Hiding in plain sight

Given the historical outperformance of mid caps, why are investors underallocated?

By ALEXIS PETRAKIS

RS Investments™

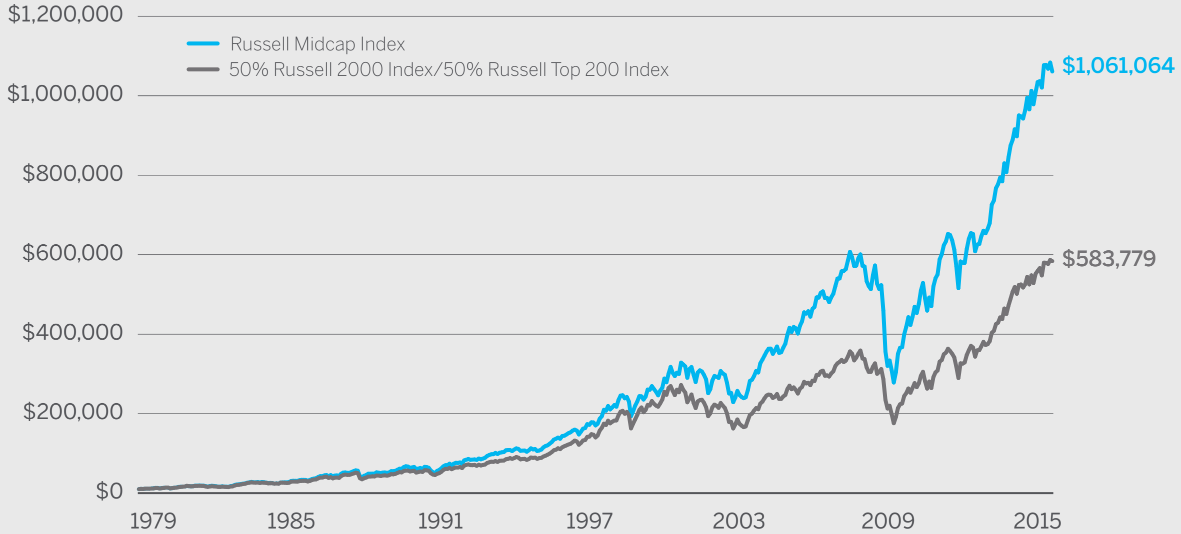
Drop the barbell

Investors who have adopted a barbell approach for domestic equities—i.e., allocating primarily to small and large company stocks at the far ends of the capitalization spectrum—may be missing some of the benefits of mid-cap stocks. In fact, history argues for a deliberate allocation to mid caps. Consider that a pure allocation to mid caps (as measured by the Russell Midcap® Index[1]) has outperformed a barbell approach (50% large-cap stocks, represented by Russell Top 200,®[2] and 50% small-cap stocks, represented by Russell 2000®[3]), over the past decade. In fact, a $10,000 investment in mid caps in 1979 would have grown to over $1 million for the period ended June 30, 2015. That same investment in a 50/50 barbell portfolio would have grown to slightly less than $600,000 during the same period. Of course, past performance does not guarantee future results.

PURE MID CAPS DID THE HEAVY LIFTING

In looking back at the risk and return profiles of a pure allocation to mid caps versus a large-cap/small-cap barbell approach, both have offered virtually identical risk profiles, as measured by standard deviation, but the returns of the pure mid-cap approach have been superior.

Growth of $10,000 (January 1, 1979 to June 30, 2015)



Historical risk and return (January 1, 1979 to June 30, 2015)

Source: Russell Investments, as of June 30, 2015.

Past performance does not guarantee future results.

Indexes are unmanaged and not available for direct investment and do not represent the performance of a single fund or any of the RS Investments Funds.

COMPANIES WITH SUSTAINABLE EARNINGS growth are coveted yet elusive commodities. And now seven years into an impressive bull market, many pundits consider domestic equities richly priced. That's worrisome to those concerned about geopolitical turmoil, a changing interest rate environment, or even a potential correction. So what's an investor to do when rebalancing or allocating new capital?

