

OVERLOOKED & UNDERAPPRECIATED...

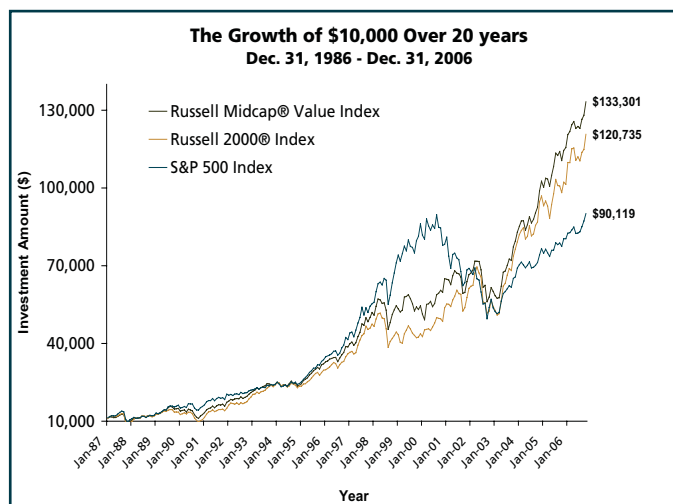
Mid-cap value stocks have posted exceptional returns over the past twenty years. According to the Russell Midcap® Value Index—the most widely applied benchmark of performance for this category of stocks—annual returns averaged 14.1 percent during the period. That is 2.3 percentage points higher than the average return from the S&P 500 Index. What's more, it's higher than the return from stocks in the Russell Midcap® Growth Index and in Russell's small and large-cap equity indexes, whether value or growth oriented¹.

Yet, despite their strong showing, mid-cap value stocks continue to receive less consideration than small or large-cap stocks in the equity allocation decisions of many investors and investment advisors. Some investors simply don't see the appeal of stocks in the somewhat nondescript mid-cap range, whether growth or value-oriented. After all, mid-cap companies typically don't offer the rapidly expanding sales, high earnings growth, or soaring stock prices associated with many small-cap companies. And, in many cases, they don't offer the earnings stability, safety, or cash dividends associated with large-cap companies. In fact, a rationale for investing in mid-cap stocks can be difficult to articulate; betwixt and between the popular small and large-cap categories, mid-cap stocks are harder to characterize and easier to overlook.

As a result, mid-cap equities in general, and mid-cap value equities in particular, are underrepresented among the product offerings commonly available to investors. There are twice as many small-cap equity products available to institutional investors interested in value investing. Large-cap equity products outnumber mid-cap products by an even greater ratio—over three to one. And within the mid-cap range, there are many more growth products than value products offered to investors².

“Clearly, compared to just about any benchmark, mid-cap value stocks have outperformed over the last twenty years.”

In some instances, mid-cap stocks may be present but not obvious in a portfolio. A portfolio manager, for example, might select a number of the smaller mid-cap stocks and place them in an otherwise all small-cap portfolio. Likewise, a large-cap manager might reach into the upper end of the mid-cap range in making stock selections for a large-cap portfolio. In such cases, an investor may have more exposure to the mid-cap range than realized, simply because mid-cap stocks are not pulled together into a separate product. To the extent this occurs, there is likely more exposure to mid-cap stocks than reported, but possibly more confusion regarding the extent of this exposure. In any case, mid-cap stocks are not the primary focus of the portfolio manager in such instances. In addition, the practice may introduce another component of risk to small or large-cap portfolios since it puts these portfolios at risk of market-timing the cap weighting of the portfolio.



¹Source: Index values used in performance calculations obtained from Frank Russell Company and Standard & Poor's.

²Source: eVestment Alliance, December 31, 2006.

We examine the long-term performance of mid-cap value stocks in detail in this report and argue that investors might want to take a closer look at such stocks when making equity allocation decisions. The excellent performance of mid-cap value stocks over the last twenty years is attributable in large part to the strong performance of value investing vis-à-vis growth investing during that period. We therefore begin our exposition with a discussion of value investing performance. Within the value category, mid-cap stocks have generally recorded higher returns than small and large-cap stocks and we explore the case for mid-cap value stocks as a complement to other equity investments. Throughout the report, we rely heavily on Russell's stock indexes for timely measures of performance in the various equity classes.

