

Viewpoint

Mid-Cap Stocks: A Proven, Underweighted Portfolio Diversifier

Staying in the middle lane may not work on certain roads. However, the middle of the U.S. stock market has been a time-tested path to reaching long-term financial goals. In fact, mid-cap companies have provided one of the most attractive mixes of risk and return of any asset class over the past several decades. This paper examines how mid-caps, a road less traveled by, have behaved since the 1970s. We highlight the benefits that we believe mid-caps can offer within a well-rounded portfolio.

Key Traits of Mid-Cap Stocks

There are more than 6,000 public companies listed on the New York Stock Exchange or traded on NASDAQ in the U.S. Medium-size companies comprise more than a quarter of this universe, representing about \$3.4 trillion in market capitalization. They can be found across every sector of the economy, and they typically share certain characteristics:

Earnings growth – Mid-cap companies are often in the accelerating growth phase of their lifecycle, or in stable industries where competition may be limited.

Financial strength – Mid-cap companies typically have greater liquidity and capital-raising ability than small-caps.

Information gap – Mid-cap companies typically receive less attention from Wall Street analysts than large companies. Less available research often provides active managers more opportunity to proactively evaluate a company and capitalize on stock market inefficiency.

Bigger pool, liquid fish – There are more than 1,500 mid-cap companies, three times the number of large-cap companies. Average daily trading volume of the typical mid-cap stock is about 500,000 shares, twice that of small-cap stocks.

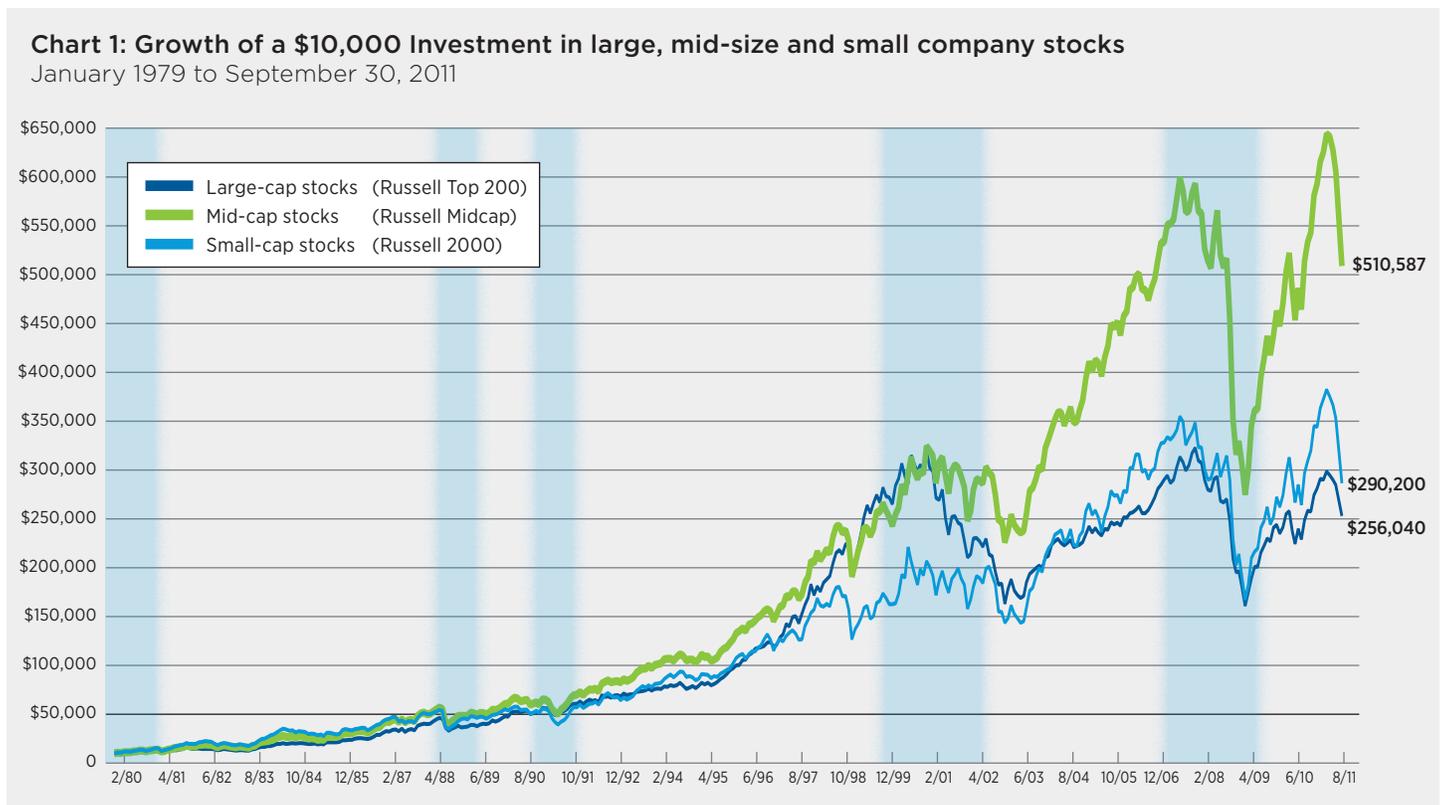
The Mid-Cap Track Record and Opportunity

