Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

Case for Mid Cap Value

"A TOUCH OF GREY"

The song title from one of the Grateful Dead's biggest hits aptly describes the common sentiment toward mid cap investing. Caught between the much bigger universes of large and small cap mandates, many investors consider the mid cap style as neither fish nor fowl or black and white. As a consequence, separate mid cap allocations are rare even in large institutional plans. However, we believe interest in mid cap value allocations will rise going forward. The increased attention will come from investors who are unable to find small cap value capacity and are committed to exposure beyond large cap commitments. This brief commentary will specifically focus on why a mid cap value allocation can be a profitable complement to small cap value.

THE DATA

The data used in this analysis will be the Russell style benchmarks. The mid cap style benchmarks have data history beginning 1/1/86 while the combined mid cap index data begins 1/1/79. The Russell Corporation provides a useful website http://www.russell.com so I will leave detailed explanations of index construction and characteristics through this link. My focus will be on the historical analysis of return patterns between the Russell Midcap® Value Index and the Russell 2000® Value Index. The data covers the period from 1/1/87 – 6/30/06 measured by calendar quarter.

THE HISTORICAL RECORD

The Russell Midcap® Value Index historical record is compelling when compared to the small cap benchmark. The analysis is summarized below. Supporting graphs on each point are updated quarterly and available through our website http://www.tswinvest.com.

- Reward and Risk. Since inception date of 1/1/86, the Russell Midcap® Value Index has returned 14.0% annually compared to 12.9% annually for the Russell 2000® Value Index. Over this same period, risk (defined as the annualized standard deviation of quarterly returns) was 15.7% annually versus 19.0% for the Russell 2000® Value Index. The Sharpe Ratio favors the Russell Midcap® Value Index over the Russell 2000® Value Index at .57 and .42 respectively. When measured over rolling 20 quarter periods the Russell Midcap® Value Index had a higher Sharpe Ratio than the Russell 2000® Value Index in 51 of the 63 (82%) of the available periods.

- Consistency of Results. The Russell Midcap® Value Index exceeded the 20 quarter return of the Russell 2000® Value Index in 36 of the 63 (57%) available periods. The median return for the Russell Midcap® Value Index relative to the Russell 2000® Value Index was +.2% with a maximum 20 quarter relative return of +6.3% (3/31/99) and a minimum relative return of -5.6% (3/31/04). What is especially compelling is the Russell Midcap® Value Index had lower volatility of returns compared to the Russell 2000® Value Index in all 63 periods (100%) with a median standard deviation 14.5% below that of the Russell 2000® Value Index.

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- **Benchmark Correlation.** Since the inception date of 1/1/87 to 6/30/06 the correlation of quarterly returns between the Russell Midcap® Value Index to the Russell 2000® Value Index is 95%. When viewed over rolling 20 quarter periods the median correlation was 94% with a maximum of 98% (6/30/06) and a minimum of 75% (6/30/96). Historical return patterns have produced a very high correlation of quarterly returns between the Russell Midcap® Value Index and the Russell 2000® Value Index.

- **Valuation.** The biggest increase in valuation among the value indexes has clearly been in the small cap bench mark. The P/E ratio of the Russell 2000® Value Index as of 3/31/06 was 19.1x versus an average since 12/31/86 of 14.9x. The P/E ratio of the Russell Midcap Value® Index as of 3/31/06 was 17.2x versus an average of 14.6x. Valuation across the entire Russell 3000® Value Index by market capitalization clearly highlights the most expensive segment of the value benchmarks is concentrated in the smallest deciles of size. As of 6/30/06 the bottom decile of market capitalization in the Russell 3000® Value Index had a weighted average P/E on FY1 of 24.3x while the 3rd decile of market capitalization was the least expensive at 10.7x.

BUT WHAT DOES IT ALL MEAN?

The point of this analysis is to present an arguable case for using a mid cap value strategy as a complement to a small cap value strategy. The historical record for the mid cap value benchmark has been competitive with the small cap value benchmark in both return and risk. In addition, from a cyclical perspective the most expensive segment of the value benchmarks is in the smallest companies today.

WHAT MATTERS THE MOST

All would agree finding the right active manager is critical to generating superior returns. What is more open to debate is where you draw the line between finding the right manager and product characteristics. We suggest the analysis presented above is compelling enough to consider casting a wider net that includes mid cap value managers in small cap value searches. Simply put, the line separating these two product areas is just a touch of grey.

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