

# The Case for Mid-Cap Growth Investing

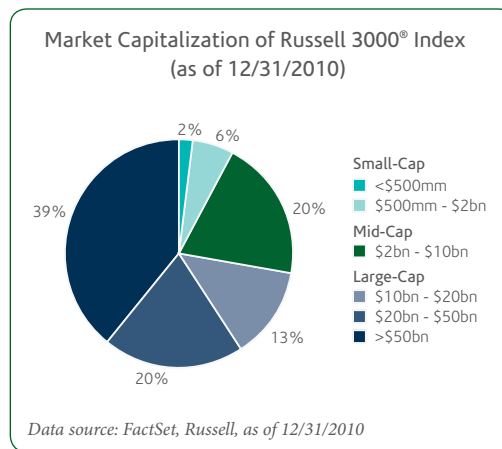
Mid-Cap equities historically have had superior risk-adjusted returns relative to other domestic equity asset classes

### REAL MID-CAP DEFINED

The capitalization of the U.S. equity investment universe, as represented by the Russell 3000® Index, is approximately:

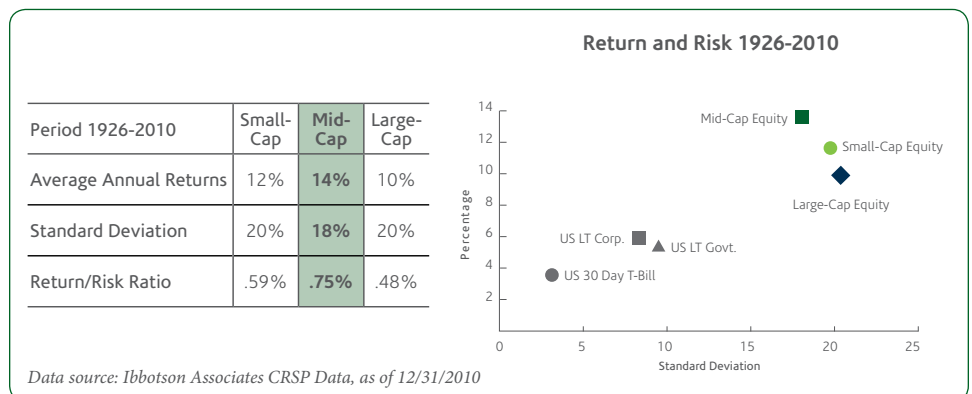
- 8% small-cap companies with capitalizations under \$2 billion;
- 20% mid-cap companies with capitalizations between \$2 billion and \$10 billion; and
- 72% large-cap companies with capitalizations above \$10 billion.

Investors often underutilize up to 20% of stocks in the U.S. equity universe because they do not consider Mid-Cap stocks to be a distinct asset class. Their exposure to Mid-Cap stocks often comes incidentally from broadly defined allocations to Small- and Large-Cap equities. Investors who appreciate the advantages of Mid-Cap stocks will generally want a higher allocation to the space.



### SUPERIOR RISK-ADJUSTED RETURNS

As shown below, Mid-Cap stocks have delivered higher average returns than either Large- or Small-Cap stocks, while exhibiting volatility comparable to Large-Cap stocks and lower than Small-Caps. *These attractive risk-adjusted returns appear to be rooted in fundamental characteristics of maturing growth companies that reside specifically in this underutilized space.*

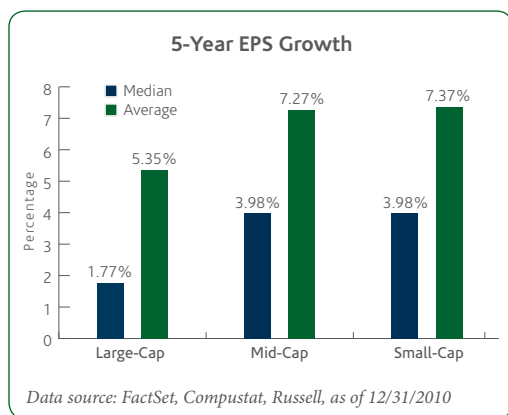


Past performance does not guarantee future results. An investment cannot be made in an index.

