Mid Cap Value Stocks:
20 Years of Experience

White Paper Overview

In the first section of this three-part series, the total return and risk profiles of the three main equity capitalization groups were examined with a particular focus on middle capitalization (mid cap) stocks. The conclusion was that mid cap value stocks have offered investors the best risk-adjusted returns over the last 20 years.

First White Paper Statistics

January 1994- December 2013	Total Return	Annualized Return	Standard Deviation	Return/Risk
Russell Top 200 Index	445%	8.8%	15.3%	0.58
Russell 2000 Index	489%	9.3%	19.7%	0.47
Russell Mid Cap Growth Index	524%	9.6%	21.3%	0.45
Russell Mid Cap Value Index	805%	11.6%	16.2%	0.72

Monthly return data provided by Russell

For more information on the calculation of the statistics shown, please see the disclaimer or contact Nuance.

In this second section, Senior Investment Analyst Adam West, CFA, and Vice President and Portfolio Manager Chad Baumler, CFA, interview Scott Moore, CFA, founder and Chief Investment Officer of Nuance Investments, LLC (Nuance)[1]. Scott, who has over 20 years of experience investing in the mid cap space, shares his thoughts and opinions regarding the attractive return and risk characteristics of mid cap value stocks.

Risk-Adjusted Returns

Scott, over the last 20 years you have invested in a variety of different market environments. Based on your experience, do you believe a risk-adjusted framework is the right way to evaluate investment performance?

"Our Nuance team has a long standing and distinct risk-adjusted return focus as it relates to the goals of our investment process and our performance over time. More specifically, while we have a goal of outperforming our peers and benchmarks on an absolute basis over a market cycle, our primary goal is to outperform our peers and benchmarks on a risk-adjusted return basis. With that backdrop, I believe an investor should be looking for two characteristics above all others when evaluating an investment opportunity in the form of an asset class. The first trait to confirm is that the asset class has outperformed other asset classes over the long term. The second trait to confirm is that the asset class has outperformed with less risk. This combination is significant and positive and has the strong potential to result in satisfying performance over the long term. As such, I believe strongly that a risk-adjusted return framework is not only appropriate, but the ideal way for investors to study asset classes and potential asset managers.

One important concept is the definition of risk. Consultants and clients calculate risk in a variety of ways. As one example, many investors define risk by measuring how a portfolio differs from its primary or secondary benchmark. The concept being that the less you track your benchmark, the more risk you have. Our Nuance team does not agree with this definition. Rather, we believe that the true definition of risk to our clients is the potential to lose capital on a one stock at a time basis. As such, our goal is to minimize the downside in each investment we make, as that is the

representation of risk to our team. With that in mind, we believe the proper long term definition of risk is calculated by measuring the true volatility of an investment strategy over time versus peers and benchmarks. Or in the case of an asset class study, to measure that asset class's volatility versus other benchmarks over time. This methodology calculates the standard deviation of returns with the goal of being less risky than peers and benchmarks over a business or economic cycle. This version of risk is the denominator in the Sharpe ratio calculation and is why we prefer its usage."

Mid Cap vs. Small Cap and Large Cap

Why do you think mid cap stocks have had better investment returns than small cap and large cap stocks over the last 20 years?

"We think the most logical explanation centers on the competitive position and the expected growth rates of the various market cap groups. In our view, mid cap companies often find themselves in what we consider a competitive sweet spot. A place where we see market share gains or market share stability as the business has already achieved long term success, financial flexibility and management depth that can lead to stable and reasonable growth over time. Smaller cap companies, by contrast, might have even faster rates of market share gains and growth as a group, but often have much smaller research and development budgets, smaller sales teams and lower barriers to entry for new and old competitors to take market share going forward. Put another way, there is the opportunity for faster growth due to the potential to take market share from mid and large sized companies, but that potential growth comes at a significant risk as the market share positions are often new and not time tested. We think this is why you see the highest risk levels for small cap companies. Finally, larger cap companies have significant histories and larger market share positions, but the price of that size and stability is often very slow growth as well as the difficult process of adjusting to competitive transitions should that be necessary. In sum, mid cap companies are large enough to have more certain competitive futures, but still small enough to grow by gaining market share or by simply growing naturally with the economy. This combination of more certainty and modestly better growth than most is what we define as a competitive sweet spot for the broader class of mid cap companies.

