

The Golden Mean? Looking at SMid-Caps

Small-cap specialist Royce & Associates looks at a little understood area of the US equity market – the so-called smid-cap market. This segment, Royce argues, has much to recommend it, including all of the attractions of small-cap stocks and more.

One interesting alternative to the typical combination of small-cap and large-cap allocations exists somewhere in between, lying in an often-underappreciated zone of the equity market. We think that the smid-cap (ie small-cap to mid-cap) universe combines many of the attractive performance attributes of the small-cap segment with some of the liquidity and business stability characteristics more traditionally associated with larger enterprises.

Interestingly, as small-cap has become an established asset class, the companies trading closest to the periphery have become somewhat orphaned, and therein lies the opportunity. In fact, a spirited internal debate among our portfolio managers has always taken place about how best to treat the legacy of information and expertise developed for those businesses that have moved far out of our traditional capitalisation parameters, that is, above \$2.5 billion in market cap.

SMid-cap portfolios therefore represent a logical extension of our core research capabilities in the small-cap universe, allowing us ongoing use of our institutional knowledge as companies we know well move up (and down) the cap spectrum.

An Emerging Asset Class

Defining and studying the SMid cap asset class is not yet a precise science, however. Most smid-cap investors measure their relative performance against the Russell 2500. Comprised of the entire membership of the Russell 2000 – the broadly accepted small-cap benchmark—and the smallest 500 companies within the Russell Midcap Index, the Russell 2500 index offers fair representation of the pool of small-cap and mid-cap stocks that make up the smid-cap universe. Examining its performance characteristics over time gives a clear case for the opportunity offered by the smid-cap space.

Since the inception of these two indexes in 1979 until December 31, 2010, the Russell 2500 has consistently outperformed the Russell 2000 – see tables below. Using standard deviation to measure volatility, the Russell 2500 has enjoyed another advantage over its strictly small-cap counterpart - the volatility of the smid-cap index has been quantifiably lower than small-cap. We think that higher returns combined with lower standard deviation makes a compelling aggregate risk-reward profile.

Average Annual Total Returns as of December 31, 2010				
	1 Year	5 Years	10 Years	Since Inception (12/31/78)
Russell 2000	26.86%	4.47%	6.33%	11.75%
Russell 2500	26.71	4.86	6.98	13.07

Standard Deviation as of December 31, 2010		
	5 Years	10 Years
Russell 2000	23.11	21.14
Russell 2500	22.10	19.84

Source: Royce & Associates

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The emerging acceptance of small-cap stocks as a permanent part of an investor's portfolio, combined with the traditionally dominant allocation to large-cap stocks, has created a meaningful investment opportunity in those stocks that fall in between. Smid-cap managers have a larger selection universe, with strong historical performance characteristics, lower volatility and greater liquidity than small-cap, while also boasting greater financial resources and business stability.

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