Why Mid-Cap?

AN EXCERPT OF A WHITE PAPER FROM RIDGEWORTH INVESTMENTS

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Introduction

Mid-caps have long been left out of basic asset allocation models, to the detriment of long-term investors. Although they make up approximately 27% of the domestic equity universe, only 15% of mutual fund assets invested in Morningstar's equity style box are invested in funds that are classified as mid-cap (as of 12/31/09).

Mid-caps have far outpaced large and small caps over the past 30 years, and have beaten them in a majority of rolling periods within it. They have generally protected the downside better than small caps going into recessions and bounced back faster than large caps coming out – providing a risk-adjusted return that has been superior to both. A portfolio that included a specific allocation to mid-cap stocks had a better risk/reward relationship than a portfolio without over short and long time periods.

Those who invested in funds benchmarked to the Russell 1000 Index in an attempt to satisfy mid-cap exposure have generally not realized the full benefits of mid-caps. The mega-caps within the Russell 1000 (Russell 200 Index) have had a disproportionate impact on the returns of the Russell 1000 over the past 30 years, dampening the positive impact of the mid-caps in the index. If an investor has not made a specific allocation to mid-caps, now may be an opportune time to add them.

A Long Record of Outperformance

An investment in mid-caps in 1979 would have significantly outpaced large, smid and small caps over the next three decades (see Exhibit 1). A $10,000 investment in mid-caps would have grown to nearly $470,000 — $175,000+ greater than either large or small caps.

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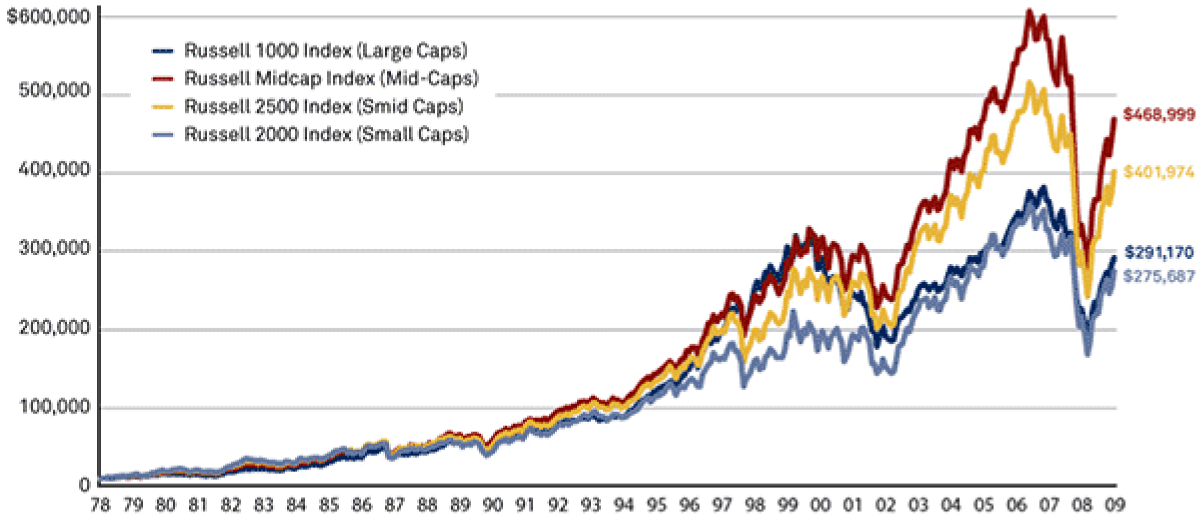
EXHIBIT 1: Growth of a $10,000 Investment in Select Russell Indices Since 1979



Source: Russell Family of Indexes, Fact Set, 12/31/09. Past performance does not guarantee future results.

A Consistent Record of Outperformance

Mid-cap stock outperformance has been consistent over time. Over rolling time periods ranging from 1 to 10 years, mid-caps have outperformed large and small caps well over half the time. In rolling 10-year periods, mid-caps outperformed small caps every single time. (*see Exhibit 3 and visit* www.addmidcap.com *to test the claim*). The importance of the 10-year period, where mid-caps have exhibited their highest rate of outperformance, is that it has often captured both recessionary and expansionary periods.

The most recent 10-year period includes the current recession beginning December 2007, the previous recession which lasted from April 2001 through November 2001 and the expansionary period in between.