I would also note that from an active management perspective, the mid cap space is relatively underfollowed by Wall Street. While this does not necessarily explain the better investment returns of the benchmarks over time, it does explain why an active manager has the potential to outperform. It is always quite interesting to see the number of high quality, competitively advantaged, mid cap companies that are available to invest in with only one, two or no sell side analysts covering them. Meanwhile, the larger companies within the same sectors could have as many as 20 or 30 analysts covering them. This is an area of the market where extra analytical work can payoff over the long term, in our opinion."

Mid Cap Value Risk

Over the same period, mid cap value stocks have had higher returns than large cap stocks with about the same level of risk. Why haven't the higher returns come with higher risk?

"I think there are two significant reasons for this empirical result. First, I believe that mid cap stocks generally are not riskier than large cap stocks. This is because the largest risk for any company is that their competitive position erodes over time and, as I mentioned before, we view mid cap companies in general to be in a competitive sweet spot. They are large enough to have historically dominant franchises as well as financial flexibility to fend off small and large competitors. As such, I would expect the volatility and risk to be more similar than different over the long term.

With the risk portion understood, we then can move on to the higher returns demonstrated in the data. Simply put, mid cap value stocks have outperformed both large cap growth and large cap value stocks over time.
The reasons, I believe, get back to the competitive sweet spot discussion combined with reasonable valuations that comprise the value portion of the mid cap universe. That combination of sustainable competitive positions, modestly better growth and reasonable valuations defines the long term advantages of the space."

Mid Cap Value vs. Mid Cap Growth

Why do you think the better risk-adjusted returns have only been seen in mid cap value stocks and not in mid cap growth stocks?

"The mid cap growth space has many companies with the characteristics that we just discussed: competitively in a sweet spot, above-average long term growth prospects and generally underfollowed by Wall Street. However, they typically are already growing very quickly and have high valuation multiples due to this growth. Given their already meaningful size, it is often very challenging for them to accelerate their growth to even higher levels and to achieve even higher valuation multiples.

Contrast that with mid cap value companies that typically have a positive growth profile over the long term (although slower than the growth stocks) but trade at significantly lower valuation multiples. I believe these companies have a much better chance of outperforming over a cycle."

Investment Opportunity

Finally, does this mismatch between mid cap value stocks' return and risk represent a legitimate investment opportunity in your opinion?

"I believe the mid cap value universe will continue to be a great universe from which to find excellent investment opportunities. When I started in the business the majority of my favorite ideas were mid cap value stocks and that is still the case today. As I mentioned before, the space has historically been underfollowed by Wall Street. In fact, it may actually be more underfollowed today than in the past given the cuts in investment research we have seen at investment banks over the last five to ten years.

So, yes, I believe the opportunity is there. But I would offer a word of caution: the mid cap value benchmark today has over 25% of its weight invested in utilities and real estate investment trusts versus a long term average of about half that number. Both industries have benefitted tremendously from historically low interest rates and the subsequent 'chase for yield' that we have seen in the market the past few years. If and when interest rates start normalizing to higher levels that are more indicative of a healthy economy, these stocks are likely to face some serious headwinds. Because of this, I would suggest that the mid cap value benchmark returns over the nearer term might not be as high as they have been historically. However, I believe an active mid cap value manager should be able to spot these market and valuation anomalies and take advantage of other opportunities being presented within the space."