## ATTRACTIVE FUNDAMENTALS

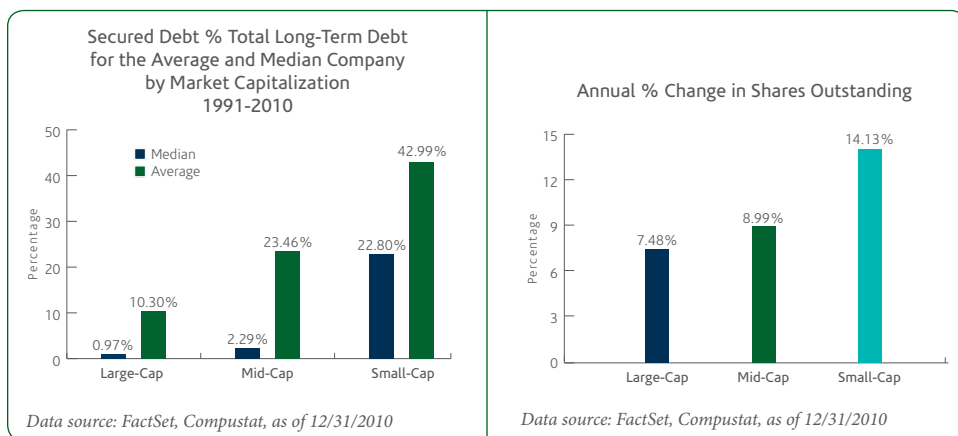
### Earnings Growth

Mid-Cap status is an important stage in a company's development. In order to attain a multi-billion dollar market cap, this group will generally have progressed past the operational and financial risks of infancy. Yet, the accompanying chart depicts, Mid-Caps still have plenty of runway left for growth.



### Positive Cash Flow

Maturing Mid-Cap companies are often cash-flow positive and self-financing. This is important because it shows that a company has moved beyond requiring dilutive infusions of capital to fund growth. As a result, shareholders potentially capture a greater level of return. When not self-funding, more mature companies will generally have excellent financing alternatives via the public debt and equity markets. As shown below, over the past 19 years, Mid-Cap companies have increased their share counts at about half the rate of Small-Cap companies and relied significantly less on secured debt (a riskier form of credit).



### Seasoned Management Teams

Established companies have typically bridged the transition from entrepreneur-led to professional management teams. These experienced executives possess the skill set necessary to take the business to the next level. This important step also establishes credibility in the public markets, enhancing the likelihood that the company remains a successful investment.

Our research shows that the Mid-Cap equity universe has an abundance of mid-lifecycle, financially sound, high-growth companies, with the potential to sustain earnings growth over time

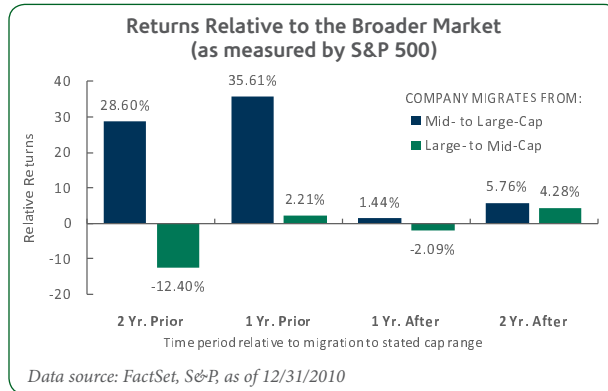
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EPS: Earnings Per Share is the portion of a company's profit allocated to each outstanding share of common stock.

While both growth and value Mid-Cap stocks offer attractive opportunities, we believe the case for Mid-Cap growth investing is particularly compelling

### The “Sweet Spot” of the Active Investment Universe?

Active Mid-Cap managers have an opportunity to select companies early in their growth and maturation cycle. We examined the returns of 900 stocks in the Standard & Poor’s Mid-Cap and Large-Cap indices. As shown below, the stocks that migrated from the S&P Mid-Cap 400 Index to the S&P 500 Index performed better than the S&P 500 Index. However, the bulk of these stocks’ more favorable performance was achieved while the stocks were Mid-Cap stocks in the process of growing into Large-Cap status.

