

C A M B R I D G E   A S S O C I A T E S   L L C

## U.S. MARKET COMMENT

### PUZZLING OVER MID CAPS

November 2004

Eric Winig  
Bennett Fisher

Copyright © 2004 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to CA reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that CA believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. When applicable, investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA manager universe statistics, including medians, are derived from CA's proprietary database covering investment managers. These universe statistics and rankings exclude managers that exclude cash from their reported total returns, and for calculations including any years from 1998 to the present, those managers with less than \$50 million in product assets. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. Performance results are generally gross of investment management fees. CA does not necessarily endorse or recommend the managers in this universe.

Cambridge Associates LLC is a Massachusetts limited liability company headquartered in Boston, MA with branch offices in Washington, DC and Menlo Park, CA. Cambridge Associates Limited is a Massachusetts limited liability company headquartered in Boston, MA and registered in England and Wales (No. FC022523, Branch No. BR005540). Cambridge Associates Limited also is registered to conduct business in Sydney, Australia (ARBD 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G).

## Puzzling Over Mid Caps

While much ink has been spilled on small caps' recent run, precious little has been said about the concurrent mid-cap rally, perhaps due to mid caps' persistent second-class status in the investment world. The recent mid-cap rally has been the longest and most powerful relative to large caps since our data series begin in 1979 (Table A).<sup>1</sup> Specifically, since bottoming relative to the Top 200® Index in October 1999, the Russell Midcap® Index has outperformed the large-cap index by a whopping 12.8 percentage points on average *per year*—the most significant outperformance on record. There were only two other periods of mid-cap outperformance that extended beyond one year: an annual average of 11.0 percentage points from November 1990 through year-end 1993, and 7.8 percentage points scored from January 1979 to May 1983.<sup>2</sup>

Even more impressive is that mid caps have also outperformed small caps recently, as there are few instances in which mid caps outperform (or underperform) both large caps and small caps. Since 1979, there were only five years in which mid caps outperformed both small caps and large caps, the three most significant of which occurred in the last five years. In 2000, the Midcap® Index outperformed the Top 200® by 20.3 percentage points and the Russell 2000® by 11.3 points, as the capitalization sectors returned 8.2%, -12.0%, and -3.0%, respectively. By comparison the 2002 and 2004 mid-cap rallies were relatively tame, with mid caps outperforming large caps by 7.2 percentage points and small caps by 4.3 points, as the capitalization sectors returned -16.2%, -23.4%, and -20.5%, respectively, in 2002, and mid caps besting large caps by 7.5 points and small caps by 2.9 points, as the capitalization sectors returned 8.7%, 1.1%, and 5.8%, respectively.

Unfortunately, we found no smoking gun that would explain mid-caps' recent run *per se*, as the drivers of equity performance appear to have shifted several times since the start of 2000, yet mid caps outperformed large caps in each year. For example, equities with high P/Es or no earnings underperformed in 2000-02, outperformed in 2003, and produced mixed results in 2004. Similarly, the importance of sector weights and returns, as expressed by sector return contributions, differed each year. For example, in 2003 returns for the consumer discretionary and information technology sectors in the Midcap® and Top 200® indices explained roughly 7 of the 13 percentage points of outperformance of the Midcap® index relative to the Top 200®, but in 2002, these same two sectors detracted approximately 2 percentage points from mid-caps' lead over large caps, which was 7.2 percentage points for the year. However, there were a few consistent sector trends: The contribution from both financials and consumer discretionary was greater for mid caps than for large caps each year from 2000 to 2004, as mid caps outperformed large caps each year in both sectors. In addition, mid caps had a higher weighting to consumer discretionary than did large caps in each year, but relative weightings to financials were mixed, with mid caps underweight financials from 2000 to 2002 and overweight from 2003 to 2004. Finally, we looked at earnings growth (Table C), which is now significantly higher for mid caps than large caps, but relative earnings growth rates are highly volatile and have varied considerably since 2000.

---

<sup>1</sup> We used the Russell Midcap® Index for our analysis, although other mid-cap indices showed similar tendencies.