Concluding Thoughts

After studying the return and risk profile of mid cap value stocks in the first section, and uncovering reasons as to why this has occurred in the second section, Adam and Chad will conclude the analysis by determining if active managers have historically been able to benefit from this apparent mismatch between returns and risk. Look for the third section of this series entitled "20 Years of Competition", when they take a look at the risk and return profile of active mid cap value managers over the last 20 years.

Disclaimer and Notes

Not An Offer or Inducement

Nuance Investments, LLC's (Nuance or the Company) White Paper has been prepared for informational purposes only and does not constitute an offer or solicitation to sell shares or securities in the Company or any related or associated company. Any such offer or solicitation will be made only by means of the Company's offer of discretionary investment management services under written contract. None of the information or analyses presented are intended to form the basis for any investment decision, and no specific recommendations are intended. Accordingly this White Paper does not constitute investment advice or counsel or solicitation for investment in any security. This White Paper does not constitute or form part of, and should not be construed as, any offer for sale or subscription of, or any invitation to offer to buy or subscribe for, any securities, nor should it or any part of it form the basis of, or be relied on in any connection with, any contract or commitment whatsoever. The Company expressly disclaims any and all responsibility for any direct or consequential loss or damage of any kind whatsoever arising directly or indirectly from: (i) the use of this White Paper, (ii) reliance on any information contained herein, (iii) any error, omission or inaccuracy in any such information or (iv) any action resulting therefrom.

Investment Performance

Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this documentation and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested.

No Warranties

Nuance takes care to ensure that the information provided is accurate and up to date. However this documentation is provided without warranties of any kind, either expressed or implied, including but not limited to warranties of title or implied warranties of merchantability or fitness for a particular purpose. Opinions expressed herein are subject to change without notice. All information and content in this White Paper is furnished "as is," without warranty of any kind, express or implied, including but not limited to implied warranties of merchantability, fitness for a particular purpose, or non-infringement. The Company will not assume any liability for any loss or damage kind, arising, whether direct or indirect, caused by the use of any part of the information provided.

Copyright

You may not copy, reproduce, recompile, decompile, disassemble, reverse engineer, distribute, publish, display, perform, modify, upload to, create derivative works from, transmit or in any way exploit any part of this material, except that you may use for your own personal, noncommercial use. The analysis and presentation included in this material may not be re-circulated, redistributed or published without our prior written consent. Modification of the materials content would be a violation of our copyright and other proprietary rights. Additionally, you may not offer any part of this material for sale or distribute it over any other medium including but not limited to over-the-air television or radio broadcast, a computer network or hyperlink framing on the internet without our prior written consent. The information contained herein may not be used to construct a database of any kind. Nor may the information be stored (in its entirety or in any part) in databases for access by you or any third party or to distribute any database services containing all or part of the information without our prior written consent.

Past performance is not indicative of future results.

Return figures for all indices are provided by Russell. Returns are calculated from January 1, 1994 to December 31, 2013. Risk adjusted return ratio is calculated by dividing the annualized return by risk.

(1) Scott Moore, Chartered Financial Analyst (CFA), is the President and Chief Investment officer of Nuance Investments, LLC (Nuance). He is also the Lead Portfolio Manager for all products within Nuance. Scott has more than 22 years of investment experience, more than 20 years of value investment analyst experience and more than 14 years of portfolio management experience using a classic value approach.

For the decade before co-founding Nuance, Scott managed more than $10 billion in institutional, intermediary and mutual fund assets for American Century Investments (ACI). Prior to becoming a Portfolio Manager, he spent three years as an Investment Analyst at ACI, specializing in the telecommunications, utility and industrial sectors. He also worked as an Investment Analyst at Boatmen's Trust Company in St. Louis, Missouri, and at ACI as a Fixed Income Investment Analyst.

Scott holds a Bachelor of Science (BS) in finance from Southern Illinois University, and a Masters of Business Administration (MBA) with an emphasis in finance from the University of Missouri. He is a CFA® charterholder.