THE MERITS OF THE MIDDLE: THE CASE FOR U.S. MID CAP EQUITIES

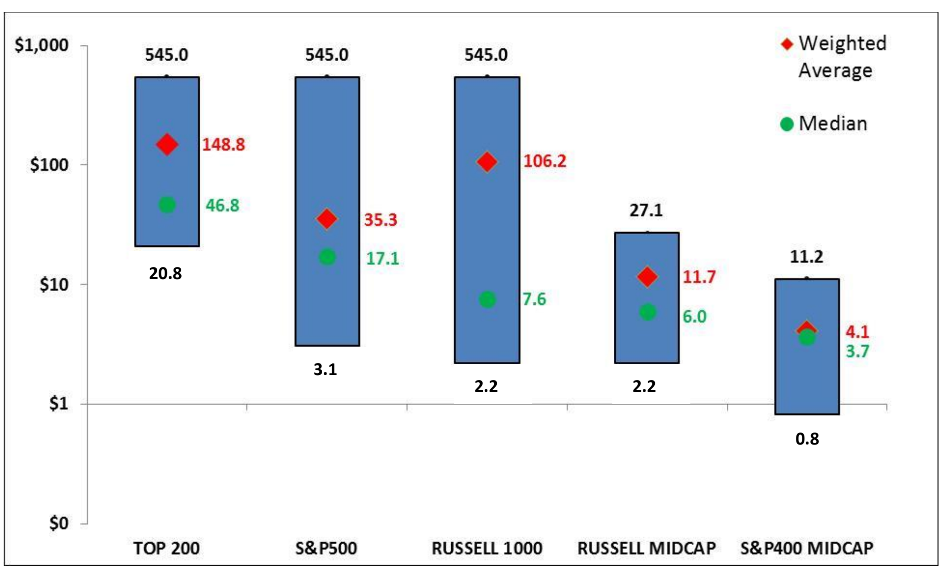
A. Intro

Do a search on Google for the term "*middle*" and the popular search engine spits out 689,000,000 results in 0.54 seconds. The same query on the other popular search engine Bing yields just 288 million results in 0.20 seconds. Yahoo's first listing is an ad banner for the ABC sitcom "The Middle". A search on the popular Morningstar site yields a more reasonable 12,100 results with one of the first being a link to the SPDR S&P 400 Mid Cap ETF. Ask institutional investors to define mid cap stocks and the reasons for investing in the asset class and one is likely to get similarly disparate and varied answers. Responses might include: "*…mid caps are safer than small caps but riskier than large cap*" or "*…we know gaining exposure to this asset class is important, but it doesn't quite fit in with our current allocation now*", etc., etc. etc. Well, after successfully managing mid cap strategies (both growth and value) for more than nine years, Herndon Capital Management would like to enter the fray and offer our explanation of **The Merits of The Middle: The Case for Mid Cap U.S. Equities.**

B. Characteristics of U.S. Mid cap Equities – What's In "The Middle"?

What makes a particular stock a ***mid cap stock***? One typical answer might be a company with a market capitalization ranging from $2 billion to $10 billion. Others may give ranges of $1 billion to $8 billion or even $2 billion to $15 billion. The reality is that there are no definitive, absolute capitalization bands that define mid cap. **Chart 1** below highlights the differences in market capitalization ranges of some of the most popular U.S. large cap and mid cap equity indices. The top of the blue band represents the highest market capitalization of the index and the bottom the lowest. The red diamond highlights the weighted average market cap of the index. The data, presented on a logarithmic scale, was sourced as of May 31, 2014. This is also the date that Russell Investments, a major provider of public equity indices data, used to set the latest companies and ranges for their annual indices reconstitutions, which take effect in July of each year.

Chart 1: Comparison of Market Ranges: Russell vs S&P; Large Cap vs Mid Cap

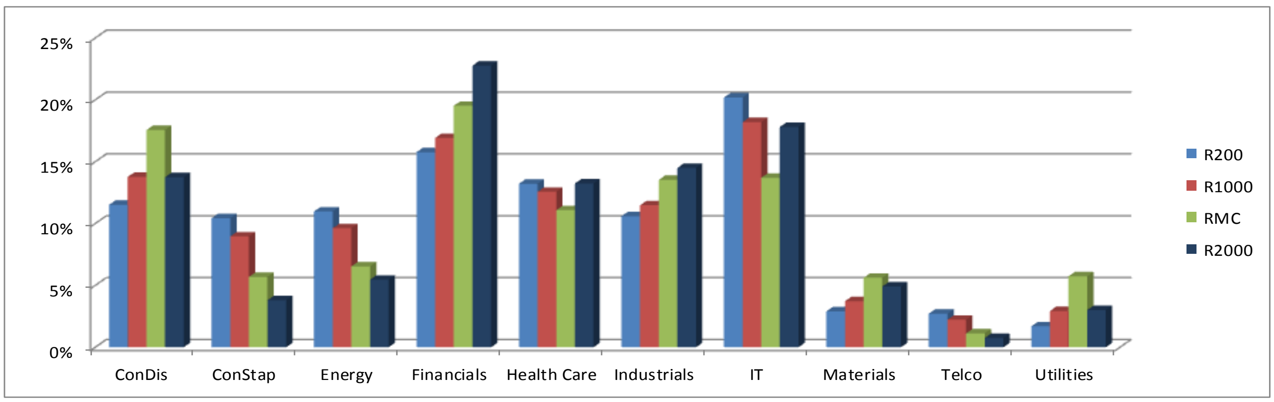


Source: ThomsonReuters, Bloomberg, Standard & Poor's. Data as of 5/31/14.