For some, the answer may be right in front of them—smack in the middle of the capitalization spectrum. Empirical research shows that mid-cap stocks have been the top performing segment of the U.S. equity market in a variety of environments. So while mid caps have historically surpassed their small- and large-cap counterparts, many investors remain underallocated to this equities niche. By foregoing an explicit allocation to mid caps, investors may be abandoning a consistent contributor to overall portfolio returns and a potential source of alpha.*

Performance history notwithstanding, targeting mid caps holds broad appeal for stock pickers. For starters, these companies are neither illiquid micro caps nor global behemoths. They are, however, vetted and well-established, with proven products and services. They generally have better access to capital compared to smaller, developmental-stage companies, but at the same time still offer a long runway of potential growth.

Some mid caps also have characteristics that make them less economically sensitive and more apt to capture durable return streams and market share.

These are just some of the reasons cited by Scott Tracy, co-portfolio manager with the RS Growth Team, and Dan Lang, co-portfolio manager with the RS Value Team, as to why the mid-cap asset class holds broad appeal. We asked Scott and Dan to share some thoughts on why they like mid caps and how they employ their respective growth and value strategies in this important but often-overlooked sub-asset class.

As a professional stock picker, what appeals to you in targeting mid caps?

Scott Tracy: Well for one, it's the opportunity set that excites me. For whatever reason investors seem dedicated to allocating to small caps, but they are not nearly as focused on mid-sized companies that are more established but still offer exciting growth potential. Right there that tells me that the market for mid caps is not as efficient as it could be, and that's a good place to hunt for alpha. As bottom-up managers, we believe that the mid-cap asset class has extremely attractive risk/return characteristics. Put another way, mid caps offer the ability to generate "small-cap-like" returns with "large-cap-like" risk profiles. And in terms of valuations, mid-cap growth stocks are in line with their 20-year average earnings multiple, so they are not as expensive as other areas of the market.

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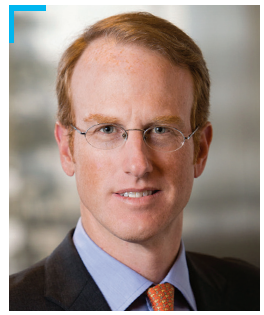
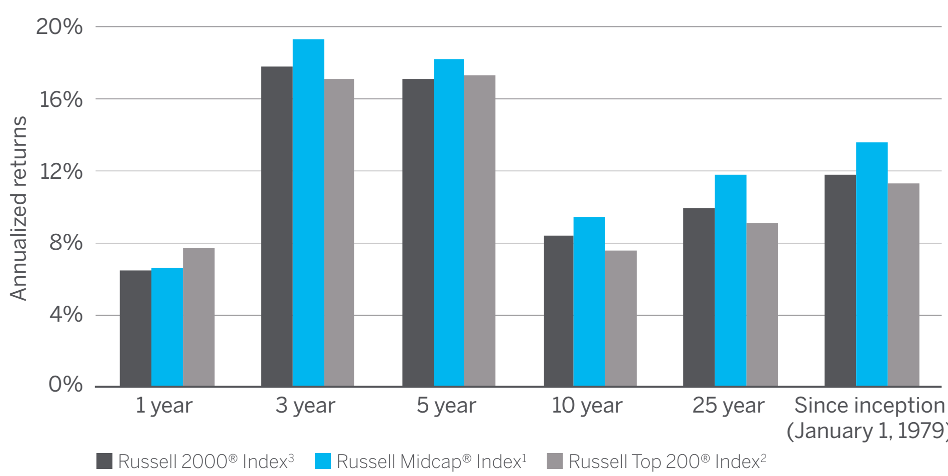


Scott Tracy is a co-portfolio manager with the RS Investments Growth Team.

MID CAPS HAVE BEEN ANYTHING BUT MIDDLING

Mid-cap stocks have outperformed both small caps and large caps over 3-, 5-, 10-, 25-year periods and since inception, for the period ended June 30, 2015.



Source: Russell Investments, as of June 30, 2015.

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** Alpha is a statistical measurement used to quantify the value added or subtracted by a portfolio manager. Specifically, alpha measures the portfolio's actual return against the portfolio's expected return given the risk of the portfolio.*

Dan Lang, MD is a co-portfolio manager with the RS Investments Value Team.