Value versus Growth Investment Studies

In the ongoing debate over value versus growth investment styles, advocates of value investing have the weight of empirical evidence on their side. Chan and Lakonishok (2004) provide a comprehensive review of the quantitative evidence supporting value investing in their discussion of four academic studies on the topic. These studies—Chan, Hamao, and Lakonishok (1991), Fama and French (1992), Lakonishok, Shleifer, and Vishny (1994), and Fama and French (1998)—each evaluated returns from value and growth strategies and concluded that value stocks came out ahead. The markets studied varied broadly: Fama and French examined the NYSE, Amex, and Nasdaq exchanges in their 1992 article and an array of international markets in the 1998 study; Lakonishok, Shleifer, and Vishny looked at the NYSE and Amex markets; while Chan, Hamao, and Lakonishok studied the Tokyo stock market³. Methodologies were similar though; in each case, stocks were sorted into categories based on characteristics such as book-to-market equity ratios and earnings-to-price ratios in order to array them from the most to the least value-oriented. Returns were then calculated for each category of stock.

In summarizing their review of the value and growth investing literature, Chan and Lakonishok (2004, p. 84) conclude: “A large body of empirical research indicates that value stocks, on average, earn higher returns than growth stocks.” In addition, while acknowledging that reasons for the differences between the performances of value and growth stocks are difficult to pinpoint, the authors dismiss the argument that the higher returns of value stocks is attributable to higher risk exposure. “The evidence from a variety of indicators, including beta and return volatility, suggests that value stocks are not riskier than growth stocks. Indeed, using the popular risk indicator that focuses on performance in down markets, we found that value stocks suffered less severely than growth stocks when the stock market or the overall economy did poorly.”

Kwag and Lee (2006) also provide support for the value style of investing. They conclude: “Empirical evidence suggests that value investing based on high valuation ratios (that is, book-to-market ratio, earnings-to-price ratio, cash flow-to-price ratio, and dividend yield) tends to outperform growth investing based on low valuation ratios. This superior performance is robust for all economic conditions, meaning that investors will be better off investing in stocks with low valuation ratios versus stocks with high valuation ratios regardless of economic conditions.”

Stock Returns: Value and Growth Indexes 1986-2006

The latest quantitative data on returns by equity investment style are consistent with the academic studies indicating that value investing outperforms growth investing. Performance results for selected value and growth-style equity indexes over 5, 10, 15, and 20-year periods ending December 31, 2006 are presented in Table 1. Included are annualized returns for Russell value and growth indexes for small, medium, and large capitalization stocks⁴. Returns for the widely

³Fama and French (1998) report results from the United States, Japan, United Kingdom, France, Germany, Italy, Netherlands, Belgium, Switzerland, Sweden, Australia, Hong Kong, and Singapore.

⁴Annualized rates are geometric means using Russell Index and S&P Index data.

cited S&P 500 Index are also reported in order to provide a measure of broad stock market performance. Annualized returns by equity style category for the 20-year period are graphed in Chart 1.

We have chosen to report returns for Russell indexes in our performance comparisons because this company's indexes are objective, transparent, and widely used within the investment community. Russell's value and growth indexes allow distinct determinations of stock performance by style of investment. To determine style, the Russell Company ranks stocks based on book-to-market price of equity ratios and Thompson Financial I/B/E/S forecasts of long-term growth in company earnings. Within this methodology, some stocks are considered growth, some are considered value, and others are considered to have both growth and value characteristics and weighted proportionately in the company's growth and value indexes⁵. The Russell Midcap® Value Index includes stocks with market capitalization ranging from \$1.2 billion to \$21.4 billion. The index has a price-to-book ratio of 2.04 and a price-to-earnings ratio (ex. negative earnings) of 16.7 as of December 31, 2006.

As shown in Table 1, returns for value indexes are higher than for growth indexes in each of the four time periods shown. The differences are largest in the small-cap category, ranging from 6 to 9 percentage points across time periods. In mid and large-cap categories, differences in returns between value and growth indexes are a more moderate 2 to 8 percentage points. The return differential diminishes over time in the mid and large-cap ranges—from 8 percentage points in the five-year period to 3 percentage points in the 20-year period.