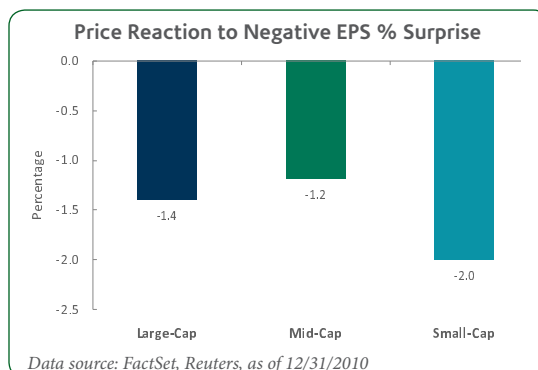


Looking at the total investment universe, there is less competition over investment opportunities in the Mid-Cap area. There are fewer active investment managers and fewer sell-side analysts working in the Mid-Cap arena than in Large-Cap, so the menu is less picked over.

The Morningstar database of active managers shows approximately 30% more Large-Cap managers than Mid-Cap managers. The Reuters database of sell-side earnings estimates indicates that from 1990 to 2009, Large-Cap companies had twice as many analysts following them as Mid-Cap companies even though there are almost three times more companies in the Mid-Cap universe. The lower level of competition in the Mid-Cap area for an investment idea suggests that stock pricing may be less efficient among Mid-Cap stocks than Large-Caps and offer active managers opportunities to add value.

Compared with many Small-Cap stocks, Mid-Caps frequently offer sufficient, good quality information to facilitate analysis. The chart below depicts how investors tend to penalize earnings disappointments of Small-Cap companies much more than those of Mid- and Large-Cap companies. We attribute this effect to lower transparency and lower liquidity of Small-Cap stocks. With less good quality information and analysis available, Small-Cap investors may be more vulnerable to surprises and the adverse stock reaction that results.

This combination of fundamental and market characteristics underpins Mid-Cap stocks’ favorable risk-reward ratio.



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## Skilled, Active Management is Key

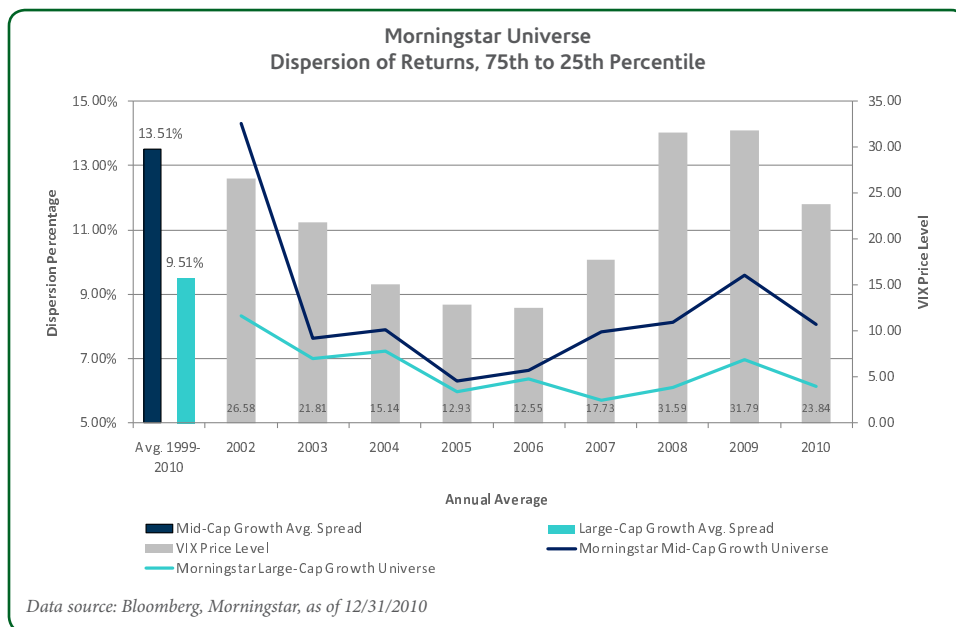
In an investment universe with potential to identify fundamentally strong investment opportunities, active management is key. There is evidence that active management is more successful and more important in growth investing than in value.

