A Case for Investing in U.S. Mid Caps

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Executive Summary

- The U.S. equity market is the largest and deepest in the world. As such, it has been analyzed in many ways to determine the optimal means of gaining exposure.
- Typically, the two main ways the market is segmented are by size (small, mid, large) and investment style (core, growth, value).
- Focusing on size, many investors have taken a barbell approach with their U.S. equity portfolios: allocating to large cap equities on one side paired with either a small or small-mid cap (SMID cap) allocation on the other side. In this way, they get exposure to the largest, most liquid bellwether companies complemented by smaller companies, where there is typically more alpha potential for bottom-up stock pickers.
- While we think this is an effective approach and has proven successful for investors over the long term, we believe it can be improved upon by swapping the small or SMID cap allocation for a mid cap allocation.
- Despite the potentially misleading industry-wide naming convention, mid cap strategies have greater latitude to invest across the full spectrum of small and mid-cap companies as opposed to the more limited small and SMID universes.
- We believe a blend of U.S. mid and large caps increases the total return potential of a U.S. equity allocation thanks to a broader investable universe in the mid cap space and the flexibility to opportunistically move up and down the small and mid cap investable universe to capitalize on market dislocations.
- This approach can also enhance a portfolio by increasing the overall quality and liquidity characteristics, increasing the investable capacity, and reducing implementation costs.

The U.S. Is a Great Place to Invest for the Next Decade and More

Before we make the case for "why mid caps," we shouldn't take for granted why investors should be excited about the prospects for U.S. companies over the next decade and beyond. Some highlights include:

1. The U.S. continues to draw in the best and brightest globally to its top schools and employers.
2. The demographic profile and population growth trends are some of the healthiest amongst advanced economies.
3. The entrepreneurial energy and support network is second to none. This includes some of the best universities, the deepest and most sophisticated capital markets, and a well-developed venture capital ecosystem.
4. A consistent rule of law, easy access to data, and developed infrastructure.
5. A large, homogeneous domestic market that allows companies to grow to scale domestically before needing to focus on the complexities of global operations.
6. Leading capabilities in many industries that are the main growth drivers of the economy today and likely tomorrow, such as technology and biotechnology.

In short, the growth prospects for U.S. companies—and therefore U.S. stocks—remain compelling with structural competitive advantages that should persist over the long term.

Defining U.S. Small, SMID, Mid, and Large-Cap Equities

Having made the case for "why U.S. equities," now we can get back to determining how to allocate to them. To start, it's important to understand what constitutes U.S. equity size classifications and the extent to which these categories are distinct versus overlapping. This provides one method of determining the optimal exposure mix.

A common classification is to use the constituents of the standard size-based investment benchmarks as noted below.

Chart 1: Distribution of Market Capitalization Exposure for Various Size-Based U.S. Equity Indices

Market capitalization	Small Cap Index Weight	SMID Cap Index Weight	Mid Cap Index Weight	Large Cap Index Weight
Less than $1 billion	18.5%	7.8%	0%	0%
$1 - $3 billion	44.6%	21.5%	1.5%	0%
$3 - $10 billion	36.3%	55.2%	23.7%	1.2%
$10 to $20 billion	0.5%	15.5%	29.4%	5.4%
$20 to $40 billion	0%	0%	35.6%	10.5%
$40 to $60 billion	0%	0%	9.7%	6.6%
$60 billion and over	0%	0%	0%	76.3%

Source: Mawer Investment Management Ltd. and FactSet. As of September 30, 2023. Small cap by the Russell 2000 Index, SMID cap by the Russell 2500 Index, mid cap by the Russell Midcap Index, and large cap by the S&P 500 Index. All figures in US Dollars and rounded to the nearest tenth of a percent.

The $10–40 billion market cap space is particularly underinvested in across the smaller and large cap indices, despite it representing an attractive blend of established business models and high growth prospects.

