest mid cap data set we have access to at the time of this publication, mid cap stocks have significantly outperformed both large and small caps. In fact, an investment in mid caps has outperformed large and small caps in a majority of all rolling year periods since 1979. When looking at monthly rolling ten year returns, mid cap has provided better returns than large cap 79% of the time and better returns than small cap 99% of the time.[20]

Percent of Time Mid Cap Outperforms Large and Small Caps

Rolling Year	# of Observations	%M>L	%M>S
1	381	52%	66%
3	357	55%	77%
5	333	67%	92%
7	309	73%	99%
10	273	79%	99%
15	213	93%	100%
20	153	100%	100%

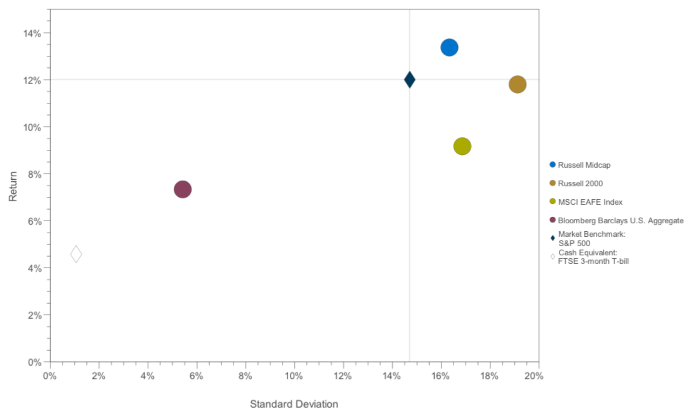
The following graphic illustrates how the Russell Mid Cap Index has outperformed both the Russell 2000 and the S&P 500 Indices over a 40-year period.[21]

Performance Across Capitalization



Risk/Return

January 1979–September 2018 (Single Computation)



Consistent Returns Create a Favorable Long Term Risk-Return Relationship

What is more interesting is the consistent performance mid caps have displayed. If you rank the calendar year performances of traditional asset classes from 1979 to 2018 mid cap was the top performer in only 2.5% of calendar years, while never being the worst performer.[22] In 85.0% of calendar years during that time period mid cap was the second, third or fourth best performer and the second or third best in 70.0% of observations.[23] Yet during this time period mid caps delivered the best absolute performance relative to the other listed traditional asset classes.[24]

The consistency of mid cap returns has led to lower volatility and less risk (as measured by standard deviation) than small caps and, over long periods of time, risk levels closer to that of large cap. Over the past 40 years mid cap displays a favorable risk-return relationship when compared to both large and small caps. The same favorable risk-return relationship holds when looking at 20 and 30 year time periods as well.[25]

Higher Long Term Risk-Adjusted Returns

The consistency of mid caps performance is also illustrated through the analysis of long term Sharpe Ratios. A Sharpe Ratio is the measure of excess return per unit of risk, or the risk-adjusted return. Mid caps have provided a favorable Sharpe Ratio relative to both small and large cap overtime. Over the past 40 years mid cap has a Sharpe Ratio of .54 versus large cap of .50 and small cap of .38 over the same time period.[26] Mid cap has a record of outperformance relative to the other asset classes on both an absolute and a risk-adjusted basis. [27]

Corporate Actions

We find large cap companies will look to acquisitions as an avenue for growth. It is important that acquisitions result in higher growth or improved profitability. As a result, mid cap companies may become attractive acquisition candidates for large cap companies. Over the last five years, we have seen over 196 acquisitions of companies with a market capitalization

Relative Return of Major Asset Classes (Calendar Years 1979–2018)

As of September 2018

	1st	2nd	3rd	4th	5th	6th
S&P 500 (Large Cap Stocks)	17.5%	12.5%	32.5%	27.5%	5.0%	5.0%
Russell Mid Cap (Mid Cap Stocks)	2.5%	45.0%	25.0%	15.0%	12.5%	0.0%
Russell 2000 (Small Cap Stocks)	25.0%	12.5%	22.5%	17.5%	7.5%	15.0%
MSCI EAFE Index (International Stocks)	32.5%	7.5%	7.5%	12.5%	17.5%	22.5%
Bloomberg Barclays US Aggregate (US Bonds)	20.0%	7.5%	2.5%	22.5%	22.5%	25.0%
FTSE 3-Month T-Bill (Treasury Bills)	2.5%	20.0%	7.5%	5.0%	32.5%	32.5%

BEST ← → WORST

between $2 billion and $20 billion, which is over 20% of all the acquisitions of publicly traded companies.[28]

We routinely see large cap companies spin-off divisions or businesses into a new publicly traded company. Generally, there is limited information about the spun-off company, which we view as an opportunity, through our research, to add value in portfolios. Over the last five years 42 of the 166 spin-offs, or 25% of all spin-offs, have emerged as mid cap.[29]

Current Conditions

The unwinding of quantitative measures by the U. S. Federal Reserve has contributed to a strengthening U.S. dollar. A stronger U.S. dollar potentially creates a headwind for large cap companies. With fewer of their business activities internationally, small and mid cap companies are not as impacted by foreign exchange issues. 43% of the revenue for S&P 500 companies is generated outside of the U.S., while only 26% of revenue for Russell Mid Cap companies and 18% of revenue for Russell 2000 companies.[30]

With a greater domestic focus, mid cap companies benefit from the recent change in U.S. corporate tax rates. Companies that have more revenue generating activities in the U.S. moved from a maximum corporate tax rate of 35% to a new tax rate of approximately 21%.[31] As a result, some companies have additional cash flow, which has been used to reinvest in the business, spend on capital expenditures, and distribute to shareholders via share repurchases or dividends.[32]

Our View

We feel mid cap stocks play an important role in a client's asset allocation as they may provide the distinctive characteristics mentioned above relative to other segments of U.S. equities. Positive absolute performance coupled with a favorable risk-return relationship contributes to higher long term risk-adjusted returns relative to large and small caps. The performance combined with mid caps being both under allocated and underfollowed tells us that opportunity exists to exploit potential inefficiencies within a large and diverse segment of the market. Investors would be well served to consider an allocation to mid caps as part of a diversified portfolio.

