Mid Cap Value Stocks:
20 Years of Outperformance

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White Paper Overview

The first in a three-part series examining the risk and return profiles of the three main capitalization groups, with a particular focus on middle capitalization stocks.

Small and Large Capitalization Stocks

The market for US equities is an ultra-competitive environment where thousands of the brightest minds compete day in and day out to make a return on their investment. Information is processed instantaneously and obvious opportunities or anomalies are believed by many to be competed away in a relatively short amount of time as the market is perceived to be too efficient to allow otherwise.

However, when examining total return data for various indices over extended periods, the results appear to be far from efficient. Investment Analyst Adam West, CFA, and Portfolio Manager Chad Baumler, CFA, of Nuance Investments, LLC (Nuance) recently examined the Russell Indices' total return data for the previous 20 years and observed that the results were far from identical. The small capitalization (small cap) stocks in the Russell 2000® Index outperformed the large capitalization (large cap) stocks in the Russell Top 200® Index over this time frame.

Starting Point: Small vs. Large Cap Stocks

January 1994- December 2013	Total Return	Annualized Return
Russell Top 200 Index	445%	8.8%
Russell 2000 Index	489%	9.3%

Monthly return data provided by Russell

The authors realize that to the astute investor this is not a novel idea. In fact, most would predict this outcome. The small cap vs. large cap phenomenon has been well-documented with multiple studies concluding that small cap stocks outperform large cap stocks over an economic cycle.

Although the difference in rate of return cannot be refuted, this does not represent, in our opinion, an untapped anomaly or arbitrage opportunity. It is logical and can be explained through the concept of risk-adjusted returns. Contrary to what some investors and investment managers claim during more risk-agnostic periods of the economic cycle, there is indeed more potential risk in holding a small cap stock than there is in holding a large cap stock. The risk can manifest itself in multiple forms such as business operational risk, balance sheet financing risk and trading liquidity risk.

When comparing the annualized returns of each index to its risk, a different story emerges. While the Russell 2000 Index did have a higher annualized return, it also provided the investor with significantly higher risk (annualized standard deviation of monthly returns is being used as an estimate of risk). By dividing the annualized return by risk, a risk-adjusted return ratio is created and this shortcoming is brought to life. The Russell Top 200 Index had approximately 40 basis points (bps) less in annualized return and over 400 bps of less risk, leading to a notably higher risk-adjusted return ratio. To put it another way, while the Russell 2000 Index had a higher annualized return than the Russell Top 200 Index, it was not enough to compensate an investor for the increased level of risk and proved to be an inferior investment from a risk-adjusted perspective, in our opinion.

Step One: Adding Volatility

January 1994- December 2013	Total Return	Annualized Return	Standard Deviation	Return/Risk
Russell Top 200 Index	445%	8.8%	15.3%	0.58
Russell 2000 Index	489%	9.3%	19.7%	0.47

Monthly return data provided by Russell

For more information on the calculation of the statistics shown, please see the disclaimer or contact Nuance.

Middle Capitalization Stocks

Recently, a variety of research reports and white papers have been written citing the attractive absolute performance of middle capitalization (mid cap) stocks. An analysis similar to the one above was performed for the Russell Mid Cap Index® to examine the risk-adjusted characteristics of the performance and to potentially debunk the idea that mid cap stocks offer a higher return than is justified.

Mid cap stocks displayed the highest annualized return of the three cap groups by a wide margin. This was not unexpected given the high level of publicity that mid cap stocks have recently received. However, what was surprising was the lower level of risk and higher level of risk-adjusted return ratios the index exhibited over the last 20 years. Annualized returns were approximately 200 bps higher than the other Russell Indices while providing roughly the same or less risk. The data suggests that from a risk-adjusted return perspective mid cap stocks were the most attractive.

Step Two: Adding Mid Cap Stocks

January 1994- December 2013	Total Return	Annualized Return	Standard Deviation	Return/Risk
Russell Top 200 Index	445%	8.8%	15.3%	0.58
Russell 2000 Index	489%	9.3%	19.7%	0.47
Russell Mid Cap Index	735%	11.2%	16.9%	0.66

Monthly return data provided by Russell

For more information on the calculation of the statistics shown, please see the disclaimer or contact Nuance.

Furthermore, it was interesting to discover that the attractive risk-adjusted return profile of the Russell Mid Cap Index was not evenly spread over its members but instead accrued primarily to the value constituents included in the Index. Annualized total return for the Russell Mid Cap Value Index® was higher than the other indices, including the Russell Mid Cap Growth Index®, by 200 bps or more while impressively having displayed approximately equal or less risk. This unique relationship became evident when comparing the risk-adjusted return ratios of the four different indices. The Russell Mid Cap Value Index was the clear leader.

Final Step: Segmenting the Russell Mid Cap Index

January 1994- December 2013	Total Return	Annualized Return	Standard Deviation	Return/Risk
Russell Top 200 Index	445%	8.8%	15.3%	0.58
Russell 2000 Index	489%	9.3%	19.7%	0.47
Russell Mid Cap Growth Index	524%	9.6%	21.3%	0.45
Russell Mid Cap Value Index	805%	11.6%	16.2%	0.72

Monthly return data provided by Russell

For more information on the calculation of the statistics shown, please see the disclaimer or contact Nuance.

Concluding Thoughts

The risk-adjusted return analysis provided some important insights. First, while small cap stocks outperformed large cap stocks over the previous 20 years, they also exhibited higher levels of risk and from a risk-adjusted perspective, may have actually been an inferior investment. Second, much like others' total return research on mid cap stocks, the research performed demonstrated that mid cap stocks have displayed the highest annualized returns of the three main cap groups over the same period.

Alternatively, the analysis raised a few questions. What caused mid cap stocks to outperform the other cap groups over such an extended period of time and why were the high returns concentrated within the value constituents? Furthermore, why did the higher returns not come with higher risk? Is this an anomaly that represents a legitimate investment opportunity?

Be on the lookout for Part 2 of this series entitled "20 Years of Experience," when Adam and Chad interview Scott Moore, CFA, founder and Chief Investment Officer of Nuance. Scott, who has over 20 years of experience investing in the mid cap space, shares his thoughts and opinions regarding the attractive risk and return characteristics of mid cap value stocks.

Disclaimer and Notes

Past performance is not indicative of future results.

Return figures for all indices are provided by Russell. Returns are calculated from January 1, 1994 to December 31, 2013. Risk adjusted return ratio is calculated by dividing the annualized return by risk.