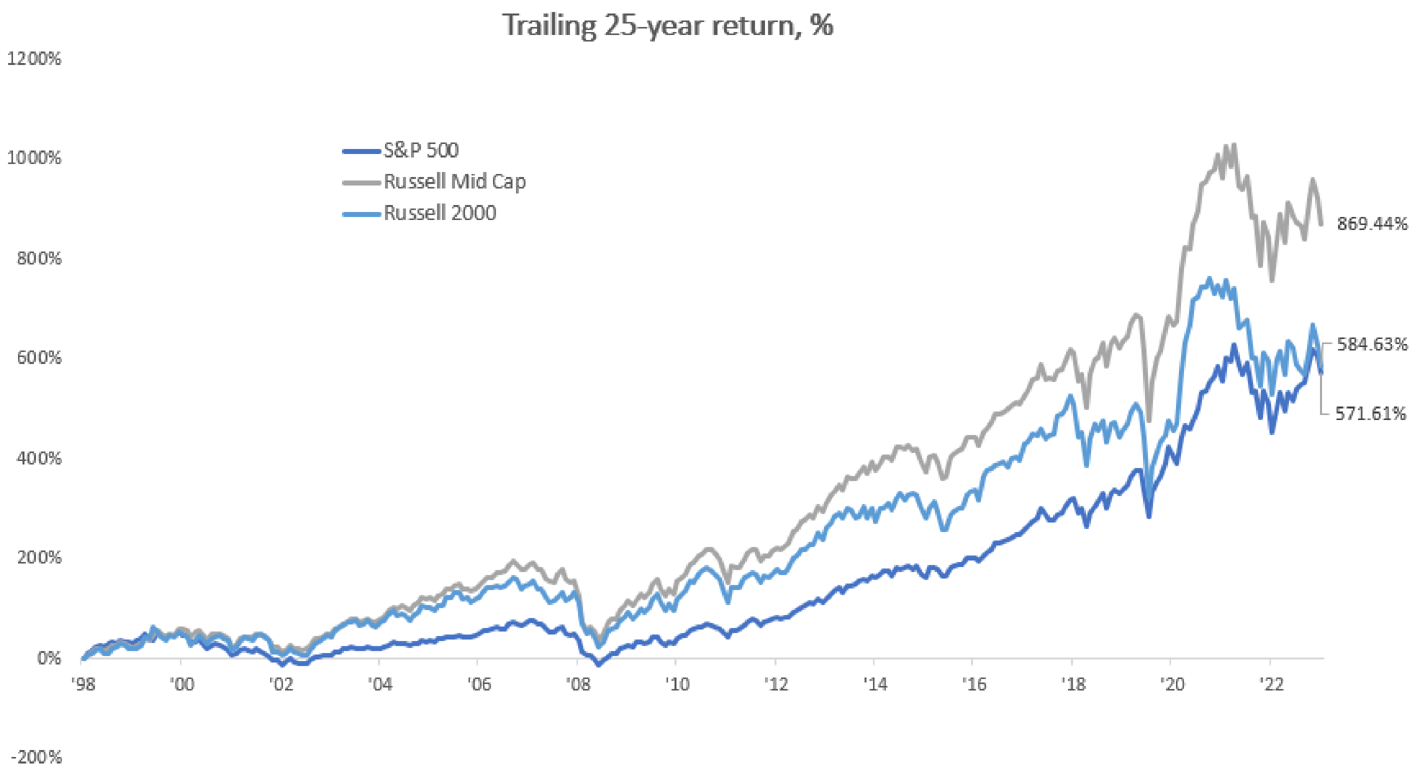
A mid cap allocation provides distinct exposure to areas of the market that aren't well addressed by the other benchmarks.

Mid Caps Are a Perfect Complement to Large Cap/S&P 500 Passive Investing

Despite the category name "mid caps" suggesting an investable universe with limited if any small cap exposure, mid caps as defined by the Russell Index is actually a very broad category: as of September 30, 2023, the minimum constituent had a market cap of $452M USD and the maximum was $53.5B USD. Our mid cap strategy uses these parameters as a guideline for portfolio construction. This breadth allows the strategy to invest in most publicly traded U.S. companies below the large caps; its maximum market cap is set at the bottom end of the S&P 500 constituents, and it extends down to a size that captures most of the established, up-and-coming companies. In other words, mid caps are a perfect complement to large cap/S&P 500 investing, giving access to "the rest of America".