Outperformance over full market cycles

Mid-caps have outpaced stocks of larger and smaller size companies over multiple periods. Mid-caps have historically outperformed small-caps heading into recessions and have historically done well in periods following stock market bottoms, as shown below in Chart 1. U.S. recessions since 1980 are shown as shaded portions of the chart.

Over full market cycles, the prices of U.S. stocks of all sizes have historically moved up and down in tandem with corporate earnings and investors' perceptions about what will happen in the

future to individual companies and the U.S. and global economies. Despite the unique economic challenges of the past decade, we believe mid-cap stocks have enjoyed distinct advantages, traits that have enabled them to outperform large-cap and small-cap stocks since 1979, as illustrated below.



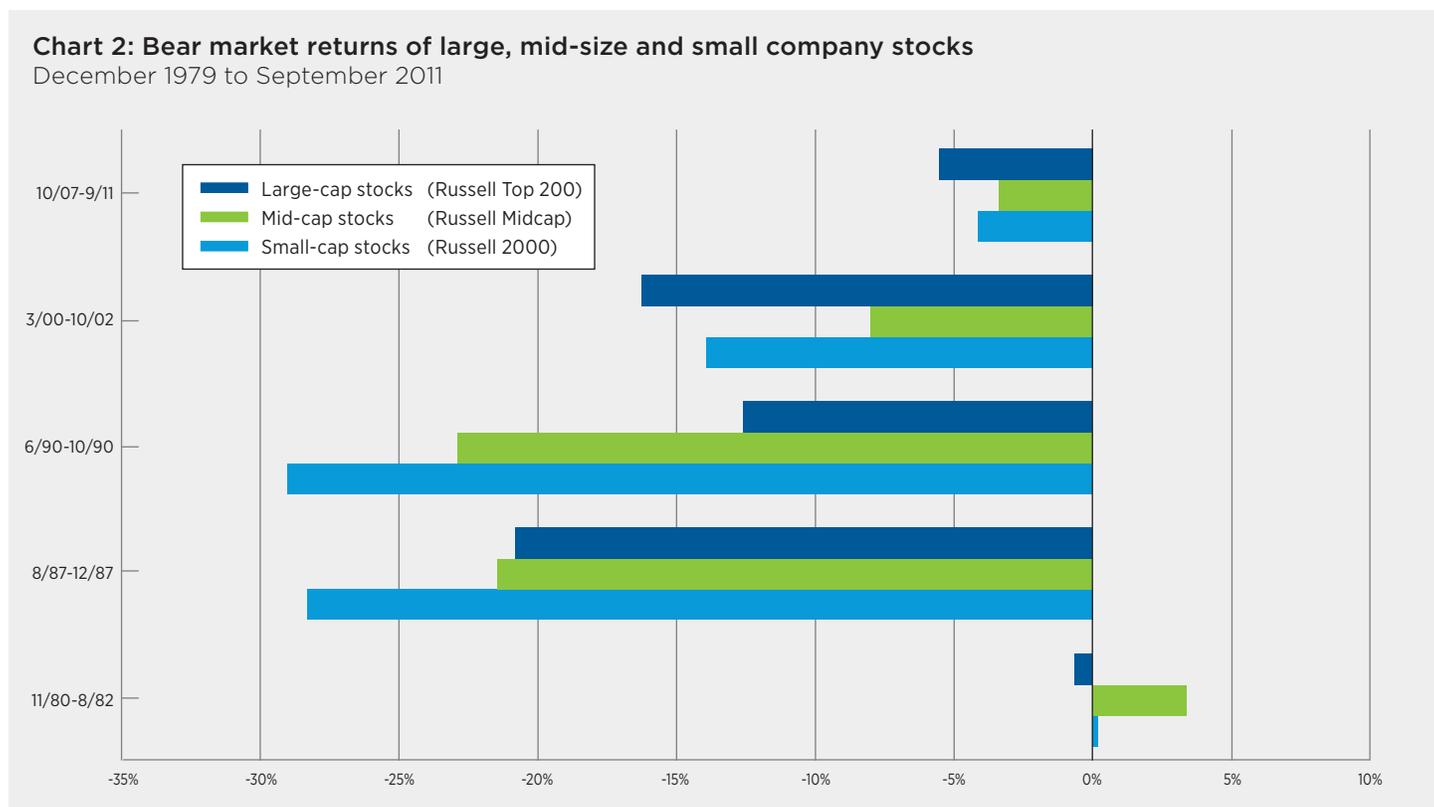
Past performance does not guarantee future results. It is not possible to invest directly in an index. The above line chart is for illustration purposes only and not intended to represent past or future performance of any product offered by Scout Investments. The Russell Midcap Index was inceptioned in Dec. 31, 1978.