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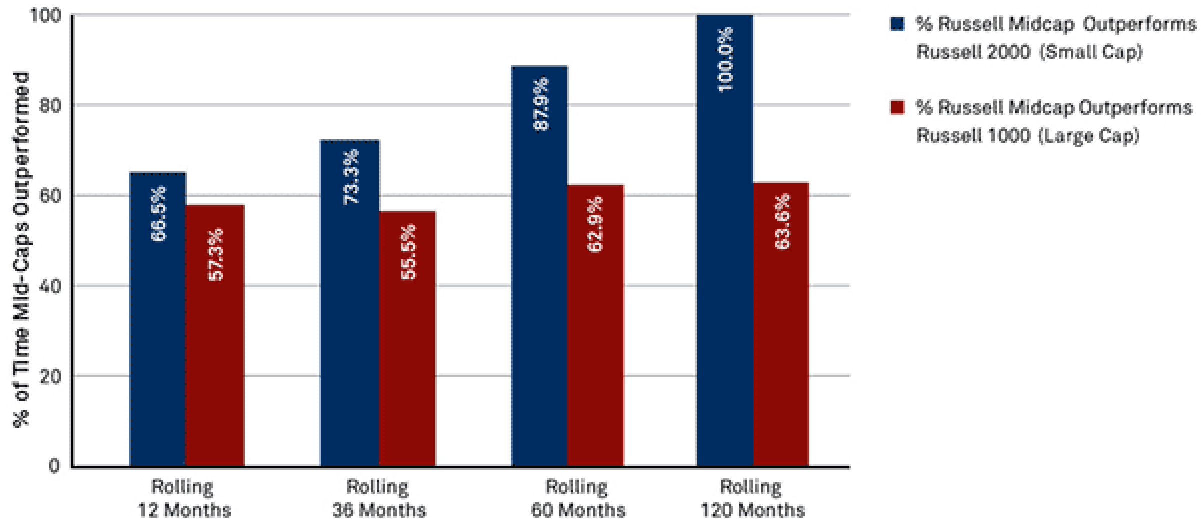
EXHIBIT 3: Percent of Time Mid-Caps Outperform Large and Small Caps



Annualized performance of the Russell Midcap, Russel 1000 and Russell 2000 Indices

	1 YR	3 YR	5 YR	10 YR
Russell 1000	28.43	-5.36	0.79	-0.49
Russell Midcap	40.48	-4.59	2.43	4.98
Russell 2000	27.17	-6.07	0.51	3.51

Source: Russell Family of Indexes, Fact Set, 12/31/09. Past performance does not guarantee future results.

A Better Risk-Reward Relationship

Though mid-caps have exhibited volatility levels that are more consistent with their small-cap peers since the start of the current recession, over longer time periods the standard deviation of mid-caps has been closer to large caps. Higher absolute returns relative to both large cap and small cap stocks and standard deviation that is more aligned with large caps have provided mid-cap investors with a superior risk/reward relationship. Using the Sharpe Ratio as a measure of risk/reward, mid-caps had a higher Sharpe Ratio than large, smid and small caps over each of the periods ranging from three to 30 years. (see Exhibit 4)

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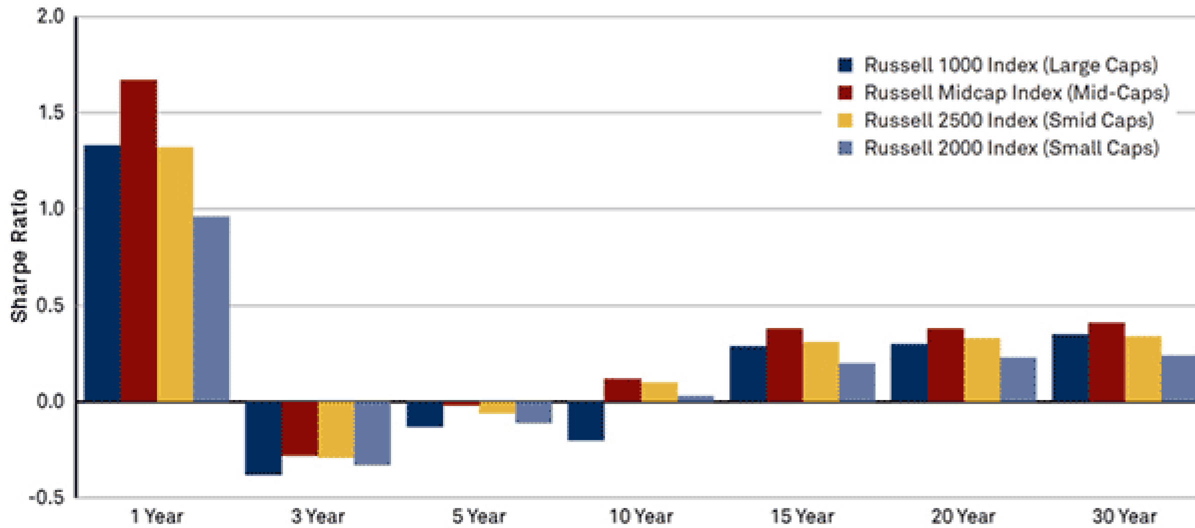
EXHIBIT 4: Sharpe Ratio Comparison of Select Russell Indices Since 1979