Our long time horizon and focus on valuation allows us to be patient investors as we watch these companies, which we trust will grow and move into larger market capitalizations. We continue to believe that the characteristics for mid cap stocks will be favorable and will add value to client portfolios.

Notes

1. Calculated by Anchor based on information found at https://www.nasdaq.com/screening/company-list.aspx
2. John Hancock Investments; Strategic Insight, Morningstar Direct 2017 - https://www.jhinvestments.com/content/dam/JHINV/Corporate/Resources/Education/etf-multifactor-mid-cap-does-your-portfolio-have-sufficient-exposure-to-mid-cap-stocks-investor-education-jhi.pdf
3. Informa Investment Solutions, Zephyr styleADVISOR/Manager vs Benchmark 1979–2018
4. Sharpe Ratio (also known as the reward-to-variability ratio) is a way to examine the performance of an investment by adjusting for its risk. The ratio measures the excess return (or risk premium) per unit of deviation in an investment asset or a trading strategy, typically referred to as risk
5. Informa Investment Solutions, Zephyr styleADVISOR//Sharpe Ratio/Time 1979-2018
6. https://www.investopedia.com/terms/r/russell_midcap_index.asp
7. FactSet financial data and analytics; Company/Security
8. Calculated by Anchor based on information found at https://www.nasdaq.com/screening/company-list.aspx
9. Ibid.
10. https://www.investopedia.com/terms/r/russell_midcap_index.asp
11. https://www.msci.com/gics
12. FactSet financial data and analytics; Company/Security
13. https://www.investopedia.com/terms/l/lawoflargenumbers.asp: The law of large numbers indicates that, as a business expands, the percentage rate of growth becomes increasingly difficult to maintain.
14. FactSet financial data and analytics; sales growth chart
15. https://www.investopedia.com/terms/c/capitalizationweightedindex.asp
16. John Hancock Investments; Strategic Insight, Morningstar Direct 2017 https://www.jhinvestments.com/content/dam/JHINV/Corporate/Resources/Education/etf-multifactor-mid-cap-does-your-portfolio-have-sufficient-exposure-to-mid-cap-stocks-investor-education-jhi.pdf
17. FactSet financial data and analytics; Company/ Security/ all estimates
18. Ibid.
19. The 40 year time frame referenced, 1979–2018, represents the largest mid cap data set accessible at the time of publication.
20. Informa Investment Solutions, Zephyr styleADVISOR/Returns/Time 1979–2018
21. Informa Investment Solutions, Zephyr styleADVISOR/Manager Performance 1979–2018
22. Informa Investment Solutions, Zephyr styleADVISOR/Calender Year Returns 1979–2018
23. Ibid.
24. Ibid.
25. Informa Investment Solutions, Zephyr styleADVISOR/Risk/Return 1979–2018

26. Informa Investment Solutions, Zephyr styleADVISOR/Risk/Return 1998–2018, 1988–2018

27. Absolute basis or terms is defined as, the absolute return being whatever the asset or portfolio returned over a certain time period. Risk adjusted basis is defined as, Risk-adjusted return refines an investment's return by measuring how much risk is involved in producing that return, which is generally expressed as a number or rating. Risk-adjusted returns are applied to individual securities, investment funds, and portfolios.

28. FactSet financial data and analytics; M&A transaction report

29. FactSet financial data and analytics; screening/ idea screening/ mergers & acquisitions/ FactSet mergers (mergerstat/ mergermetrics)

30. FactSet financial data and analytics; Portfolio analytics report

31. https://www.reuters.com/article/us-usa-tax-provisions-factbox/whats-in-the-final-republican-tax-bill-idUSKBN1ED27K

32. http://time.com/money/5267940/companies-spending-trump-tax-cuts-stock-buybacks/

Index Definitions

S&P 500 Index: widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large-cap segment of the market, with about 75% coverage of U.S. equities, it is also an ideal proxy of the total market.

Russell Mid Cap Index: offers investors access to the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is constructed to provide a comprehensive and unbiased barometer for the mid-cap segment and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid-cap opportunity set. The Russell Midcap Index includes the smallest 800 securities in the Russell 1000.

Russell 2000 Index: offers investors access to the small-cap segment of the U.S. equity universe. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set. The Russell 2000 includes the smallest 2000 securities in the Russell 3000.

MSCI EAFE Index: the MSCI EAFE Index (Europe, Australasia, Far East) is a free float- adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

FTSE 90-Day Treasury Bill Index: measures the average return of the last three-months U.S. Treasury Bill issues. U.S. Treasury Bills are short-term securities issued by the U.S. government with maturities of up to one year. They are backed by the faith and credit of the U.S. government who guarantees full payment of principal and interest at maturity.

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. The components of this index are as follows:

Government/Credit Index: the Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Government Index: securities issued by the U.S. Government (i.e., securities in the Treasury and Agency Indices).

Treasury Index: public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Agency Index: publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB). The index includes both callable and noncallable agency securities.

Credit Index: publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

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