Source: Russell Family of Indexes as of Sept. 30, 2011

A compelling mix of risk and reward

In the summer of 2011, many mid-cap stocks exhibited volatility levels that were consistent with small-caps. However, over longer periods the behavior of mid-caps has been closer to that of large-cap stocks. If one takes a look at how mid-caps have performed during bear markets, one can see that mid-caps outpaced small-caps during each of the five market drops of 15% or more since 1980. Over the same period, mid-caps also outpaced large-caps three of five times, including the most recent “Great Recession” period since October 2007. (See Chart 2).

To more clearly show performance differences between large and mid-size companies, we have used the Russell family of indexes in Charts 1 and 2. The S&P 500 Index, one of the most widely followed measures of stock performance, is actually a blend of both large and mid-size companies. We have used the Russell Top 200 Index to provide a clearer illustration of historical large-cap returns. On the next page, Table 1 details the returns of each index.



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Source: Russell Family of Indexes as of Sept. 30, 2011

The *Russell Top 200 Index* is a market capitalization weighted index and a benchmark index for U.S.-based large-cap stocks; the average member has a market cap above \$100 billion. The *Russell Top 200* is a more concentrated index than the S&P 500, although most of the *Russell Top 200* members are also included in the S&P. The *Russell Top 200* Index represents approximately two thirds of the total market capitalization of all U.S. listed stocks.

An underweighted category in many portfolios

Mid-cap stocks represent an underweighted asset class for many investors. Conversely, as can be seen in Chart 3, large-cap exposure is often overweighted. This is due in part to the perceived safety of larger companies and the result is that U.S. investors have only about half the exposure to mid-caps within their portfolios compared to mid-caps' share of the equity market as a whole. In fact, as equity market volatility increased in 2011, investors generally sold a greater percentage of assets from mid-cap funds than other categories of stock funds.

Table 1 below shows that mid-caps outpaced large-caps and small-caps for the 3-, 5-, 10- and 20-year periods ended Sept. 30, 2011. The mid-cap advantage has been strong over the past decade as large-caps languished.

Chart 3: The asset mix within the U.S. stock market and within equity fund portfolios

As of Sept. 30, 2011

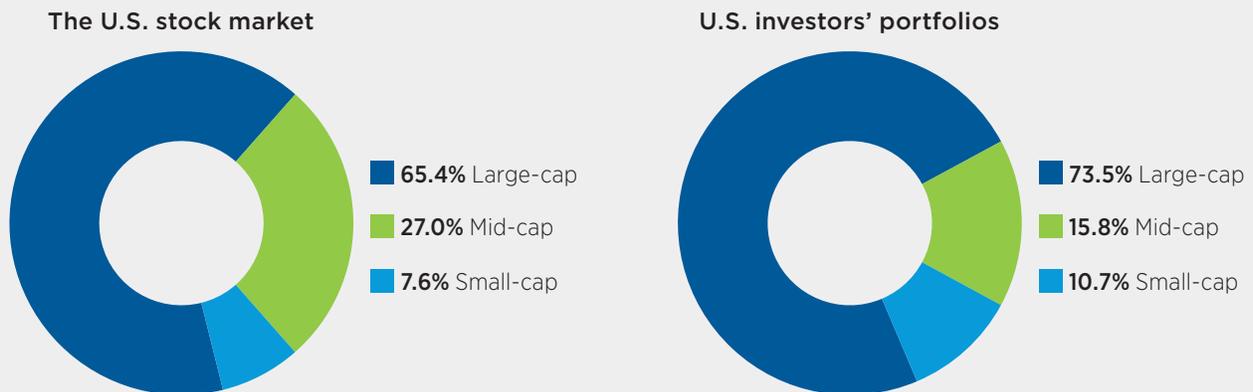


Table 1: Large-, Mid- and Small-Cap Stock

Average Annual Total Returns

As of Sept. 30, 2011

	1 year	3 years	5 years	10 years	20 years
Russell Top 200	1.67%	0.72%	-1.46%	1.85%	7.14%
Russell Midcap	-0.88%	3.96%	0.56%	7.45%	10.06%
Russell 2000	-3.53%	-0.37%	-1.02%	6.12%	8.05%