For the Russell Mid Cap index, which include the smaller 800 companies of the Russell 1000 index, the market capitalization range was \$27.1 billion to \$2.2 billion, with a weighted average of \$11.7 billion. Russell's competitor, Standard and Poor's also offers a mid cap index. The market cap range for the S&P400 Mid Cap index was \$11.2 billion to \$825 million, with a weighted average market capitalization of \$4.1 billion. So, regardless of the strict definitions and index guidelines, typically companies larger than \$1 billion but smaller than \$20 billion fit the bill.

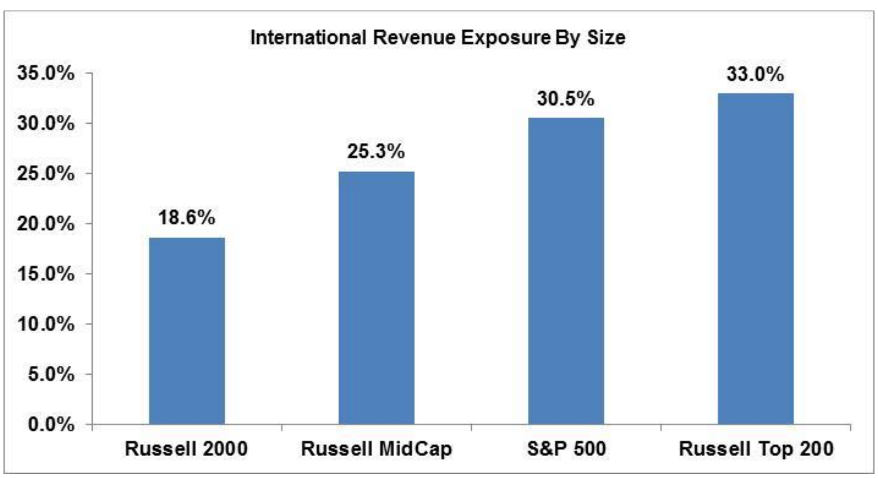
What are some other salient characteristics of "*the middle*" and mid cap indices? For one, the middle does not mirror large cap or small cap when it comes to sector weights and economic exposure. The data in **Charts 2** and **3** highlight these points. **Chart 2** compares the sector distribution of several large cap, mid cap and small cap indices. The biggest differentials are in the Financials, Consumer Discretionary and Information Technology sectors. Note also the larger weight of the Russell Mid Cap's Utilities and Materials sectors. **Chart 3** highlights the mix of international versus domestic revenues.

Chart 2: Comparison of Sector Weights for Major U.S. Mid Cap and Large Cap Indices



Source: ThomsonReuters, Bloomberg. Data and values as of 12/31/13.

Chart 3: International Revenue Exposure by Index



Source: ISI. Revenue exposure based on 2Q 2014 Quarterly Results

Another key feature of mid cap U.S. equities is that these stocks combine the high growth attributes of the small cap segment with the stronger balance sheets and more diversified business models of large cap companies.

Additionally, given their often more experienced management teams, larger geographic footprint and established product base, we believe mid cap offers multidimensional diversification benefits that complement compelling risk/return dynamics.