Dan Lang: We define mid caps in a pretty wide range between $4 and $25 billion, but we tend to find the more exciting opportunities at the lower end of that range in growing companies that have matured but are still relatively underfollowed. Many of these companies have done very well as small caps. We've invested in some of them, followed their management teams over the years, and we understand their business models and key drivers. Many of these companies have now grown to $5 or $6 billion, and some are on their way to $15 billion and higher. So that's the sweet spot for us and, as Scott points out, there's less efficiency in terms of information, which allows us to generate a differentiated thesis.

Scott, can you elaborate on how the RS Growth Team's tenure and stability have benefited the team's ability to select mid-cap stocks?

Scott: One thing we're proud of is the consistency of our performance over the years, especially in the mid-cap space. My co-portfolio managers and I have worked side by side for almost a decade, and our research process and risk management checks and balances have been tested in a variety of market environments. And having the ability to invest up and down the cap spectrum with strategies that focus on both small and large companies has been invaluable. For example, many of the holdings within our mid-cap growth strategy have been previously researched and owned in our small-cap fund, so we have been able to monitor the progress of these companies over the years.

Turning to your different investment styles, how does your value approach work in the mid-cap space?

Dan: Mid-cap companies tend to have relatively durable business models because they are mature enough to have lived through different market conditions. They tend to have better balance sheets too. Mid caps are generally cash flow-positive, and they usually have seasoned management teams that have experience in all economic environments.

From there we dig into the details, and we like to think of ourselves as business analysts as opposed to stock analysts. We're more interested in evaluating the business and finding companies at an inflection point or otherwise undergoing some structural changes that will improve returns on capital. We believe these types of opportunities are abundant in the mid-cap space, so if we turn over enough rocks and find those truly great opportunities where businesses are reinvesting capital shrewdly, we should be able to generate consistent investment performance.

We also spend a lot of time analyzing company management teams to see how well management has done as both operators of the existing business and as capital allocators. A lot of small-cap companies are so early in their life cycle that they haven't really had the opportunity to deploy capital in a meaningful way, whereas mid caps may be generating cash or have enough cash on the balance sheet to do an acquisition or invest in a new facility. This capital allocation history is very important to us.

Scott, what about from your team's perspective? How do you apply your growth investing philosophy to mid caps?

Scott: I think one of the most exciting parts about the mid-cap asset class is that many of the underlying businesses are mature, but they don't face the law of large numbers that challenges large companies. When you start from a group of proven companies—which is exactly what these mid caps are—you're looking at a universe of high-quality businesses with good cash flows, margins, and returns on capital. So what it comes down to is stock selection. We know that many of these are good businesses, but we need to confirm that they are going to be good stocks for the next three to five years.

Specifically, we like to focus on sustainable growth—say mid-teens growth year-in, year-out. We often prefer this steady growth to a high-flier that's growing at a much faster rate because that growth rate tends to be unsustainable. We also look for innovative companies with competitive advantages.

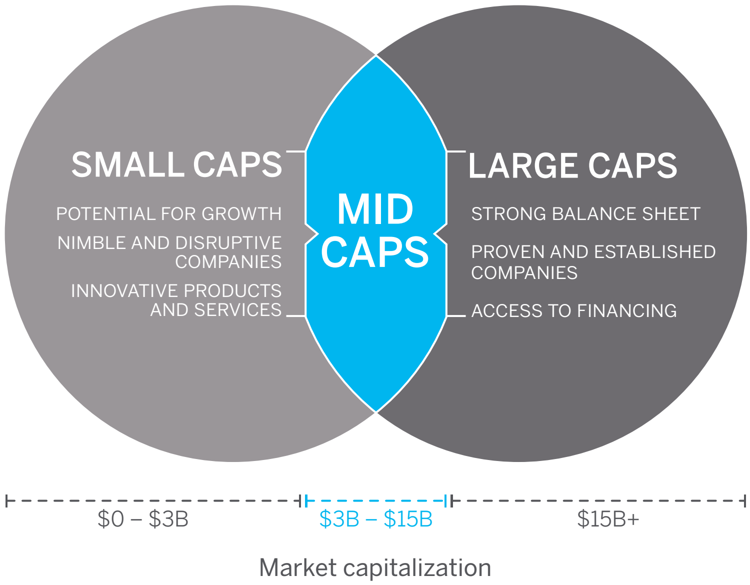
THE SWEET SPOT

> Mid caps often sit at the sweet spot of a business' life cycle

> Mid caps can blend characteristics of dynamic, small companies with the stability of stable, larger counterparts