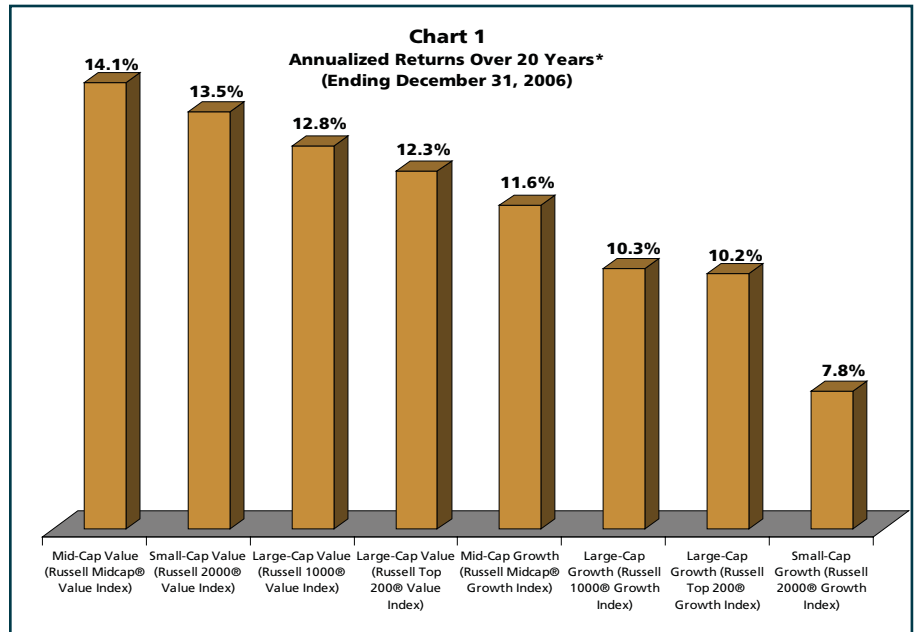


Table 1 - Stock Indexes - Annualized Returns*
Selected Time Periods Ending December 31, 2006

	5 Years	10 Years	15 Years	20 Years
Small-Cap Indexes:				
Russell 2000® Value Index	15.4%	13.3%	15.2%	13.5%
Russell 2000® Growth Index	6.9%	4.9%	7.1%	7.8%
Mid-Cap Indexes:				
Russell Midcap® Value Index	15.9%	13.7%	14.9%	14.1%
Russell Midcap® Growth Index	8.2%	8.6%	10.1%	11.6%
Large-Cap Indexes:				
Russell Top 200® Value Index	8.7%	9.9%	12.2%	12.3%
Russell Top 200® Growth Index	1.1%	4.8%	7.7%	10.2%
Russell 1000® Value Index	10.9%	11.0%	13.1%	12.8%
Russell 1000® Growth Index	2.7%	5.5%	8.0%	10.3%
Standard & Poor's Index:				
S&P 500 Index	6.2%	8.4%	10.6%	11.8%

*Source: Frank Russell Company and Standard & Poor's.

Risk-Adjusted Returns

Our performance results through December 2006 also support Chan and Lakonishok's conclusion that higher returns to value stocks are not simply the result of higher risk exposure. After adjusting for risk, we find that value stocks consistently outperform growth stocks.

⁵Although monthly data for Russell's small and large-cap style indexes extend back to January 1979, data for the Russell Midcap style indexes are not available prior to January 1986. We report data in five-year increments for only 20 years because of this limit on the availability of mid-cap index data.

Our measure of risk-adjusted return is the Sharpe ratio. For a stock portfolio, this ratio is calculated by subtracting a risk-free rate of return from the rate of return for the portfolio, and dividing the result by the standard deviation of portfolio returns. This measurement is very useful because, although one portfolio or fund can reap higher returns than its peers, it is only a good investment if those higher returns do not come with too much additional risk. The greater a portfolio's Sharpe ratio, the better its risk-adjusted performance has been.

$$\text{Sharpe ratio} = (r_p - r_f) / \sigma_p$$

where r_p = portfolio return

r_f = risk free rate, assumed to be the interest rate on a 90-day Treasury bill

σ_p = standard deviation of portfolio returns

Table 2 presents Sharpe ratios for the same value and growth style equity indexes and time periods included in Table 1. Data for the 20-year period are graphed in Chart 2. As with the absolute returns in Table 1, Sharpe ratios are larger for value indexes than for growth indexes in each time period and capitalization range. Mid-cap value stocks have the largest Sharpe ratios in the four periods while small and large-cap growth stocks have the smallest. In addition, Sharpe ratios are larger for value indexes than for the S&P 500 Index in all time periods shown.