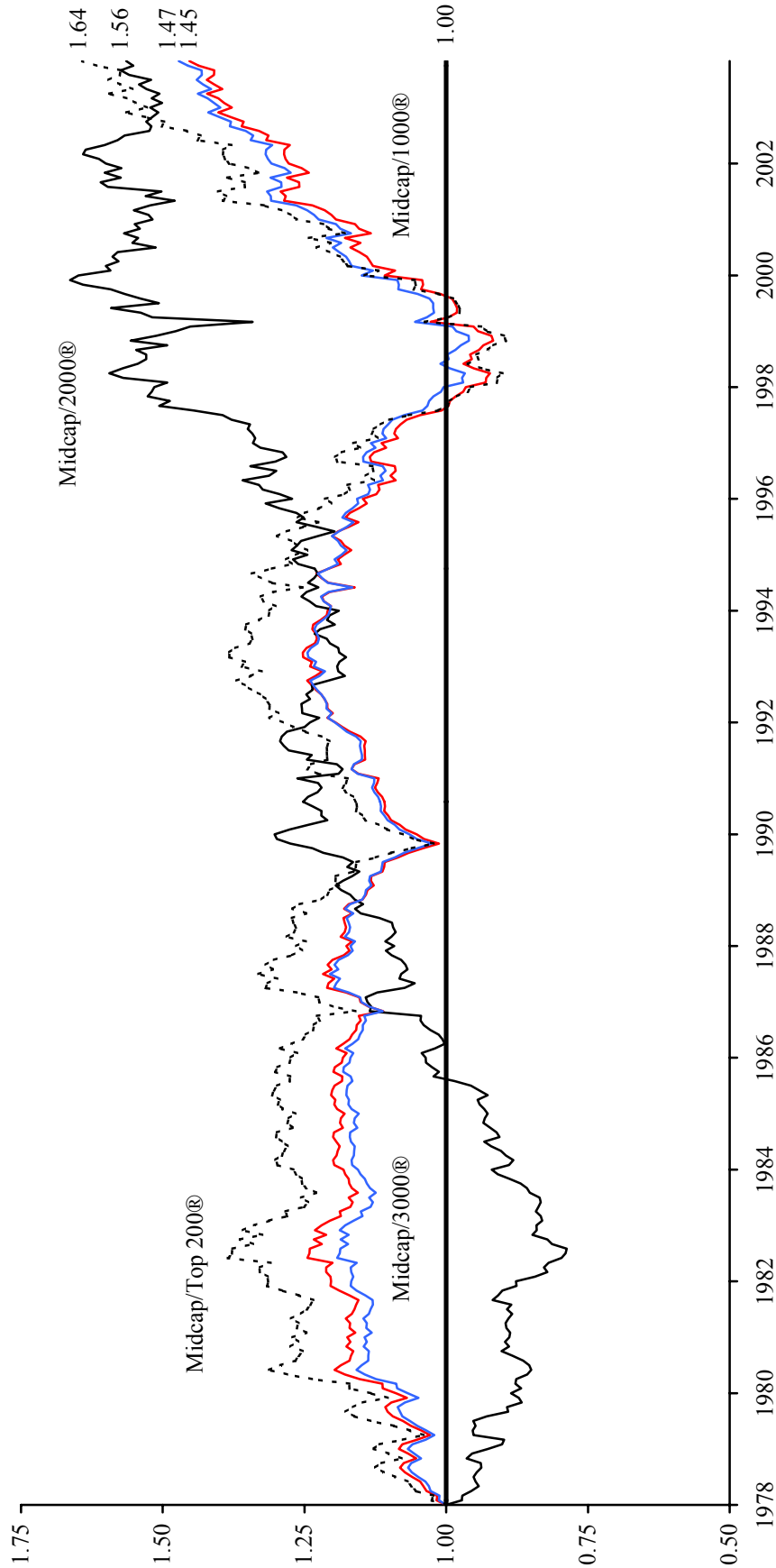
<sup>2</sup> The Russell Top 200® and Midcap® indices together make up the Russell 1000®: the Top 200® consists of the largest 200 companies and the Midcap® the bottom 800.

While the reasons for mid-cap equities' outperformance are certainly unclear, the sector's recent dominance may cause some to question whether mid cap has broken out as an independent investment sector. We continue to believe that mid-cap stocks represent the middle of a continuum between large cap and small cap and do not have independent properties. We expect mid-cap stock returns will continue to fall in between those of small cap and large cap most of the time as they generally have in the past.