> Mid caps have successfully graduated from the challenges of building and financing a small company

WHAT'S BEHIND THE PERFORMANCE OF MID CAPS?



Source: RS Investments.

Performance quoted represents past performance and does not guarantee future results.

Sometimes that's the result of a new product or technology, or maybe it's a disruptive approach to delivering an established service. Our process is all about deep fundamental research, aided by quantitative tools to help us focus our research efforts on the right universe of companies.

Since so many of these mid caps are already good businesses, they can get bid up to pretty high multiples. So, you have to be disciplined with mid caps, and you don't want to get over your skis and pay too much for that growth. I think that's what has undermined other managers—not having enough of a valuation framework and discipline around price on the entry point.

But discipline doesn't just apply to the front end, and our work isn't done after buying. Having embedded risk management tools helps ensure that we don't overstay our welcome. We use models that flag underperformers in our portfolios, and those models force us to review our investment thesis and defend any mid-cap stock that's not performing. We think these risk protocols help us deliver a consistent strategy that not only performs during up markets, but just as importantly, aims to do well during volatile or down markets.

Let's talk investment themes. Dan, where do you see potential opportunities in the mid-cap asset class for value-oriented investors?

Dan: The consolidation theme within healthcare is very topical and powerful. Almost every month there seems to be a big healthcare deal. Take the specialty pharma and generic companies. It's still a very fragmented industry with a couple hundred U.S. companies and maybe double that number outside the U.S. But if you look at the big picture there's a lot of redundancy in R&D programs and also in sales and marketing.

Market forces will eventually make this sector more efficient, so M&A activity is bound to happen, and an acquirer can create value through cost savings by merging infrastructures. A mid-cap company might also create value by leveraging its more powerful global distribution channel to bring new consumers to a smaller, regional company. Many countries recognize FDA approval, so all they have to do is file a supplemental application as opposed to conducting a full-blown new drug review and approval.

So in this scenario, in addition to benefiting from cost synergies by consolidating smaller sub-scale companies, revenue synergies can also be realized to increase returns. And this dynamic isn't just relevant to specialty pharma and generic companies. There's consolidation in many healthcare sub-sectors, including device companies, small biotechs, and others.

Our preference is to invest in the acquirer, as long as we believe that the acquisition is a smart use of capital. Some investors may find this counterintuitive. If you own a business and it gets taken out at a premium, that can be a nice one-day bump. But we're more interested in finding mid-cap companies that can benefit from consolidation and increase business value sustainably over a long period of time.

What about you, Scott? Can you share with us a mid-cap investment theme for growth investors?

Scott: All of our sector specialists will have a different take given their specific industry expertise. I follow the financial services industry, and I'm seeing innovation revolving around payments. Clearly, companies are trying to make the transition from terminal-based card transactions to mobile transactions. And it's early days to see who's going to be the winner, and it might take a little while to sort things out.

So rather than betting on one ultimate winner, we're taking a good look at the payment companies that are doing the processing, with the belief that card-based transactions are not going to go away for quite a few years because there isn't a standardized protocol for mobile phones just yet. We believe the agnostic merchant providers can win no matter what, because even if you're doing a transaction on a mobile phone, it still needs to ride some kind of payment network and attach back to a credit card.

We are also watching those companies enabling communication between mobile phones and the merchant because not every merchant has a device that can read phones. There are semiconductor companies, for example, making chips for phones that allow for near-field communication. So while we don't know which payment system will gain the dominant market position, we think we can benefit through some mid caps that are providing the technology that is riding the rails of this trend.

Any final thoughts on the opportunities in mid caps?