Table 2 - Sharpe Ratios*
Selected Time Periods Ending December 31, 2006

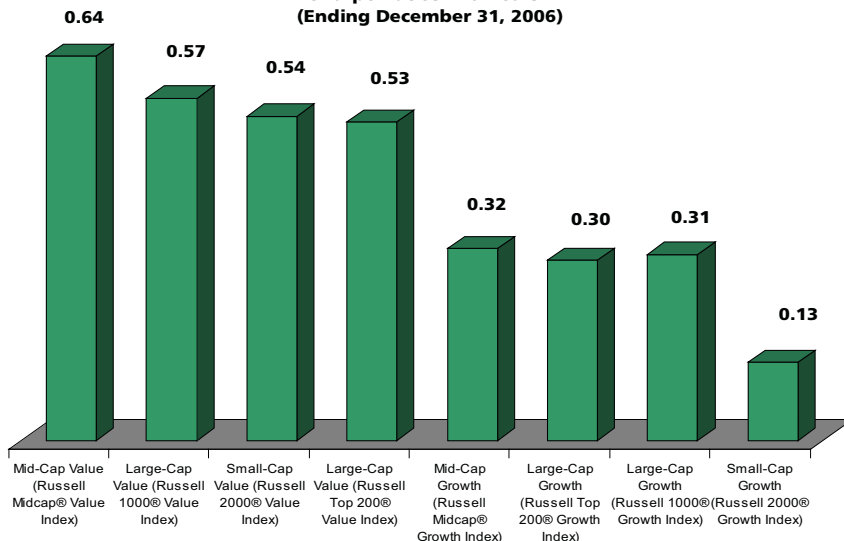
	5 Years	10 Years	15 Years	20 Years
Small-Cap Indexes:				
Russell 2000® Value Index	0.82	0.60	0.80	0.54
Russell 2000® Growth Index	0.23	0.04	0.13	0.13
Mid-Cap Indexes:				
Russell Midcap® Value Index	1.08	0.69	0.86	0.64
Russell Midcap® Growth Index	0.37	0.20	0.29	0.32
Large-Cap Indexes:				
Russell Top 200® Value Index	0.49	0.41	0.62	0.53
Russell Top 200® Growth Index	-0.10	0.05	0.22	0.30
Russell 1000® Value Index	0.69	0.50	0.71	0.57
Russell 1000® Growth Index	0.02	0.08	0.24	0.31
Standard & Poor's Index:				
S&P 500	0.30	0.30	0.49	0.46

Mid-Cap Value Performance

Without a doubt, value stock investments have outperformed growth investments in the small, medium, and large capitalization ranges over the last twenty years. But what about mid-cap value investing compared to small and large-cap value investing?

The academic literature doesn't provide as much guidance on mid-cap value performance as it does on the topic of value versus growth investment⁶. A review of Tables 1 and 2, however, suggests that by standard measures of performance, the mid-cap value sector has performed remarkably well over the last twenty years. The absolute returns

Chart 2
Sharpe Ratios - 20 Years*
(Ending December 31, 2006)



*Source: Frank Russell Company and Standard & Poor's

⁶While the topic of mid-cap value performance has received scant attention in the academic literature, there have been a few studies addressing the relative performance of mid-cap stock indexes. Zwecher (1997) takes a look at mid-cap performance using three measures: 1) absolute; 2) relative to total risk, employing Sharpe's measure; and 3) relative to risk-adjusted benchmarks, employing Jensen's alpha. He examines the performance of four mid-cap benchmarks and concludes that mid-cap indexes outperform their benchmarks on a risk-adjusted basis.

reported in Table 1 show that the Russell Midcap® Value Index rose at an average annual rate of 14.1 percent over the twenty-year period ending December 2006. That's above the 13.5 percent annual rate posted by the Russell 2000® Value Index, the 12.8 percent rate of the Russell 1000® Value Index, and the 12.3 percent rate of the Russell Top 200® Value Index.