Over the long term, mid caps have meaningfully outperformed both small caps (less established businesses) and large caps (less growth).

Chart 2: Long-Term Performance of Small, Mid, and Large Cap U.S. Equities



Source: Mawer Investment Management Ltd. and FactSet. As of September 30, 2023. Small cap by the Russell 2000 Index, mid cap by the Russell Midcap Index, and large cap by the S&P 500 Index.

While large cap stocks have led the charge for performance in more recent memory, the market leadership in large caps has been very narrow, with a small group of mega cap technology companies generating an overwhelming amount of the total return. When the performance of those handful of companies is removed from the S&P 500, the returns moderate considerably.

Chart 3: S&P 500 Returns Without Mega Caps

Mega Cap Stocks Drives the Market

Time Frame	Ex-Mega Tech	S&P 500
2012-2022 (10 Year)	9.8%	11.9%

Source: Mawer Investment Management Ltd. and FactSet. As of September 30, 2023.

Investors betting this narrow market leadership will persist for the next decade are taking a gamble with their portfolio if they don't have meaningful small and mid cap exposure. Instead, risk-aware U.S. equity investors should consider positioning their portfolios to be resilient across a variety of outcomes by pairing their U.S. large cap exposure, be it passive or active, with a mid cap allocation.

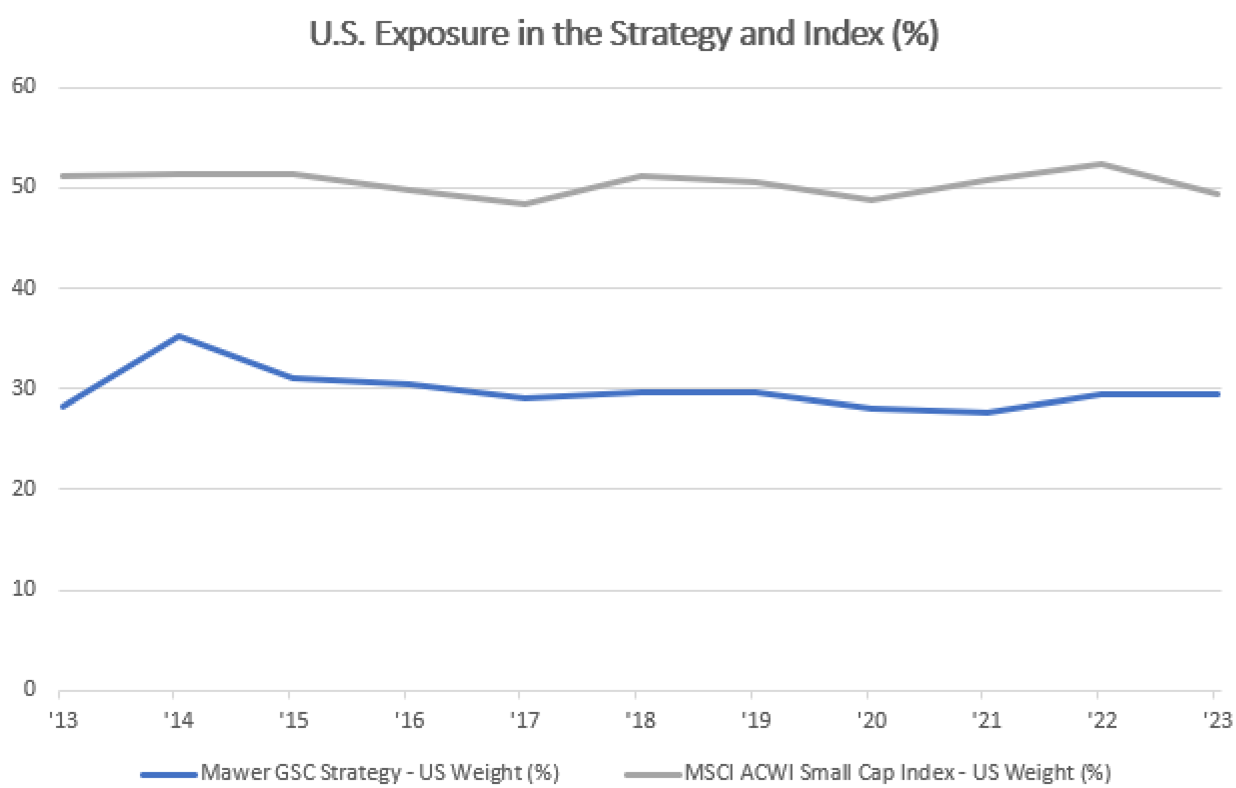
Mid Caps Are the Sweet Spot of Size in Development