Table A

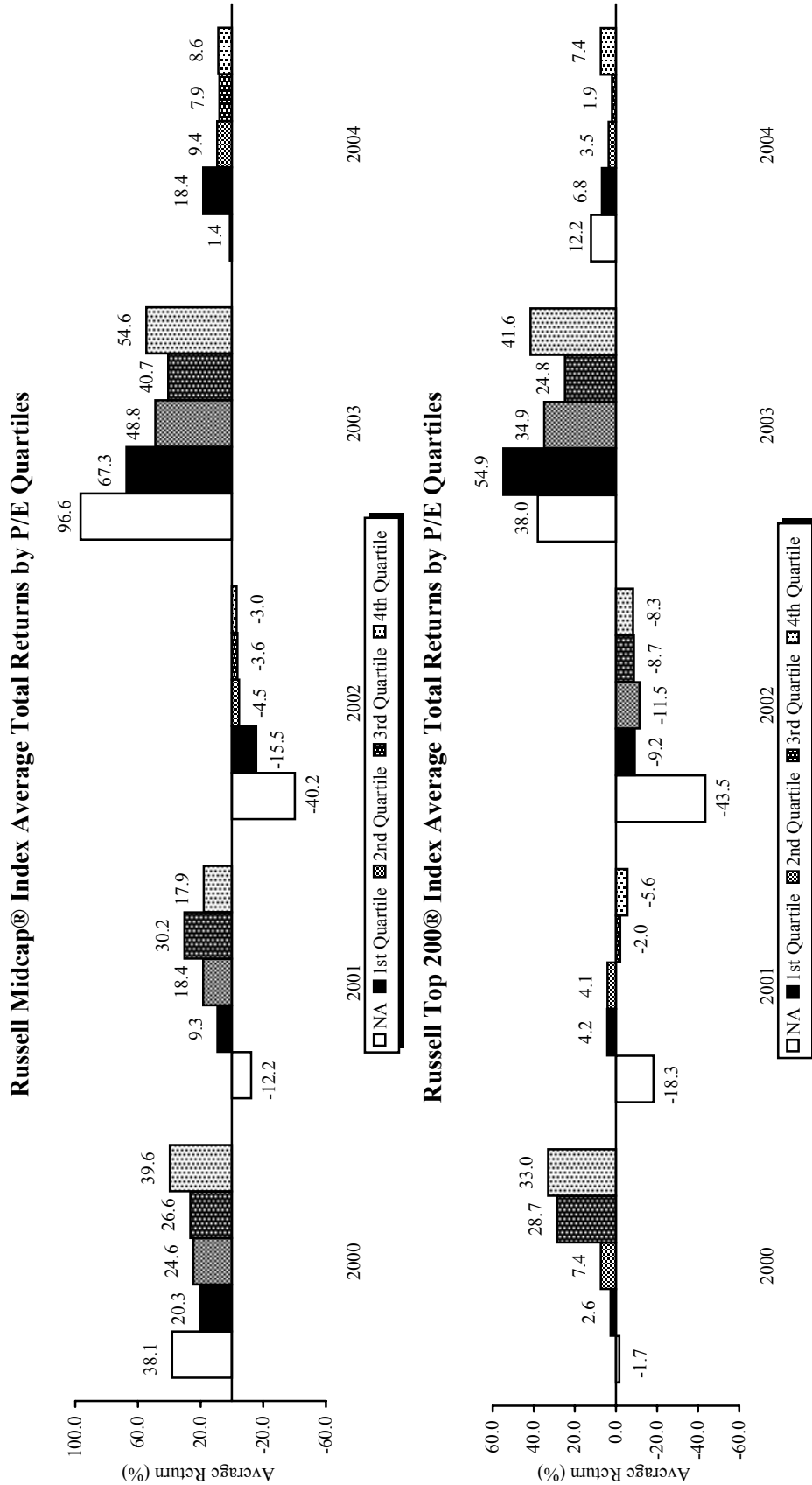
RELATIVE CUMULATIVE WEALTH

Russell Midcap® Index Relative to Russell 1000®, 2000®, 3000® and Top 200® Indices  
(December 31, 1978 = \$100)



Sources: Frank Russell Company and Thomson Datastream.

**Table B**  
**THE P/E EFFECT**



Sources: Frank Russell Company and Standard & Poor's Compustat.