Source: Russell Family of Indexes, Fact Set, 12/31/09. Past performance does not guarantee future results.

Performance Over Economic Cycles

Economic cycles are loosely defined as fluctuations in growth patterns caused by overall economic and financial trends, competitive forces as well as the nature of supply and demand. While these cycles may be predictable in pattern, they are rarely predictable in duration.

The current equity market is no exception as it is beginning to exhibit some familiar patterns relative to past recessions – notably the 1980, 1982, 1990 and the 2001 recessions. Looking back on these four recent recessions, bear markets, on average, have bottomed four months prior to the official end of the recession (see Exhibit 6). Another familiar pattern has been the performance of mid-caps relative to large caps (represented by the S&P 500) around the market bottom. The exhibit clearly illustrates that as the market approaches the bottom, mid-caps have tended to underperform large caps, but once the recession end is established, mid-caps have progressively outperformed large caps as the economy recovers. This illustration of the economic cycle suggests that mid-cap stocks tend to underperform large caps when investor fear and risk aversion are rising, but steadily outperform as investors' regain confidence in the market.

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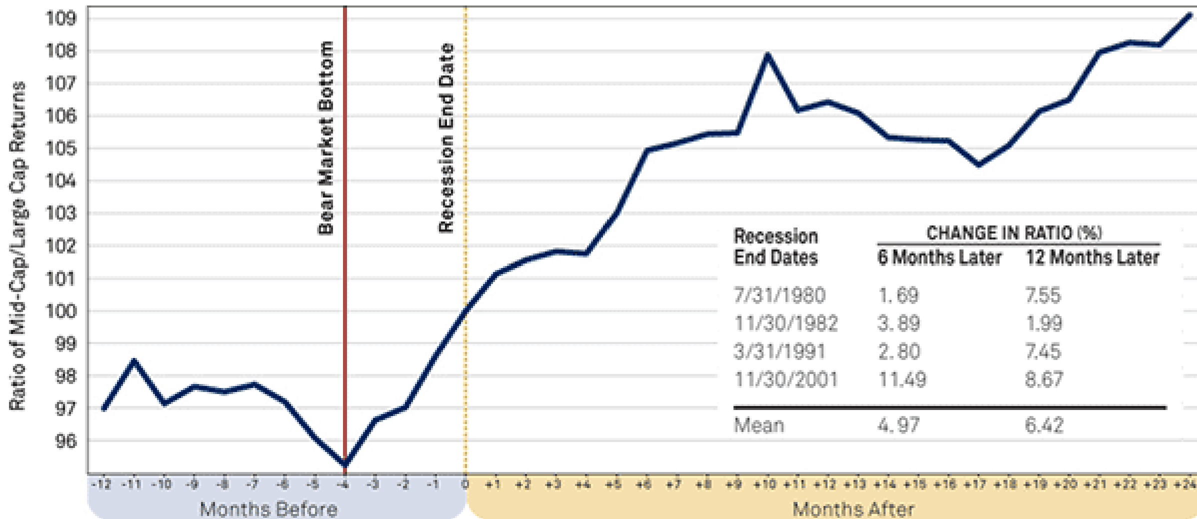
EXHIBIT 6: Average Mid-Cap/Large Cap Ratio Around the Last Four Recession End Dates



Source: Ned Davis Research, 12/31/09. Past performance does not guarantee future results.
The "Change in Ratio" compares the ratio between the value of the mid-cap index and the large cap index over designated time periods. A positive number indicates that mid-caps outperformed large-caps over the period and a negative number would indicate that large caps outperformed mid-caps. For example, the ratio of the two indexes at the end date of the 1980 recession was 10.07 (see Exhibit data by clicking on the link below). Six months later, the ratio was 10.24. The ratio increased by 1.69%, indicating that the mid-cap index outperformed the large cap index by 1.69% over the period.
Bear market bottoms have occurred an average of 4 months before recession end dates. Mid-caps = Russell Midcap Total Return Index. Large caps = S&P 500 Total Return Index Monthly Data Starting in 1978
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Allocating to Mid-Cap