In our experience, the $5–40B USD market capitalization range is that sweet spot where mid cap companies have established their competitive advantages and business models but often are still at a size where there is meaningful growth left in their runway.

We have also had a long history as a firm of doing well finding strong companies in both Canadian and global small caps. Most companies in global markets, such as Canada, tend to hit their sweet spot in the $500M–4B USD market cap range as they saturate their domestic market, develop scale, and solidify competitive advantages. Most other advanced economies are about 1/10 the size of the U.S. economy, and so it makes perfect sense then that in the U.S., companies that are $5–40B USD of market cap are in the same stage of development as the global small cap companies we've had a lot of success investing in as a firm.

Another case in point, our global small cap strategy has always had an underweight to the U.S. relative to its index; they have found more attractive companies in their cap size range in Europe and Asia rather than in the U.S. as many U.S. companies below $5B USD market cap are not yet at an established scale to have strong competitive moats.

Chart 4: Mawer Global Small Cap (GSC) U.S. Exposure



Source: Mawer Investment Management Ltd. and FactSet. Strategy based on representative account for the Mawer Global Small Cap Equity strategy as of September 30, 2023.

Mid Caps vs. SMID Caps?

Small-mid (SMID) cap is generally more established as the complement to large cap investing. There isn't one universal definition of SMID, however it generally sets an upper market cap band of $20B USD.

While it's technically the definitionally most accurate complement to US large caps (the S&P 500 traditionally are the 500 largest listed US companies, and the Russell 2500, the SMID index, is the Russell 3000 – the all cap index, minus the 500 largest companies), the fact is that most large cap managers (or the passive index) have a very small weight in the bottom end of the S&P 500, and conversely, SMID managers might not always have a high concentration in companies at the top end of the Russell 2500's market cap range because if they keep growing, the manager has to sell them.

While in theory, active large cap managers may choose to come down into the mid cap segment, and active SMID-cap managers may move up, the reality is there ends up being a gap in the weightings of most investors' portfolios in companies in the mid cap range; and, as we said, in our experience, these tend to be the primary sweet spot of companies to invest in in the U.S equity universe. This sweet spot is underinvested in across many investor portfolios because of market conventions for defining asset allocation categories. A mid cap strategy solves for this problem by providing the ideal coverage with U.S. large cap allocations without completely forfeiting exposure to small cap companies.

You Want to Go Active in Mid Caps

The U.S. equity market is known for having a bias towards higher quality companies than global peers. By high quality, we mean companies which are wealth-creating by virtue of their competitive advantages. This leads them to have more stable earnings, higher margins, and stronger balance sheets. However, the degree of quality varies widely by market cap segment.

A rudimentary proxy used to assess company quality is return on equity (ROE). The higher the return on equity, all else equal, the higher average quality. The large cap universe—represented by the S&P 500—is very high quality: companies with ROEs typically in the low to mid-20s. For comparison, the Russell Midcap Index is typically more in the mid-teens and the Russell 2500 (the SMID index) in the mid to high single digits and the Russell 2000 (small cap index) has even seen periods of negative ROE. As you decrease in market cap, the ROEs decline significantly.