In a research paper, Janet Robovsky, a Practice Leader with Watson Wyatt Worldwide, concludes, "Style does matter, and should be considered when making the active/passive decision." Robovsky studied active manager performance versus index returns going back to the mid-1980s and observes:

*"... there are times when the Index has been in the top quartile (the five year period ending December 1998), when an investor would have been better off with an index fund. There have been more times, however, when the Index was in the 3rd or 4th quartile, and active management was the better strategy. We also charted the VIX which is a measure of implied market volatility. Not surprisingly, the higher the volatility of the market, the more likely it was for active managers to perform better than the Index..., unlike the Growth Index, where active management has been the better approach, the results for the Value Index are much more mixed."<sup>41</sup>*

We have also found that active managers are more differentiated in the Mid- and Small-Cap spaces where there tends to be greater dispersion in stock performance, indicating greater opportunity for outperformance. This manager differentiation, as illustrated in the graph on the following page, is an essential component to active management. Skilled, active Mid-Cap growth managers can add value compared to their Large-Cap growth counterparts especially during more volatile markets where investors require excellent risk-adjusted returns. Given this, a passive investment strategy in the Mid-Cap growth space could lead to missed opportunities for outperformance.

Within the Mid-Cap growth space, sufficient dispersion exists in the performance of active managers to suggest that good manager selection has the potential to enhance investor returns



### Past performance does not guarantee future results.

<sup>1</sup>Robovsky, J. (2009, May 12) In Search of Alpha. Asset Classes, 2. Retrieved from [http://www.benefitscanada.com/investments/asset\\_classes](http://www.benefitscanada.com/investments/asset_classes). There is no assurance that any investment or investment strategy will achieve its objectives.

## Conclusion

Mid-cap stocks have generated attractive risk-adjusted returns over long periods. Mid-cap stocks provide much of the liquidity, transparency, and stability associated with Large-Cap stocks, coupled with certain advantages relative to Small-Cap stocks.

Specifically, the Mid-Cap area appears to be: (1) less efficient than Large-Cap; (2) transparent enough for credible and thorough analysis; and (3) liquid enough that investment strategies are not distorted by the trading costs, maneuverability, and scale issues that Small-Cap managers face.

This compelling performance reflects attributes of the companies themselves, not just their segment of the market. The companies have moved beyond infancy, with its many risks, but many have business models with plenty of runway left for growth.

With these advantages, many investors would benefit from a targeted allocation to this space. It is an area where skilled investment management can pay off by uncovering the hidden gems that are found in this attractive class of stocks.

**Returns represent past performance and are not a guarantee of future performance.** References to indexes are made for comparison purposes. Indexes are unmanaged and cannot be invested in directly. Index performance does not include fees or expenses. Financial and statistical information provided is obtained or derived from sources deemed reliable but is not guaranteed as to accuracy or completeness.

**Mid- and Small-Cap investing involve special risks. Mid- and Small-Cap funds are designed for investors who can accept short-term fluctuations in principal and earnings and can assume the higher risk typically associated with an aggressive-growth fund. Mid- and Small-Cap stocks are more volatile and drop more in down markets than Large-Cap stocks. Growth stocks can perform differently from the market as a whole and can be more volatile than other types of stocks.**

The Russell Midcap® Growth Index generally represents the U.S. market for medium-capitalization growth stocks. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization which represents approximately 98% of the investable U.S. equity market. The S&P 400 Mid-Cap Index is a group of 400 domestic stocks chosen for their market size, liquidity and industry group representation. The S&P 500 Index is the Standard & Poor's composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices. The Russell 2000 Growth Index represents the smallest 2000 stocks with the highest price-to-book ratio and future earnings according to the Frank Russell Company.

Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time.

Risk/return ratio is the relationship between the amount of return gained on an investment and the amount of risk undertaken in that investment.

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