With many economic factors at play, including increased investor risk appetites and outperformance of consumer discretionary versus consumer staples, we believe that investors should benefit from an allocation to mid-cap stocks. Not only will an allocation to mid-caps help diversify investor portfolios, but it has proven to improve returns with only minimal additional risk (as measured by standard deviation - see table below). Exhibit 9 illustrates the benefit of making an allocation to mid-caps. The incremental benefit of adding up to a 40% allocation to mid-caps has been great over longer time periods. Portfolios with higher allocations to mid-caps experienced the greatest benefit.

While investors' allocations to mid-cap should be consistent with their risk tolerance, including a mid-cap allocation has historically resulted in improved portfolio performance with a minimal increase in risk (as measured by standard deviation). Reallocating from large caps to mid-caps has improved the diversification of the portfolio and resulted in better risk-adjusted returns.

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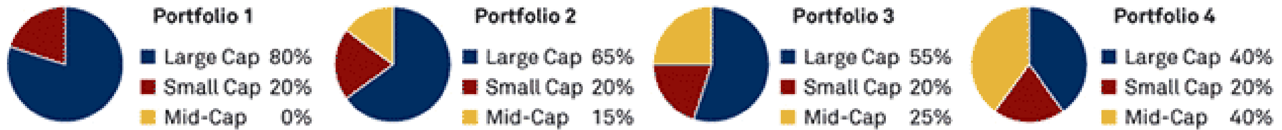
EXHIBIT 9: Comparison of Index Return and Risk for Mid-Cap Allocation Scenarios



RETURNS AS OF 12/31/09 (%)	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4
1 year	24.95	27.31	28.90	31.29
3 year	-5.62	-5.44	-5.33	-5.17
5 year	0.31	0.67	0.90	1.24
10 year	-0.98	0.11	0.83	1.90
STANDARD DEVIATION (%)				
1 year	28.77	29.91	30.75	32.11
3 year	19.45	20.26	20.83	21.74
5 year	16.54	17.26	17.77	18.59
10 year	16.47	16.99	17.39	18.07

Source: Frank Russell Co. (Morningstar, Inc.) as of 12/31/09. Past performance does not guarantee future results.
Small Cap = Russell 2000 Index
Mid-Cap = Russell Midcap Index
Large Cap = S&P 500 Index

Conclusion

While the market faces many headwinds – mainly in the form of weak employment, high levels of consumer debt and the likelihood of higher taxes - we at RidgeWorth are cautiously optimistic about the continuing economic recovery. In 2010, we believe many investors who were sitting on the sidelines in 2009 in low yielding money market funds will begin to move cautiously back into the equity markets as a result of an increased appetite for risk.

Investors who are ready to re-enter the equity markets may be well served by adding an allocation to mid-caps as part of a diversified portfolio because mid-caps have had:

1. Consistent outperformance relative to large caps and small caps
2. A better risk-reward profile than other market cap sizes
3. Less extreme behavior under changing economic conditions
4. Favorable characteristics regardless of economic environment

We believe that an analysis of mid-caps relative to other capitalization segments reveals the continuing strength of mid-caps as part of a diversified investment portfolio. Check it out for yourself by comparing rolling returns of mid-cap stocks to large, smid and small cap stocks at www.addmidcap.com.

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Past performance does not guarantee future results.

Click here for index definitions and investment terms. Equity securities (stocks) are more volatile and carry more risk than other forms of investments, including investments in high grade fixed income securities. The net asset value per share of this Fund will fluctuate as the value of the securities in the portfolio changes. Mid capitalization funds typically carry additional risks since smaller companies generally have a higher risk of failure. Small capitalization funds typically carry additional risks since smaller companies generally have a risk of failure. Indexes are unmanaged and investors cannot invest directly in an index.

This paper reflects the analysis and opinions of RidgeWorth Investments as of March 2010. Because market and economic conditions are often subject to rapid change, the analysis and opinions provided may change without notice. The analysis and opinions may not be relied upon as investment advice.

Statements of fact are from sources considered reliable but no representation or warranty is made as to their completeness or accuracy. Although historical performance is no guarantee of future results, these insights may help you understand our investment management philosophy.

In preparing this paper, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from reliable sources.

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