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A Case for SMidCap

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A Case for Smid Cap

This year we will reach the fifth year mark for the management of our SMidCap Strategy. We have experienced growing interest in the Strategy not only due to our lengthening track record of successful performance, but also due to an overall heightened interest by clients and consultants in the combined small-to-mid cap segment of the US equity market.

Several considerations are behind the growing interest in the combined small-to-mid cap, or smid cap market segment. The smid cap market segment has effectively captured the “small stock” return premium while providing the following potential benefits over small cap only universes:

- Smid caps have outperformed small caps over time historically
- Smid caps are generally more liquid to trade than small caps
- Smid caps may provide a better aggregate complement to large caps
- Smid cap indexes may provide a better benchmark for the typical small cap core manager.

Smid Cap vs. Small Cap Returns

Let's look at the returns generated by smid cap and small cap stocks. Using the Russell 2500 and Russell 2000 Indexes to represent the returns of smid caps and small caps, respectively, we find that the return patterns for smid caps and small caps are very similar. The table below shows a very strong positive correlation of monthly and quarterly returns between smid caps and small caps.

Russell 2500 vs. Russell 2000 January 1979 - March 2007*

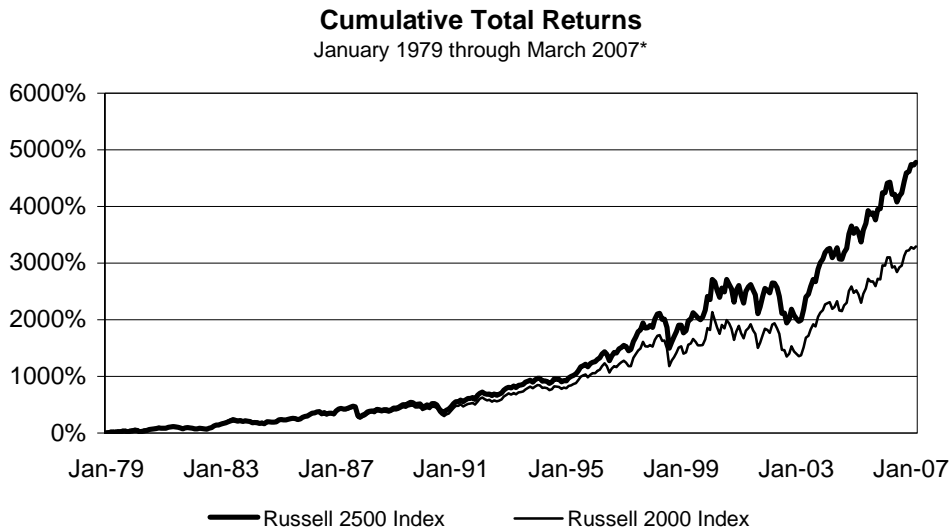
Monthly Total Return Correlation	+0.99
Quarterly Total Return Correlation	+0.99

*Data Source: Russell Investment Group.

With such a strong historical positive correlation, we believe smid caps have effectively captured the diversifying return pattern – relative to large caps – typically sought from small caps. However, even with such a strong relationship between the two return patterns, smid caps have delivered higher total returns. On an annualized basis for the January 1979 through March 2007 period, smid caps returned 14.8% while small caps



returned 13.3%. The chart below reveals the cumulative returns for smid caps versus small caps.



*Data Source: Russell Investment Group.

Trade Liquidity Advantage of Smid Caps

A frequently cited challenge for investors is the ability to actually earn the returns associated with smaller cap stocks. Critics have argued that a portion of the returns generated by smaller cap indexes disappear once you take into account the higher transaction costs arising from lower levels of trade liquidity.

From the table below we see that the smid cap universe of stocks has generally higher measures of trade liquidity than small caps. Using trailing three month dollar volume as a measure of trade liquidity (i.e., average share volume times share price), smid caps as a whole offer approximately twice the prevailing trade liquidity than that found with small caps. Therefore, transaction costs and implementation shortfall should generally be lower for smid caps which increase the likelihood of earning the historically attractive returns demonstrated by smaller cap stocks.