Returns for the mid-cap class were strong in the shorter time periods as well. Average returns for the mid-cap value index exceeded those for the large-cap value indexes by substantial margins in the 5, 10, and 15-year periods presented in Table 1. Mid-cap value returns have been at or slightly below returns of the small-cap value index in these shorter time periods.

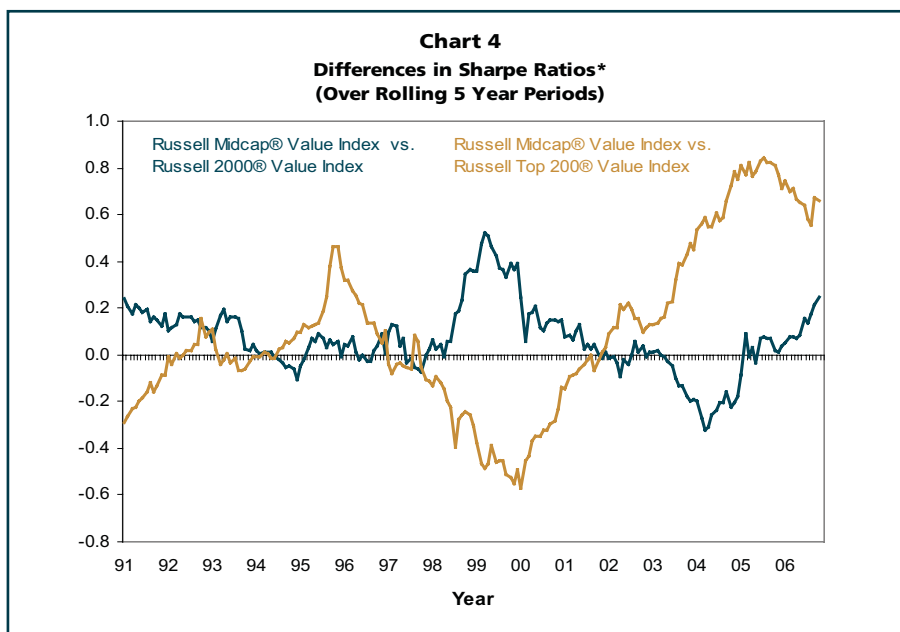
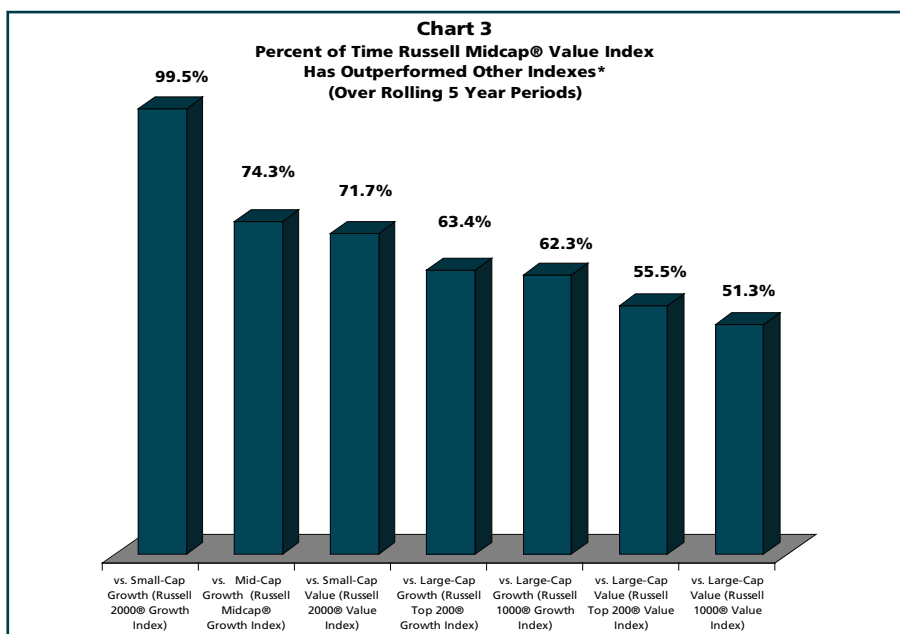
On a risk-adjusted basis, mid-cap value stocks outperformed small and large-cap value stocks in all four of the time periods for which results are reported in Table 2. Mid-cap value stocks have done particularly well in the last five years by this measure, with a Sharpe ratio of 1.08.

