WHITE PAPER

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HARDLY 'MID', NO CAP: THE CURIOUS CASE OF THE MISSING MID CAPS

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EXECUTIVE SUMMARY:

- Ranging between \$5 - \$60 billion, mid cap stocks comprise roughly a quarter of the U.S. equity universe.
- Most investors underweight mid cap stocks compared to the addressable marketplace.
- Mid caps tout a strong risk/return profile historically and attractive valuations presently.
- Industries like Trucking, Cruise Lines, Homebuilders, and REITs are best accessed via mid caps.
- Active managers are well-positioned to capitalize on mid cap informational inefficiencies via specialized research and stock selection skills.
- Investors should consider a higher allocation to actively managed, mid cap stocks.

The overall capitalization level of the U.S. market has expanded substantially over the past decade; mid caps included. Once characterized as the \$2 - \$10 billion range, today's mid cap companies reflect valuations between \$5 - \$60 billion; averaging out at \$24 billion.

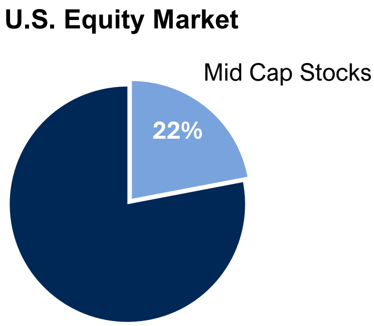
	Average (\$B)	Max (\$B)
Large Cap	991	3,475
Mid Cap	24	61
Small Cap	3	11

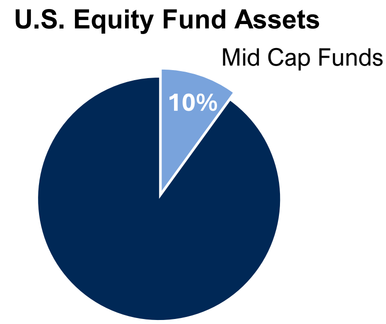
Source: FactSet. Data as of 7/7/24. Indexes used:
Large Cap R1000, Mid Cap RMC, and Small Cap R2000.

Standing at nearly a quarter of the addressable universe by name[1] with valuations in the tens of billions a piece, it's fair to say that mid cap companies comprise a statistically significant segment of the U.S. market. Yet data suggests that institutional and individual investors remain significantly under allocated to the space.

Most investors hold less than half the mid cap stock exposure versus to the addressable market, as represented by the Russell 3000. Per Morningstar, the average U.S. investor's exposure stands near 10%, when compared to the index's 22%. This deficiency is even greater in the \$11 trillion Defined Contribution space, where small and mid caps combined comprise only 7.2% of U.S. retirement plan assets, as reported by Callan[2]. Why?

[1] Russell 3000 Index captures approximately 98% of listed U.S. stocks. Mid cap companies typically comprise 22 - 26% of the index by name and 6 - 8% by revenue.
[2] Callan Research Institute, March 31, 2024, data





Source: FactSet, FTSE Russell and Morningstar Direct, as of 3/31/24. U.S. Equity Market = Russell 3000 Index. Mid-Cap Equity Market = Russell Midcap® Index. U.S. Equity Fund Assets = Morningstar U.S. Mid-Cap categories.

Some investors choose to eschew mid caps entirely. This decision can be based on any number of reasons: fundamental, technical, lack of familiarity, et al. But these investors purposefully avoid mid cap ownership.

Another camp prefers to access mid caps via SMID mandates. However, there are structural issues at play here: unless the SMID manager is SIGNIFICANTLY overweight mid caps, this approach dilutes an investor's exposure, splitting an already small piece of the portfolio pie into a "sub-slice".