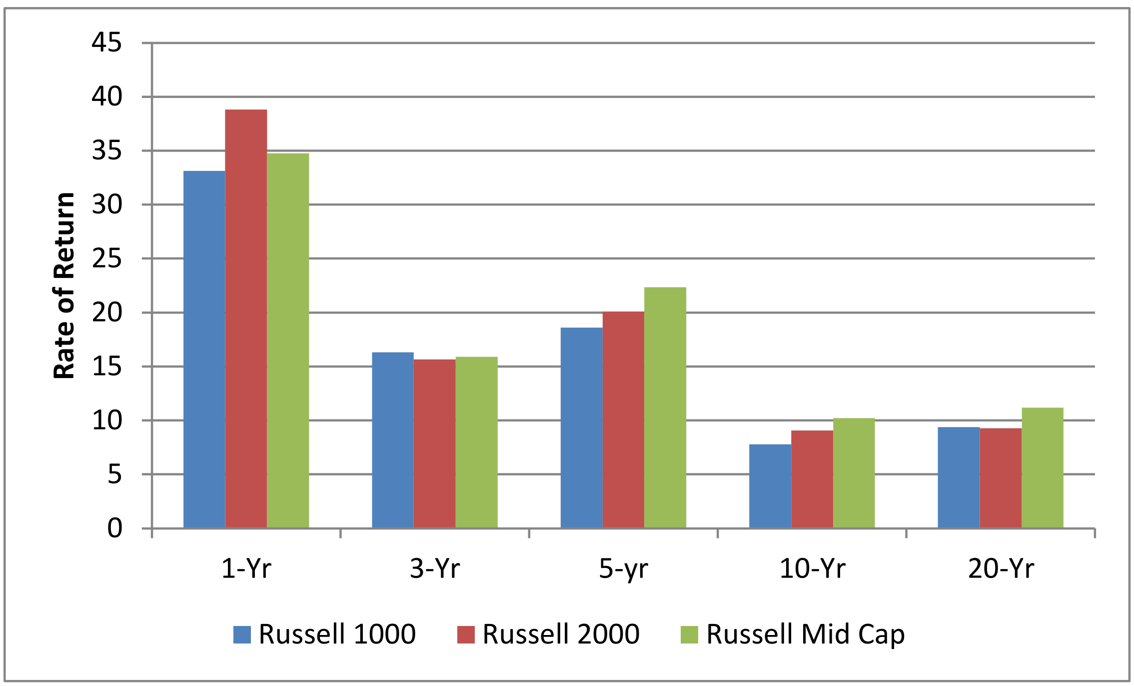
In summary, much of the data and information on mid cap stocks highlight the fact that in areas other than just market capitalization, mid cap stocks are not merely smaller versions of large caps or larger version of small cap stocks. They are, in many respects, unique.

C. Risks and Returns

Mid Cap companies are an important growth engine for the U.S. economy. Over multiple investment cycles and time periods, the mid cap segment has been among the strongest performing sectors when compared to their large cap and small cap counterparts on both an absolute and risk-adjusted basis. Paradoxically, few investors have taken full advantage of the opportunity to invest directly in this segment. Mid Cap is often an afterthought in asset allocation as many investors consider it to be a sub-set of their large and small cap allocations.

The excess returns generated in mid cap offers investors an attractive risk/reward relative to other market cap segments. Mid Cap stocks have outperformed large cap and small stocks on an absolute basis over the long term. Annualized returns in **Chart 4** underscore the fact the mid cap segment has been among the best performing equity asset classes.

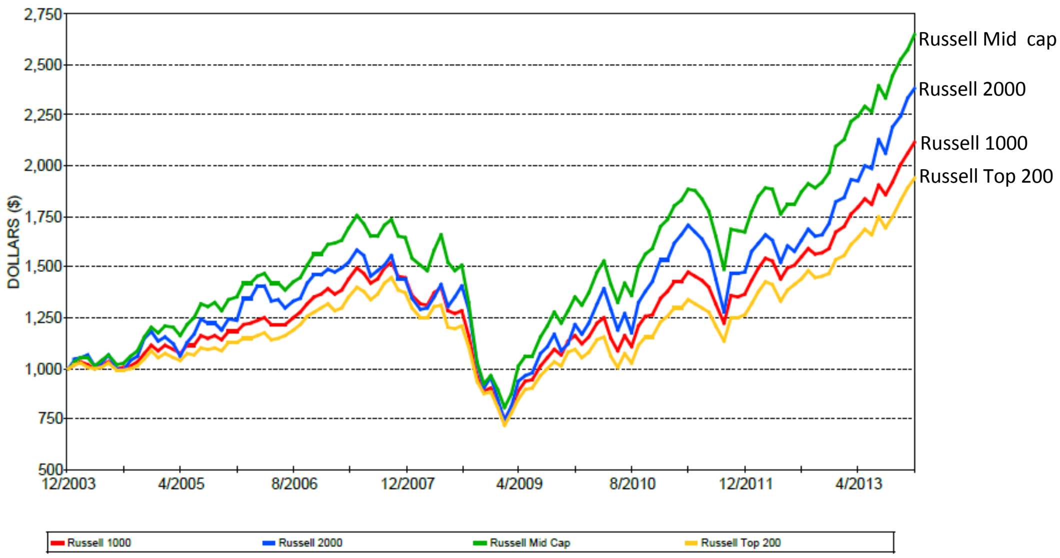
Chart 4: The Russell Mid Cap is outperforming both the Russell 1000 and Russell 2000 Indices over the past 5 and 10 Years



Source: PSN and Russell Investment. Performance for periods ending 12/31/13.

How does this outperformance manifest itself? From a practical perspective, a hypothetical investment of $1,000 in 10 years in mid cap equities would have outpaced investments in both the large and small cap indices. **Chart 5** below demonstrates how a hypothetical $1,000 investment in the Russell Mid Cap Index would have been worth $2,647 for the period ending 12/31/13. Similar investments in the Russell 1000 and Russell 2000 indices would have yielded investors less compelling results of $2,116 and $2,383 respectively over the same time period.