Chart 5: Return on Equity Levels Across U.S. Indices

	Small Cap Index	SMID Index	Mid Cap Index	Large Cap Index
2012	-2.99	-1.18	13.76	19.41
2013	2.89	4.19	13.87	19.42
2014	8.17	9.26	14.10	19.87
2015	4.19	7.28	12.34	17.83
2016	6.80	9.37	12.19	18.42
2017	7.56	10.59	15.16	19.60
2018	6.06	10.83	15.83	22.68
2019	3.90	8.39	14.23	23.95
2020	-2.26	3.50	8.85	24.33
2021	6.23	11.23	16.07	27.62
2022	7.91	12.79	17.18	24.98

Source: Mawer Investment Management Ltd. and FactSet. As of September 30, 2023. Small cap by the Russell 2000 Index, SMID cap by the Russell 2500 Index, Mid cap by the Russell Midcap Index, and Large cap by the S&P 500 Index.

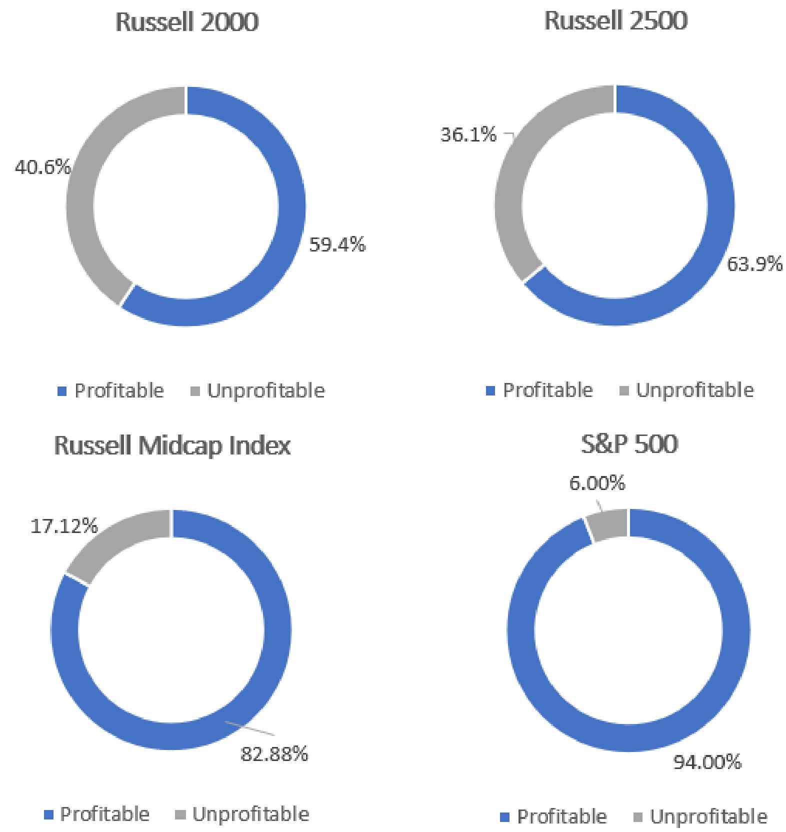
Lower market cap companies are also affected by near-term market sentiment that is detached from company fundamentals more pronouncedly than larger cap companies. The meme stock craze of 2021 is an excellent example of this, with retail traders piling into the stock of companies like GameStop Corp and AMC Holdings. As shares of these companies briefly shot up without any real improvements to the underlying businesses, passive index strategies would have been rebalancing into these stocks (as they now made up a larger weight in the various indices) only to see those stocks slowly revert to their negative long-term trend.

Chart 6: AMC Holdings Meme Stock Share Valuation Example

Source: Mawer Investment Management Ltd. and Bloomberg. As of September 30, 2023.

Another way to think about average quality is to look at the proportion of each universe where the companies don't earn a profit. Despite the impressive market caps, there is a substantial group of mid cap companies that are not profitable. In some cases, the growth trajectory of the business may justify a large market cap despite the current lack of profitability, but in many cases, these are just low-quality businesses which an active mandate would avoid owning.

