THE MISSING PIECE | Mid Caps

Why Invest in Mid-Cap Equities Now?

By Matt Orton, CFA, and Mark Pera, CIMA, AIF

CARILLON TOWER ADVISERS

Amid the historic rise in U.S. equity markets from the COVID-19-driven lows in March 2020, most of the narrative has focused on the outperformance of mega-cap technology and small caps. However, one asset class has received little attention throughout the rebound: mid caps.

Although mid caps tend to be under-owned and absent from market dialogue, most of us are generally familiar with some of their key advantages: strong earnings growth potential, stable balance sheets, high-quality management, and potential inefficiencies as they are underrepresented in portfolios and sometimes not regarded as a discrete asset class. Perhaps most importantly, mid caps offer competitive risk-adjusted returns relative to small, SMID, and large capitalizations, even after the big runs that both mega-cap technology and small-cap companies have experienced over the past year.

While the advantages of mid caps are fairly compelling, one must still consider the current environment and ask why it makes sense to invest in this asset class now? After all, mid caps already have rebounded strongly, surging 112.7% from the market low on March 23, 2020, through Sept. 30, 2021. History shows strong, durable mid-cap performance, particularly following periods of sharp market volatility like the "corona crash," the Global Financial Crisis (GFC), or the bursting of the tech bubble. In fact, mid caps have historically performed best in modest-GDP growth environments, like we saw after these market events — and what we are likely to witness as the current economy recovers. The key is that this performance is not transitory, but can last longer term.

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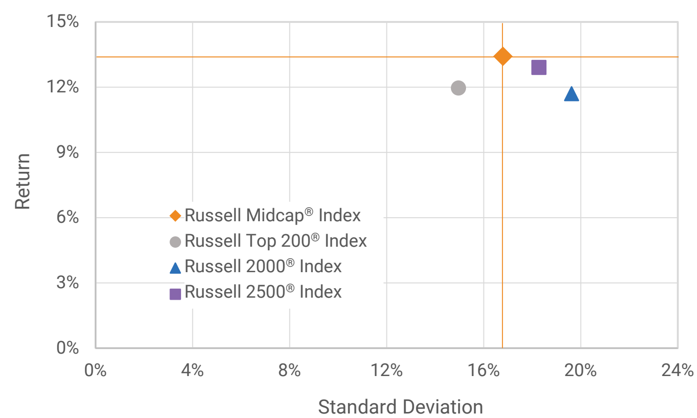
Mid caps have provided stronger risk-adjusted returns than the other capitalization ranges

Russell index performance and standard deviation (1/1/1979 – 9/30/2021)



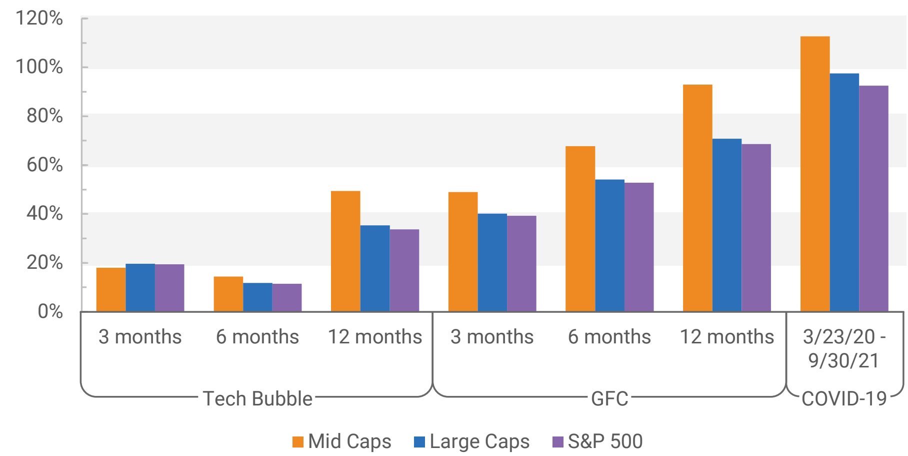
Source: Russell, as of 9/30/2021

	Annualized Return	Standard Deviation	Sharpe Ratio
Russell Midcap	13.43%	16.80%	0.54
Russell Top 200	11.97%	14.96%	0.50
Russell 2000	11.71%	19.62%	0.37
Russell 2500	12.91%	18.27%	0.46

Source: Bloomberg, as of 9/30/2021

Mid caps are resilient in recovery environments

Performance of mid caps over time periods following market crashes



3m, 6m, 12m periods calculated post market lows of 10/9/02, 3/9/09, 3/23/20.
Source: Bloomberg, as of 9/30/2021

Additionally, as geopolitical concerns increase and global growth concerns linger, companies with more leverage to the U.S. economy could provide additional safety. Mid-cap equities are actually very similar to small-cap companies with respect to U.S. revenue exposure – the Russell Midcap® Index derives 70.3% of revenues domestically and the Russell 2000® derives 78.2%, while the Russell 1000® gets only 61.5% from the U.S. This domestic focus mattered in 2019 when mid caps outperformed large caps for the first three quarters as trade tensions intensified.

While mid caps might stay under the radar in typical market dialogue, this asset class boasts the best risk-adjusted returns, has performed the best in modest growth GDP environments, can benefit from a larger U.S. focus, and remains underinvested. These characteristics all provide tailwinds for mid caps going forward.

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Risk Considerations: Investments in mid-cap and small-cap companies generally involve greater risks than investing in larger capitalization companies. Mid-cap companies often have narrower commercial markets, more limited managerial and financial resources, and more volatile trading than larger, more established companies.

Mid-cap and small-cap stocks may temporarily fall out of favor or perform poorly relative to other types of investments. While stocks of mid-cap companies may be slightly less volatile than those of small-cap companies, they still involve substantial risk.

Growth companies are expected to increase their earnings at a certain rate. When these expectations are not met, investors may punish the stocks excessively, even if earnings showed an absolute increase. Growth company stocks also typically lack the dividend yield that can cushion stock prices in market downturns. The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence. The values of these companies tend to fluctuate sharply.

Real Estate Investment Trusts (REITS) may be affected by economic conditions including credit risk, interest rate risk and other factors that affect property values, rents or occupancies of real estate.

Foreign investments present additional risks due to currency fluctuations, economic and political factors, government regulations, differences in accounting standards and other factors. Investments in emerging markets involve even greater risks. Groups of stocks, such as value and growth, go in and out of favor, which may cause certain portfolios to underperform other equity portfolios.

DEFINITIONS

Risk is measured by standard deviation. Standard deviation measures the risk or volatility of an investment's return over a particular time period; the greater the number, the greater the risk.

Sharpe ratio: a measure that indicates the average return minus the risk-free return divided by the standard deviation of return on an investment.

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The Russell 2500® Index measures the performance of the smallest 2,500 companies covered in the Russell 3000® index, which represents approximately 19 percent of the total market capitalization of the Russell 3000® Index.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8 percent of the total market capitalization of the Russell 3000® Index.

The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.

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