Dan: Scott spoke earlier about the importance of risk management, and I would just like to echo those sentiments. Right now we're into the third quarter (2015), and the market has been on an incredible run since the lows in early 2009. But over the next five years this market is likely to be very different. Multiple expansion has been a big driver of returns in recent years. However, with rates rising, the market may favor those who can identify value creation opportunities that are underappreciated or misunderstood by Wall Street. And I believe that a focus on fundamentals, cash flow, management teams, and value creation potential will win out.

We're not chasing fads or momentum. For example, we haven't really liked REITs or utilities from a business perspective. But we think that our decision to stay away from leveraged, rate-sensitive business in a potential rising interest rate environment will be vindicated going forward. People tend to have short memories. Remember, there was a time when managers were chastised for missing the big run in Internet stocks. But avoiding the carnage when the bubble burst in 2000 proved even more important than participating in the upside. That's an extreme example, and I'm not saying we are in a bubble now. But there are companies and even entire sectors that may face massive headwinds going forward as the interest rate environment shifts. It will be important to position the portfolio correctly in this environment. RS

"With rates rising, the market is likely to favor those who can identify value creation opportunities that are underappreciated or misunderstood by Wall Street."

Investing in mid-cap equities with RS Investments

RS MID CAP GROWTH FUND (CLASS A: RSMOX) (CLASS Y: RMOYX)

The RS Investments Growth Team is headed by four co-portfolio managers with an average of 19 years of investment experience, and they have worked side by side for almost a decade. The team's investment approach is built around the belief that sustainable earnings growth drives long-term stock appreciation, and that a multi-dimensional risk management process can enhance long-term strategy performance. Some of the growth team's key tenets include:

> **Emphasize innovation.** We search for innovative, disruptive businesses that we believe can change an industry. Our team of sector specialists digs deep to understand companies of all sizes, applying a consistent process across portfolios up and down the market capitalization spectrum.

> **Focus on the long term.** We pursue companies that align with our fundamental beliefs and rank highly on five key metrics: growth sustainability, company quality, attractive relative valuation, improving earnings estimates, and favorable relative strength.*

> **Manage risk throughout the investment process.** We assess the risk/reward ratio at the time of purchase to restrict holdings to those in which the team has highest conviction, and our three-stage sell discipline helps mitigate the negative impact of any single position.

RS VALUE FUND (CLASS A: RSVAX) (CLASS Y: RSVYX)

The RS Investments Value Team is a specialized team of business analysts focused on finding domestic equities with intriguing, long-term potential. Stock selection centers on thoroughly researching a business, not simply screening for low price-to-earnings ratios or price-to-book ratios. The team looks for good businesses led by strong management teams and invests when a stock's price reflects an attractive valuation. Some of the value team's key tenets include:

> **Buy businesses, not stocks.** We assess each opportunity as a potential business owner and believe that over time a stock's price will reach the per-share value of the underlying business.

> **Focus on the long term.** We have a three- to five-year investment horizon, which allows us to take advantage of short-term dislocations and market mispricing to invest in good businesses at attractive valuations.

> **Invest with conviction.** Our team constructs relatively concentrated portfolios, which allows us to put capital behind our highest-conviction ideas.

** Relative strength is a technical indicator that compares the relative strength of recent gains to recent losses to determine if a stock is considered overbought or oversold.*

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1 The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on total market capitalization. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index, and, unlike the Fund, it does not incur fees and expenses.

2 The Russell Top 200® Index measures the performance of the largest cap segment of the U.S. equity universe. The Russell Top 200 Index is a subset of the Russell 3000® Index. It includes approximately 200 of the largest securities based on total market capitalization. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index, and, unlike the Fund, it does not incur fees and expenses.

3 The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which consists of the 3,000 largest U.S. companies based on total market capitalization. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index, and, unlike the Fund, it does not incur fees and expenses.

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. Investing in small- and mid-size companies can involve risks such as having less publicly available information, higher volatility, and less liquidity than in the case of larger companies. Overweighting investments in certain sectors or industries increases the risk of loss due to general declines in the prices of stocks in those sectors or industries. Foreign securities are subject to political, regulatory, economic, and exchange-rate risks not present in domestic investments.

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