Chart 7: Index Exposure to Unprofitable Companies



Source: Mawer Investment Management Ltd. and FactSet. Profitability reported as US GAAP net income as of September 30, 2023.

Whether it's looking at ROE, momentum/hype stocks, or absolute profitability, the results are clear: when you go below large caps, you typically sacrifice quality. While this is true on average, by applying Mawer's philosophy of identifying companies with sustainable competitive advantages, the Mawer U.S. Mid Cap Equity strategy has consistently been able to find 'blue chip mid caps' and maintain an ROE in the 20%+ range, close to the S&P 500 and usually quite a bit higher than the Russell Index.

The Mawer U.S. Mid Cap Equity Strategy

The Mawer U.S. Mid Cap Equity Strategy is designed to provide what we believe is the optimal mix of exposure to small cap and mid cap companies by pairing more established mid caps with strong competitive advantages with smaller caps that have higher growth potential.

We feel this approach should outperform small and SMID cap portfolios over a cycle while also providing better downside protection thanks to the tilt towards higher quality businesses. With over three years of data from managing this strategy, we believe our theory has some validity.

Chart 8: Mawer U.S. Mid Cap Equity Strategy Performance vs. Market Cap Indices

Performance	3 Month	YTD	1 Year	2 Year	3 Year
Mawer U.S. Mid Cap Equity Strategy (Gross)	-6.32%	6.40%	6.18%	-6.30%	10.98%
Mawer U.S. Mid Cap Equity Strategy (Net)	-6.47%	5.82%	5.49%	-6.90%	10.26%
Small Cap Index	-16.69%	-4.45%	-8.56%	-13.70%	3.95%
SMID Cap Index	-14.80%	-2.70%	-4.63%	-11.34%	5.51%
Mid Cap Index	-12.90%	-1.28%	-1.01%	-9.45%	6.04%
Large Cap Index	-8.25%	10.69%	10.14%	-3.02%	10.36%

Source: Mawer Investment Management Ltd. and FactSet. Strategy returns are for the U.S. Mid-Cap Equity Composite, gross and net, in USD as of October 31, 2023. Small cap returns represented by the Russell 2000 Index, SMID cap returns represented by the Russell 2500 Index, Mid cap returns represented by the Russell Midcap Index, and Large cap represented by the S&P 500 Index, All performance in US Dollars as of October 31, 2023.

We see opportunities evenly distributed across the cap spectrum of "mid cap" as defined by the index and as illustrated by our positioning noted below. You'll also see an average ROE across the portfolio that is materially higher than the benchmark while also being exposed to less financing risk given the lower-than-index debt-to-equity. Lastly, the active share of the portfolio—a measure of how differently the portfolio is positioned from the index—shows the portfolio is almost 95% different than the index.

Chart 9: Mawer U.S. Mid Cap Equity Strategy Portfolio Characteristics

Market cap	Number of Companies	Portfolio Weight
Less than $1 billion	0	0%
$1 to $3 billion	6	14%
$3 to $10 billion	11	32%
$10 to $20 billion	9	21%
$20 to $40 billion	9	18%
$40 to $60 billion	3	7%
$60 billion and over	2	7%
Total	40	100%

Source: Mawer Investment Management Ltd., FactSet and Xpressfeed. Data as of October 31, 2023. Portfolio weights exclude cash exposure.

Characteristics	Mawer U.S. Mid Cap Equity Portfolio	Russell Midcap Index
Number of Companies	40	799
ROE (%)	23.4	15.8
Trailing P/E	16.4	23.2
Forward P/E	18.0	16.6
Price/Book	3.0	2.4
Dividend yield (%)	0.7	1.8
Historical 3 year EPS Growth	24.2	21.1
Debt-to-equity	0.9	1.2
Active share (%)	95.3	
Annual turnover (%)	46.4	

Source: Mawer Investment Management Ltd., FactSet and Xpressfeed. Data as of October 31, 2023. Debt-to-equity ratio excludes securities from the Banks and Insurance industries. Portfolio weights exclude cash exposure.