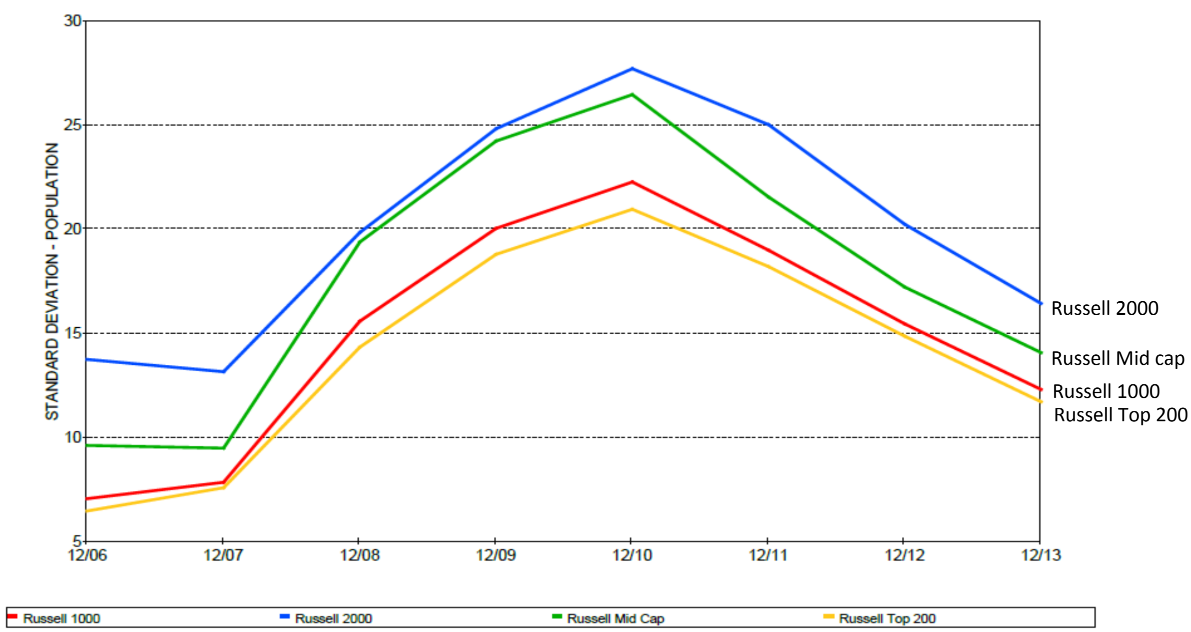
Chart 5: Growth of an Investment (12/31/03 – 12/31/2013)



Source PSN and Russell Investments. Returns for period ending 12/31/13.

More importantly, these strong excess returns have been achieved, on average, without significant increases in the amount of risk taken. In fact, evidence suggests that adding mid cap stocks to an investor's portfolio has offered significant diversification benefits over the long-term. **Chart 6** demonstrates this point well as it shows how the return volatility of the Russell Mid Cap Index has consistently been lower than that of the Russell 2000 while remaining modestly higher than the Russell 1000 Index.

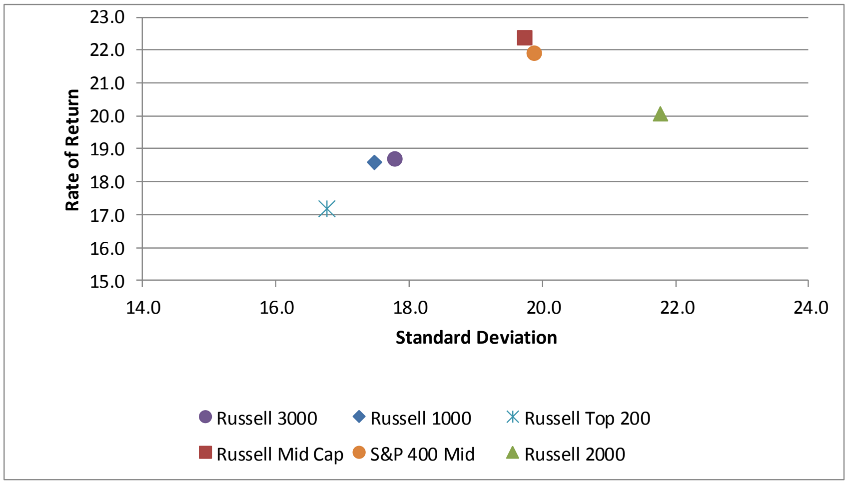
Chart 6 – Rolling 5-year Standard Deviations



Source: PSN and Russell Investments. Performance over 5-year period ending 12/31/13.

Furthermore, when one compares the risk and return of the two major mid cap indices to the other indices, over longer time frames, a compelling case can be made for the attractive risk/reward characteristics of the mid cap space. **Chart 7** highlight this point as both the Russell Mid Cap and S&P 400 Mid Cap indices has delivered significantly stronger returns given their volatility compared to the all cap, mega cap, large cap and small cap indices.