Consistency Matters

Another way to measure stock performance is to check the consistency of returns over a period of time. Over rolling five-year periods, and measured on a monthly basis, the Russell Midcap® Value Index has outperformed the Russell 2000® Value Index (on a risk-adjusted basis) 72 percent of the time. (See Chart 3). Large-cap stocks have proven to be stiffer competition by this measure. Still, the Russell Midcap® Value Index has outperformed the large-cap Russell Top 200® Value Index 56 percent of the time and the Russell 1000® Value Index 51 percent of the time.

Chart 4 provides a view of the performance of mid-cap value stocks compared to small and large-cap value stocks over time. Two lines are plotted in Chart 4 indicating: 1) the difference between Sharpe ratios for the Russell Midcap® Value and Russell 2000® Value Indexes over rolling five-year periods and 2) the difference between Sharpe ratios for the Russell Midcap® Value and Russell Top 200® Value Indexes over these five-year periods. The two lines in essence measure the extent to which the Russell Midcap® Value Index outperformed the small and large-cap value indexes.

As seen in Chart 4, the Russell Midcap® Value Index outperformed the Russell 2000® Value Index in most of the five-year periods shown. Five-year periods ending in late 1998 through 1999 showed particularly strong relative performance by mid-cap value stocks. In the comparison of mid-cap value to large-cap value stocks, five-year periods ending from the middle of 2003 to 2006 showed strong relative performance by mid-cap value stocks. In contrast, periods ending from mid 1998 through 2000 showed strong performance by large-cap value stocks.



*Source: Frank Russell Company

Concluding Remarks

A stellar long-term performance record is a compelling reason for investing in mid-cap value stocks. With an annualized return of 14 percent since 1986—as measured by the Russell Midcap® Value Index—mid-cap value stocks have performed well vis-à-vis other major categories of equity investment. On a risk-adjusted basis, mid-cap value stocks have looked even better, posting higher returns than small and large-cap stocks, both value and growth oriented, over 5, 10, 15, and 20-year periods.

Given such a strong mid-cap performance record, we believe that institutional investors should take a closer look at their mid-cap value equity exposure and consider increasing their exposure if necessary. In instances where mid-cap stocks are mixed in with other stocks in small or large-cap portfolios, efforts should be taken to properly measure the extent of exposure to the mid-cap range. As a benchmark for comparison, as of December 31, 2006, we note that stocks in the Russell Midcap® Index represent a substantial 26.0 percent of the capitalization of stocks in the Russell 3000® Index. The remaining 74.0 percent of the capitalization of the Russell 3000® Index is split between the Russell Top 200® Index at 65.2 percent and the Russell 2000® Index at 8.8 percent.

Of course, as always, past performance may not be an accurate indicator of future results. Still, there are good reasons why mid-cap value stocks could continue to outperform other equity classes going forward. Valuations in the class remain attractive—the price-to-earnings ratio of the Russell Midcap® Value Index is 16.7, substantially lower than the 22.0 of the Russell Midcap® Growth Index, and below the P/E ratios of the Russell 1000®, Russell 2000®, and Russell 3000® Indexes⁷.

In addition, mid-cap value stocks may receive a sizeable boost from investors finding it increasingly difficult to find adequate capacity in the small-cap value space. Many of these investors would likely extend their search for value by taking a look at smaller stocks in the mid-cap range.

If so, they could very well find offerings in the mid-cap universe more attractive than those in the small-cap universe. Mid-cap companies are often better established, less likely to be overly dependent on a single product or market for sales and profits and, thus, less risky than many small-cap companies. They are also more likely than small-cap companies to pay dividends, making them particularly appealing to value investors. Finally, mid-cap stocks are generally more liquid than small-cap stocks, a factor of considerable importance to many institutional investors.

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⁷Price-to-earnings ratios as of December 31, 2006. Ratios cited exclude negative earnings in their calculation.

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