Conclusion

Diversification is arguably the only free lunch in investing and mid cap stocks offer investors uniquely attractive properties: higher quality and liquidity than small caps and greater growth potential and lesser concentration of returns than large caps. Naming conventions aside, if investors are seeking an optimal exposure to small, mid, and large market cap U.S. companies, we believe the best way to do this is by pairing a dedicated mid cap allocation with a large cap allocation.

U.S. Mid-Cap Equity Composite

Period Start	Period End	Gross-of-Fee Composite Return	Net-of-Fee Composite Return	Benchmark Return	Internal Dispersion	Composite Gross 3-Yr St Dev	Benchmark 3-Yr St Dev	Number of Relationships at Period End	Total Composite Assets (millions) at Period End	Total Firm Assets (millions) at Period End
31 Oct 2020	31 Dec 2020	19.89%	19.76%	19.15%	-	-	-	1	$0	$42,883
31 Dec 2020	31 Dec 2021	31.53%	30.67%	22.58%	-	-	-	1	$0	$55,129
31 Dec 2021	31 Dec 2022	-18.54%	-19.07%	-17.32%	-	-	-	3	$47	$44,345
31 Dec 2022	31 Oct 2023	6.40%	5.82%	-1.28%	-	-	-	3	$91	$43,845

Compliance Statement

Mawer Institutional claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Mawer Institutional has been independently verified for the periods from January 1, 2007 to December 31, 2022. The verification report(s) is/are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

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Composite Description

U.S. Mid-Cap equity products with a market capitalization a market capitalization of approximately US$60 billion and below, with the primary objective being growth. These products include American stocks with a market capitalization of approximately US$60 billion and below. Includes only accounts considered Institutional.

Restrictions — Maximum 15% cash and cash equivalents.
Minimum 70% U.S. Mid-Cap Equity.

Composite Creation Date — January 1, 2021

Composite Inception Date — October 31, 2020

Reporting Currency — All numerical information is calculated and presented in US Dollars.

Investment Management Fees — 65bps on first $25m, 55bps on next $25m, 50bps on next $200m, 45bps on next $250m, 40bps on balance.
The amounts of assets in the investment fee tiers are based on US Dollars.

Returns

Returns presented are time-weighted returns. Past performance does not guarantee future results.
Gross-of-fee returns include the reinvestment of all income received/earned. Gross-of-fees returns are presented before management fees and other expenses. Returns do not reflect the deduction of investment advisory fees. Advisory fees are described in part 2 of the firm's Form ADV.

Net-of-fee returns are calculated by deducting 1/12th of the top tier of the management fee schedule (0.65%) from the monthly gross composite return. Actual fees may vary depending on the applicable fee schedule and the size of the account. Mawer Institutional bears the costs of investment research. Research costs are not separately charged to clients.

Benchmark — Russell Midcap

The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index.

All benchmarks are total return indices (TRIs). Composite benchmarks, if they consist of a blend of more than one index, are calculated by weighting the respective index returns on a monthly basis. Composite and benchmark returns are in USD and net of withholding taxes, if applicable.

Internal Dispersion

Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those relationships that were included in the composite for the entire period. No dispersion measure is presented when the composite consists of five or fewer portfolios for the full year.

Standard Deviation

The three-year annualized standard deviation measures the variability of the composite gross returns and the benchmark returns over the preceding 36-month period; it is not presented when 36 monthly returns are not available.

Trademark

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A list of composite descriptions, a list of limited distribution pooled fund descriptions, and a list of broad distribution pooled funds are available upon request.

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Gross-of-fee returns include the reinvestment of all income received/earned and are presented before management fees and other expenses, and after withholding taxes, if applicable. A client's actual return will be reduced by management fees and other expenses that may be incurred in the management of the client account. Mawer Investment Management Ltd.'s management fee schedule is outlined in Part 2A of its Form ADV. Net-of-fee returns are calculated by deducting 1/12th of the top tier of the management fee schedule from the monthly gross-of-fee returns of the composite. Actual fees may vary depending on the applicable fee schedule and the size of the account.

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