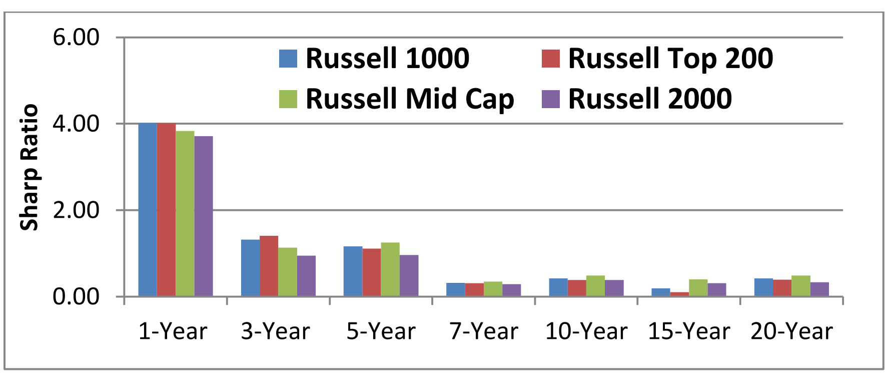
Chart 7: Mid Cap Stocks have outperformed their Large Cap and Small Cap Counterparts



Source: PSN & Russell Investments. Performance over 5-year period ending 12/31/13.

To further emphasize the risk/reward offered by investing in mid cap stocks, **Chart 8** demonstrates how the Sharpe Ratio, another measure of risk-adjusted performance, for mid cap stocks has been higher than both the large and small cap segments over most historical rolling periods. The consistency of this performance underscores the fact mid cap stocks have historically provided attractive risk-adjusted returns while also serving as another means of achieving portfolio diversification.