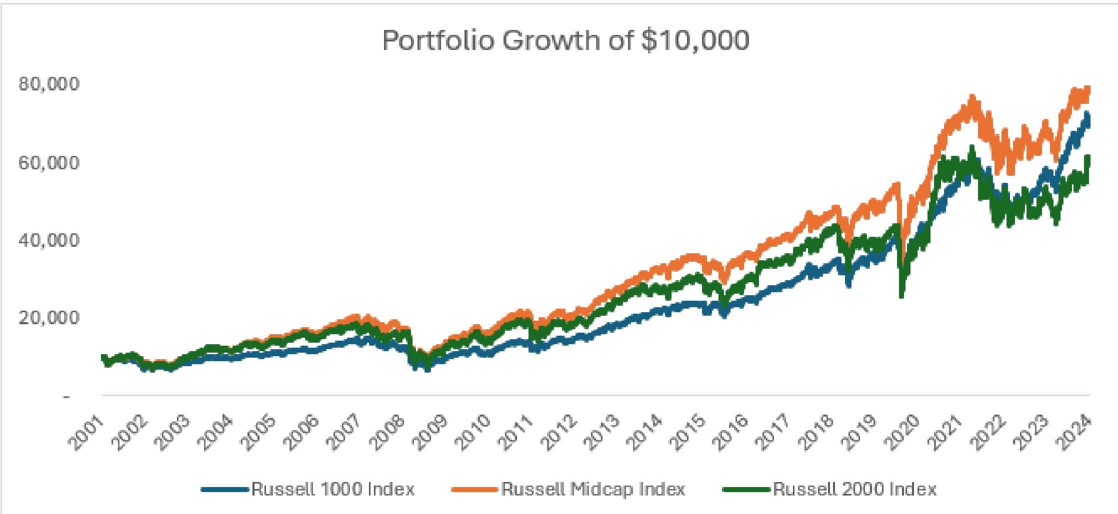
Still others employ a "barbell" approach, reasoning that a combination of small and large cap exposure "averages out" to mid cap ownership. This method is fundamentally flawed. Owning small and large cap stocks averages out to owning small and large cap stocks; you don't own mid caps.

Interestingly, some categories are accessible almost exclusively via the mid cap market. The chart below is a partial list of S&P industries with the largest company in each. For example, the largest Auto Components manufacturer holds a $17.8 billion valuation. A stock of this size may be too small for a large cap mandate, leaving large cap managers unable access the Auto Component space. With limited exception, these industries are <u>not</u> represented within the large and mega cap universe. The dominant players in these categories are mid caps. While investors *can* gain access via small cap stocks, the benefits of owning the larger and more well-funded companies often outweigh the risks of owning their smaller competitors.

Industry	Largest Company	Ticker	Mkt Cap ($B)
Video Gaming	Electronic Arts	EA	$38.6
Auto Components	Aptiv	APTV	$17.8
Casinos	Las Vegas Sands	LVS	$28.8
Cruise Lines	Royal Caribbean	RCL	$39.1
Homebuilders	DR Horton	DRI	$56.9
Grocery Stores	Kroger	KR	$37.8
Trucking	Old Dominion	ODFL	$41.2
Airlines	Delta	DAL	$25.1
Copper	Freeport-McMoRan	FCX	$59.8
Retail REITs	Simon Properties	SPG	$58.7

Source: FactSet

Since 2000, mid cap stocks have outperformed their peers with only slightly elevated volatility versus large caps and lower versus small. Also, mid cap stocks are efficient with their risk, touting a Sharpe ratio far exceeding that of small caps, while effectively matching that of large.



Index	CAGR	Std. Dev.	Sharpe Ratio
Russell 1000	8.92%	13.98%	0.58
Russell Midcap	9.48%	15.53%	0.57
Russell 2000	8.23%	17.09%	0.45

Source: FactSet

While indexing the space is indeed an option, we believe that active managers hold a decisive edge versus passive. A lack of sell-side research offers mid cap specialists the opportunity to assess idiosyncratic strengths and weaknesses: identifying the best- while avoiding the worst- companies for investment.

Active managers also hold an empirical advantage. Concentrated, high-conviction portfolios typically yield the most attractive results. Tracking error and active share measure a portfolio's differentiation versus its index. Research confirms that managers with strong selection skills, a repeatable process and high Active Share are those who outperform the market most consistently[3].

[3] Based on the work of Martijn Cremers and Antii Petajisto (source: "How Active is your Fund Manager" University of Notre Dame, 2000) and countless studies since.

CONCLUSION:

All investors hold large cap stocks and most hold small caps. Yet many underweight or entirely avoid mid cap stocks. These investors are missing out.

Mid cap companies exhibit lower risk than small caps yet, possess solid growth potential. Mid cap companies have attractive risk/return profiles and trade at discounted valuations to large caps today. Finally, attractive investment opportunities in Trucking, Cruise Lines, Homebuilders and other categories exist almost exclusively within the mid cap universe.

Active managers are well-positioned to identify strong mid cap names. And a high conviction, high active share approach to portfolio construction typically delivers the most attractive results to investors. As such, most would likely benefit from a higher allocation to actively managed, mid cap stocks.

ABOUT US:

Vaughan Nelson is a $18 billion, Houston-based investment manager focused U.S. and International equity strategies. Vaughan Nelson constructs factor diversified, high active share portfolios with a targeted return philosophy seeking a 50% return over a three-year holding period, with an asymmetric risk profile.

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