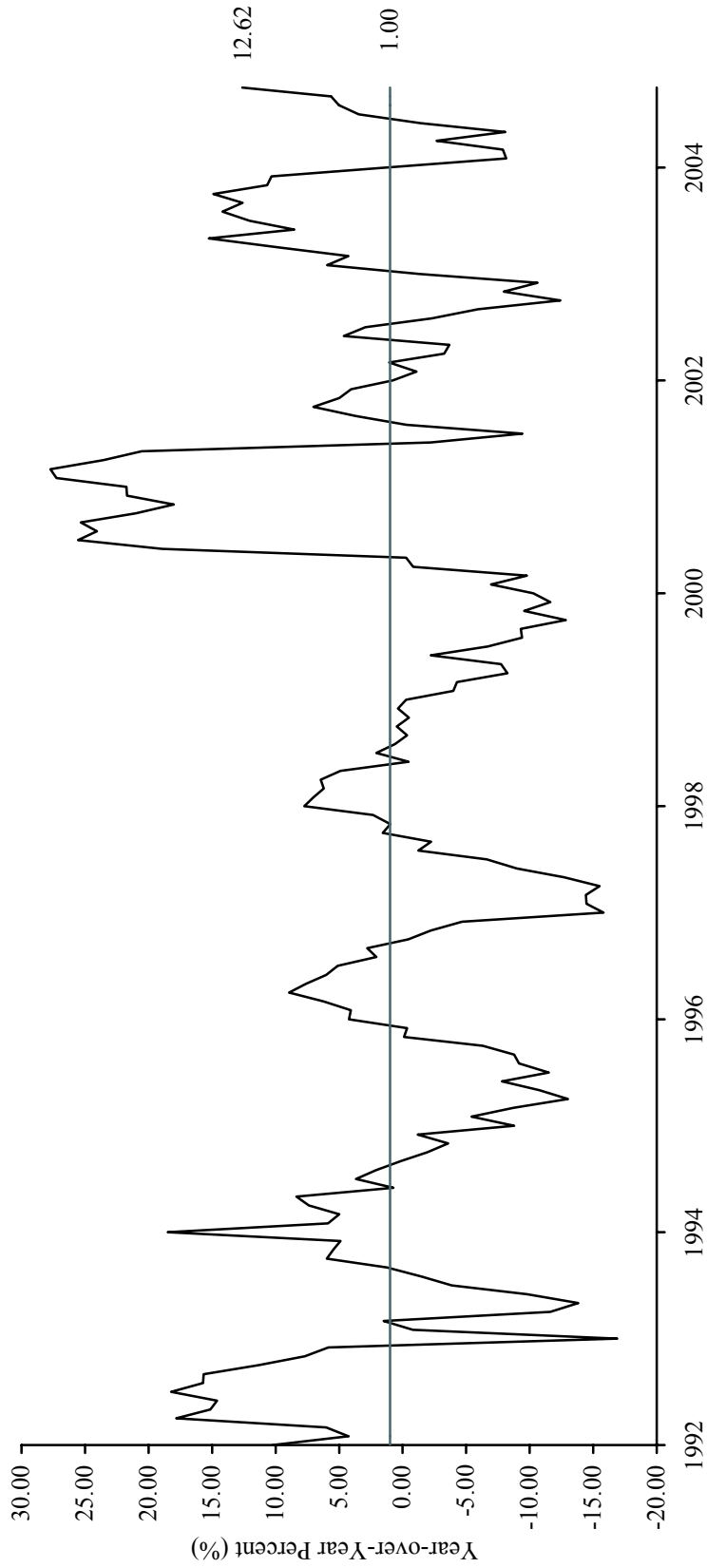
Notes: Data for 2004 are as of October 31, 2004. Rankings are based on P/E ratios as of October 31, 2004, and average total returns are calculated on constituents that had a reported total return for the specified period. Total return outliers were deleted as they would have drastically skewed the results. Quartile 1 represents the highest P/E companies while quartile 4 represents the lowest. "NA" represents companies that do not have a P/E ratio.

Table C

**RUSSELL MIDCAP® INDEX EARNINGS GROWTH MINUS RUSSELL  
TOP 200® INDEX EARNINGS GROWTH**

Relative Earnings Growth

January 31, 1991 - October 31, 2004



Sources: Frank Russell Company and Thomson Datastream.