Chart 8: Sharp Ratio Comparison of Select Russell Indices

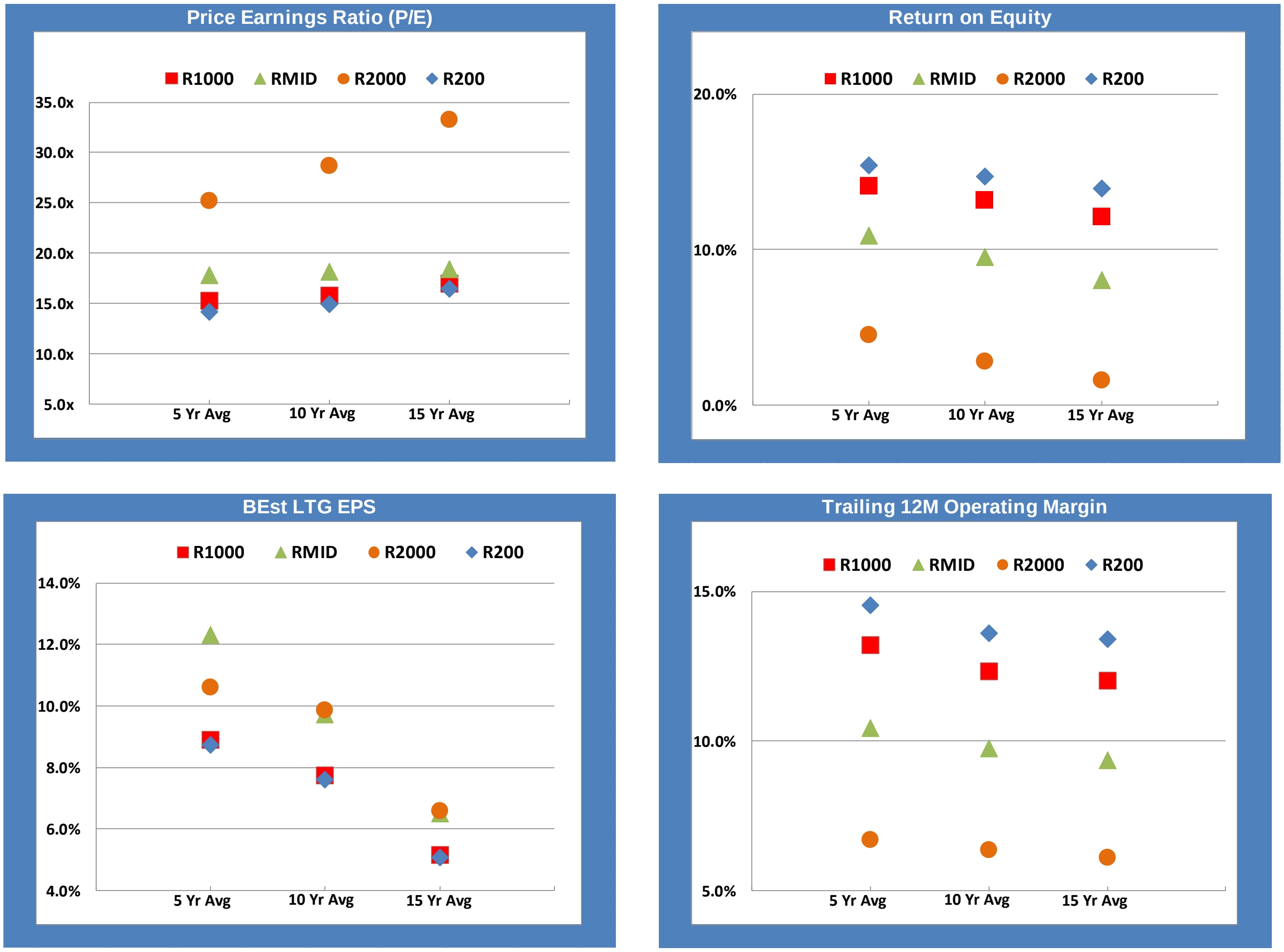


Source: PSN and Russell Investments. Data based on 5-year period ending 12/31/13.

D. Deeper Dive Into Data

Digging deeper into the data, why and how do mid cap stocks differ and/or diverge from small and large cap stock? There are similarities and variations across several dimensions. Earlier, we detailed several of the differences in market capitalization, geographic exposure and sector weights. The panel of graphs in **Chart 9** below highlight several of the similarities and differences in valuation (price to earnings multiple) and operating performance (return on equity, operating margins and earnings growth rates). The charts compare the major large and mid cap indices across those four measures. Additionally, to get a truly representative picture, average data across the past 5, 10 and 15 years periods has been included.

Chart 9: Comparison of Valuation, Profitability and Growth for Large, Mid and Small Cap Indices



Source: Bloomberg. Data based on time periods ending 06/30/14.

As the data highlights, from a valuation perspective, mid cap stocks appear roughly in-line with large caps (Russell 1000 and Russell Top 200) albeit at a consistent but slight premium. The return on equity measures for mid cap are also solidly in the middle – outpacing small cap but still trailing large caps. The valuation multiple for the Russell 2000 stands in stark contrast to the other three. These are not surprising facts. However, when earnings growth (Bloomberg Estimates of Long Term Earnings Per Share) and trailing twelve months operating margins are compared, the story is quite different. Mid Cap stocks look more like small cap! This, perhaps, could explain much of the consistent outperformance: **investors are paying what are close to large cap multiples but getting growth more akin to small cap equities.**

What explains this divergence? One of the principal reasons for the strength in mid cap earnings growth rate could be the segment's ability to capitalize on the early phases of an economic recovery. The performance of mid cap stocks has typically been highly correlated with the economic outlook. A study by Giuseppe Moscarine, and economist at Yale University, and Fabien Postel-Vinay of the University of Bristol, attributes this trend to how mid cap companies respond to employment growth during early phases of an economic cycle. They argue that employment growth at mid and small cap firms is faster during the recovery period because these firms are more nimble in responding to weak labor markets. As a result, mid cap and small cap firms are better suited to exploit the economic environment by producing stronger gains in both revenue and earnings.

As **Chart 10** below demonstrates, small and mid cap stocks have historically been the early beneficiaries of upticks in economic momentum. As an economic recovery begins to take shape and leading indicators show positive economic momentum, small and mid cap stocks have historically risen sharply against large cap stocks from the midpoint of a recession. This has been the case in most periods excluding the 5-year period from the 1981/82 recession and the 1-year period during the 2008/2009 recession.

Chart 10: Returns during Periods Beginning from each Recession's Midpoint

	Recession Feb 1980 - July 1980 Returns for periods beginning April 30, 1980			Recession Aug 1981 - Nov 1982 Returns for periods beginning March 31, 1982			Recession Aug 1990 - March 1991 Returns for periods beginning November 30,			Recession Apr 2001 - Nov 2001 Returns for periods beginning July 31, 2001			Recession Dec 2007 - June 2009 Returns for periods beginning September 30,		
	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year
Russell 1000	32.48%	21.56%	16.35%	44.41%	22.56%	25.76%	23.01%	17.34%	17.51%	-22.91%	-1.05%	3.45%	-6.14%	n/a	n/a
Russell 2000	66.33%	33.93%	20.75%	61.83%	23.40%	23.19%	40.58%	27.38%	21.30%	-17.96%	5.74%	8.99%	-9.55%	n/a	n/a
Russell Midcap	49.58%	27.36%	19.47%	49.66%	23.39%	26.02%	32.73%	23.73%	20.77%	-15.67%	5.87%	10.07%	-3.55%	n/a	n/a
Russell 2000 outperformance vs. Russell 1000	33.85%	12.37%	4.40%	17.42%	0.84%	-2.56%	17.57%	10.04%	3.79%	4.95%	6.79%	5.54%	-3.41%	n/a	n/a
Russell Midcap outperformance vs. Russell 1000	17.11%	5.80%	3.11%	5.25%	0.83%	0.26%	9.72%	6.39%	3.25%	7.23%	6.92%	6.62%	2.59%	n/a	n/a

Source: National Bureau of Economic Research

In addition to the high return potential of mid cap stocks during nascent economic recoveries, the segment also provides investment managers with an excellent opportunity to exploit a diverse and inefficient market place. Within the Russell Mid Cap universe of companies there are over 800 companies representing over $6.3 trillion in total market capitalization. Furthermore, the mid cap universe is constantly expanding as new companies are added through IPOs, spinoffs, valuation declines and other market changes. This large and constantly growing pool of stocks creates a plethora of opportunities to invest in emerging companies across multiple industries and sub-industries.