Index Member Liquidity Statistics*
As of March 31, 2007

	Trailing Three Month Dollar Volume (\$M)*	
	Russell 2500	Russell 2000
Weighted Average Stock	24.526	13.379
Average Stock	12.227	8.016
Median Stock	5.546	3.851

* Data Source: FactSet.

Smid Caps as a Better Large Cap Complement

The most common benchmark or target index used by investors to represent large cap US equities is the S&P 500 Index. Similarly, the Russell 2000 Index is quite frequently used to represent targeted exposure to smaller cap stocks. When these two target indexes are combined to represent aggregate overall US equity exposure, a significant gap is created among securities with a market cap between \$1 billion and \$5 billion relative to a broad market index such as the Russell 3000 Index. This combination misses 50.4% of the securities within this range.. Therefore, if an investor were to use the S&P 500 and Russell 2000 Indexes as the components of an aggregate US equity target, then they would likely need to add a dedicated mid cap target to address their aggregate shortcomings.

S&P 500 and Russell 2000 Combination*
As of March 31, 2007

Market Cap Range	Total Market Capitalization (\$B)*		Missing From Russell 3000	
	Russell 3000	S&P 500 + Russell 2000	Market Cap (\$B)	Market Cap (%)
> \$5.0B	13,566	12,606	960	7.1%
\$1.0B - \$5.0B	2,406	1,193	1,213	50.4%
< \$1.0B	678	676	2	0.3%
Total	16,650.0	14,475	2,175	13.1%

*Data Sources: Russell Investment Group and MSCI Barra.

We believe the Russell 2500 Index is a much better complement to the S&P 500 Index. This combination provides a much more complete coverage of the broad US equity market – missing only 2.7% of the securities within the \$1 billion to \$5 billion market cap range. Therefore, the investor would be able to cover the broad market with two



managers – a large cap plus a smid cap – rather than needing three managers – a large, mid and small cap.

S&P 500 and Russell 2500 Combination*
As of March 31, 2007

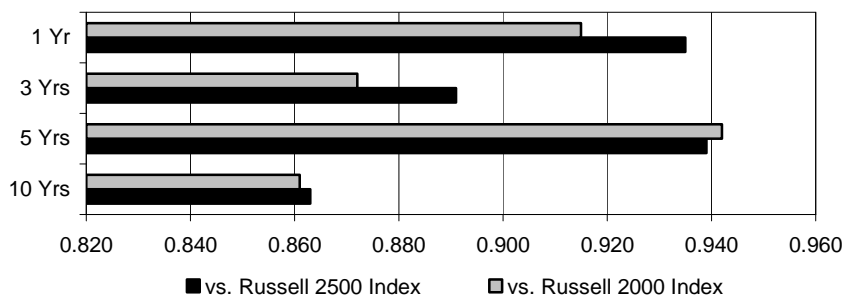
Market Cap Range	Total Market Capitalization (\$B)*		Missing From Russell 3000	
	Russell 3000	S&P 500 + Russell 2500	Market Cap (\$B)	Market Cap (%)
> \$5.0B	13,566	12,848	718	5.3%
\$1.0B - \$5.0B	2,406	2,340	66	2.7%
< \$1.0B	678	677	1	0.1%
Total	16,650	15,865	785	4.7%

*Data Sources: Russell Investment Group and MSCI Barra.

Are Small Cap Managers Really Smid Cap?

Whether investors have realized it or not, if they have hired small cap core managers they have most likely received in actuality a smid cap core manager. The chart below shows the R² measure over several trailing time periods for the Zephyr (PSN) Small Cap Core manager universe relative to the Russell 2500 and Russell 2000 Indexes. The R² measured relative to the Russell 2500 has typically been higher over time – especially over the last one to three years.

Small Cap Core Manager Universe*
Average R Squared through March 2007



Source: Zephyr (PSN).

Based on the above findings – historically attractive returns, lower implementation shortfall, better large cap complement, and the fact that the typical small cap manager is actually smid – I believe we’ll continue to experience a rising interest in smid cap stocks and strategies.



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