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Sources: Russell Family of Indexes and Morningstar, as of Sept. 30, 2011

A Lost Mid-Cap Opportunity: Too Much Faith in Large-Caps Has Costs

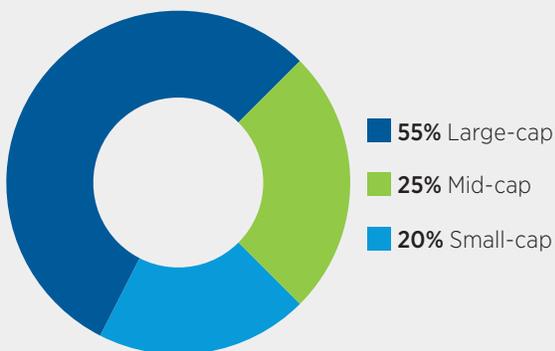
Historically, a large-cap-focused asset allocation plan has cost U.S. investors more in return than it has “saved” in avoided risk.

Having a 25% equity portfolio allocation to mid-cap stocks – a position comparable to mid-caps’ overall representation with the stock market – over the past 1-, 3-, 5- and 10-year periods would have produced materially higher returns with a modest increase in volatility, as shown below in Chart 4.

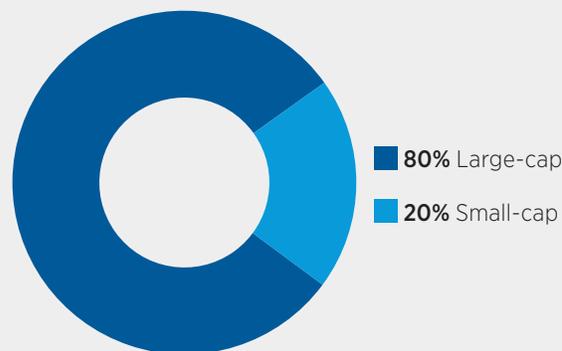
While investors’ allocation to mid-cap stocks should be consistent with their overall risk tolerance and goals, reallocating from either large-caps or small-caps to mid-caps has historically improved the diversification of a portfolio and resulted in more attractive risk-adjusted returns, as shown below.

Chart 4: Comparison of Average Annual Total Return, Risk and Sharpe Ratios
Two portfolios: A mid-cap-neutral portfolio vs. a mid-cap-free portfolio
 As of Sept. 30, 2011

Mid-cap-neutral portfolio (A)



Mid-cap-free portfolio (B)



Portfolio	Total Return		Standard Deviation		Sharpe Ratio	
	A	B	A	B	A	B
1 year	0.10%	0.73%	15.16%	14.34%	0.00%	0.04%
3 years	1.41%	0.58%	22.95%	21.67%	0.05%	0.02%
5 years	-0.77%	-1.31%	19.61%	18.57%	-0.12%	-0.16%
10 years	4.18%	2.77%	16.71%	16.00%	0.14%	0.05%

Past performance does not guarantee future results. It is not possible to invest directly in an index. The above line chart is for illustration purposes only and not intended to represent past or future performance of any product offered by Scout Investments. Standard deviation is a statistical measure of price volatility. The reward-to-risk ratio, or Sharpe ratio equals total return, minus risk-free return (T-bill rate), divided by standard deviation.

Analysis and Insights from Scout Investments

December 2011

Conclusion

Evaluating U.S. stocks by size to help diversify and manage a portfolio has been a proven investment technique since the early 1960s. Beginning in the early 1980s, with a “nine-box” mix of investing styles, mid-caps began to be appreciated as a distinct type of stock category with unique performance and risk characteristics. This recognition process is still ongoing, given how investors allocate equity resources.

At Scout Investments, we strongly believe that having an appropriate allocation to mid-caps is a vital factor for any U.S. stock market investor and financial advisor to consider in building a plan to achieve long-term goals.

Mid-cap stocks include a wide universe of U.S.-based companies that historically have had an attractive combination of:

- Earnings growth
- Financial strength
- Market liquidity

We believe there is also an information gap in the equity market about mid-caps that active management teams can potentially exploit. When paired with a consistent, disciplined effort to deliver long-term performance and manage risk, a mid-cap portfolio appears to us to be one of the most compelling investing opportunities available in the U.S. stock market.

To research opportunities for allocating a portion of your portfolio to mid-caps with the help of Scout Investments, contact us today at 877.726.8842 or visit scoutinv.com.



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