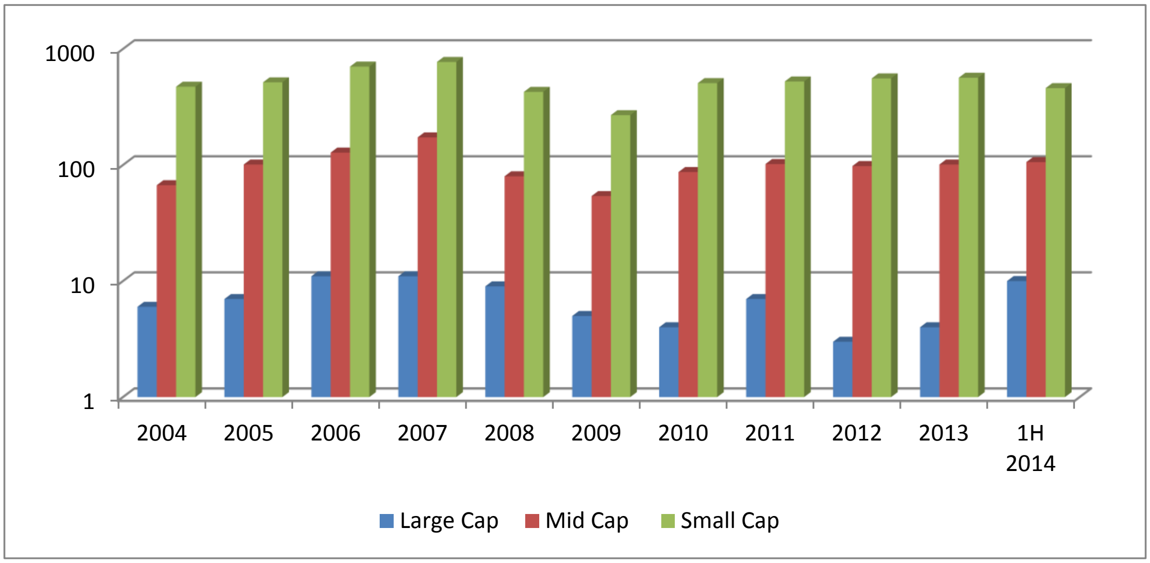
Chart 11: Analysts' Coverage of Small, Mid and Large Cap Companies

	Average # of Analysts	Median # of Analysts	% of Companies with $\leq$ 3 Estimates	% of Companies with $\leq$ 6 Estimates	% of Companies with > 10 Estimates	% of Companies with > 20 Estimates
R200	24	24	0.5%	1.0%	97.0%	78.0%
RMID	**15**	**14**	**5.4%**	**11.3%**	**71.0%**	**23.3%**
R2000	6	5	33.9	66.1%	13.4%	1.40%

Source: ThomsonReuters. Data as of 12/31/13.

In addition to possible inefficiencies due to inconsistencies in Wall Street coverage and ratings, there is also evidence that mid cap stocks are being afforded a premium for being potential mergers and acquisition ("M&A") targets. Mid Cap stocks tend to gain an additional tailwind in performance from increased M&A activity. A major portion of this activity is driven by large companies, flushed with cash, whose organic growth has slowed, and are seeking to buy earnings growth. This need for higher earnings growth is exacerbated in slower economic environments. Within the mid cap segment, there are many high quality companies with niche product offerings, new innovations and/or accelerating earnings growth. Larger companies are often willing to pay attractive premiums for companies that represent the aforementioned characteristics. From 2002-2007, M&A activity was particularly active in the mid cap segment. Following relatively low deal volume in 2008 and 2009, M&A activity has picked up in the mid cap segment. Wall Street analysts continue to see the mid cap segment as attractive targets for M&A money that has been sitting on the sidelines, even though volumes have not resumed to pre-crisis levels in 2006-2007. The total number of M&A deals announced in the first half of 2014 for mid and large equities have already surpassed the total number of deals completed in all of 2013.

Chart 12: Mergers & Acquisition Annual Deal Count



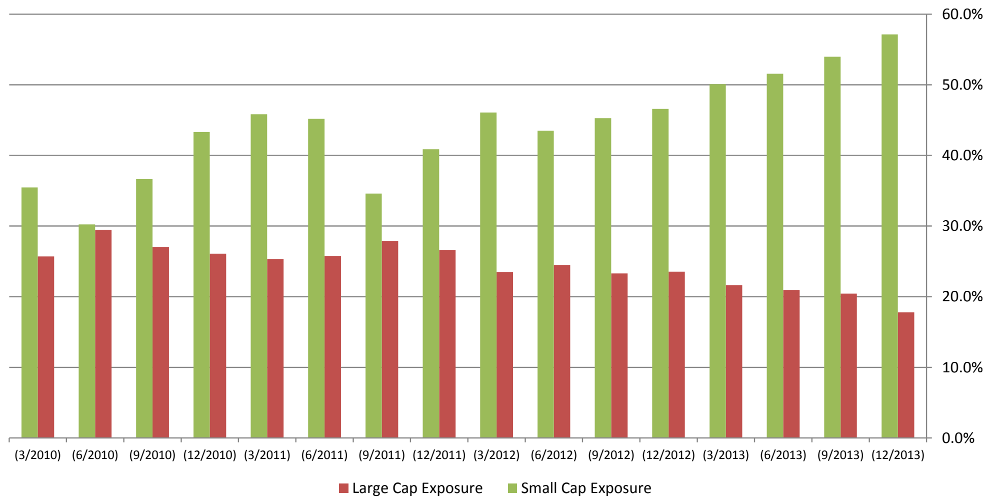
Source: Bloomberg. Large Cap deals are M&A transactions above $20 billion; Mid Cap $2 - $20 billion and Small Cap $0.25 to $2 billion

E. Mid Cap Exposure via Large and Small Cap Allocations

Another reason often cited by investors for not directly investing in mid cap strategies is that they may be getting adequate exposure to this market cap segment through both their large and small cap allocations. We explored the reliability of this approach using the eVestment Manager Database, a global database of institutional money managers. This approach yielded mixed results.

Per **Chart 13** below both large and small cap managers allocate, in aggregate, some portion of their portfolio to the mid cap space. This percentage among large cap managers has ranged from as high as 30% in early 2010 to 18% as of the 4th quarter of 2013. With respect to small cap manager's, the aggregate exposure to the mid cap segment has tended to be higher in the more recent periods, peaking at over 57% at the end of 2013 and while being as low as 30% during 2010. We suspect that the higher percent of mid cap exposure among small cap managers is being driven by the dynamic nature of market cap segment ranges which we explored earlier, coupled with the buy and hold nature of small cap managers who hold stocks that fall within the lower ranges of the mid cap universe. Nevertheless, we believe a direct allocation to mid cap equities is optimal so investors can fully exploit benefits offered in mid cap.

Chart 13: Mid Cap Exposure by Market Cap Segment



Source: Evestment

F. Summary & Conclusion

Rodney Dangerfield was a well-known comedian whose career spanned decades but peaked in the mid-1980s. His tag line for years was "*I don't get no respect*"! In some ways, mid cap equities have been the underdog and often times have not been given the respect and interest due. This has occurred despite mid caps, on many dimensions, offering a much more attractive risk-reward profile. Mid cap's alpha generation and propensity to outperform are well documented and have been known, discussed and written about for many years. Alas, we also know that many (but not enough?) investors have discovered *and* are allocating assets to mid cap – both domestically and internationally.

While many investors know some of the general reasons (small cap effect e.g. Fama and French, analyst coverage gaps, cyclical recovery opportunities, etc.), the *why* behind the better risk adjusted returns that mid cap stocks offer is less understood. In addition to the capitalization and valuation related premiums, mid cap equities also offer investors diversification, growth and idiosyncratic features that uniquely differ from large and small cap stocks. These are key elements that may help to explain why the asset class has consistently outperformed without significantly more volatility.

Mid Cap equities, on many dimensions, look like large cap equities: there are more similarities than differences with respect to valuation metrics (P/E, P/B, P/S and Dividend Yield). However, on several other important dimensions, namely growth rates (earnings per share) and profitability (gross margins), mid cap stocks bear more resemblance to their small cap brethren. Herein, we believe, lies the crux of the opportunity set offered: ***mid cap stocks appear to reflect large cap risks but yield small cap rewards***! Mid Cap stocks appear to offer some of the best of both *and* something different from just a blended portfolio with doses of large and small caps. We believe, the "middle" does offer much merit and unique opportunities* for investors seeking to diversify their asset allocation.

Herndon Capital Management's experienced portfolio management team offers large and mid cap investment products including a Mid Cap Value strategy. A principal tenet across all of our investment styles is our application of a disciplined investment process rooted in fundamental research. Our Mid Cap Value strategy has a 9-year track record with an investment process that identifies stocks based upon relative value versus the other stocks in our Russell Mid Cap Index. We combine fundamental analysis in a valuation-oriented framework with risk assessment. The stocks we own tend to have low valuation metrics, yet sound fundamental characteristics, which we believe will lead to outperformance as their value is recognized in the market.

** For additional information, characteristics and performance data for the Mid Cap Value and Mid Cap Growth strategies offered by Herndon Capital Management, please see our website http://herndoncapital.com and/or contact our Directors of Marketing & Client Services at:*

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