

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

EUROPEAN MARKET COMMENT

EUROPEAN MID-CAP EQUITIES: WHY THEY SHOULD NOT BE DISREGARDED

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European Mid-Cap Equities: Why They Should Not Be Disregarded

The Neglected Sector

Mid-caps have often been regarded as occupying an indeterminate no-man's-land between large- and small-caps. They have been defined more by what large- and small-cap equities are *not*, rather than by their own unique features. With their recent stunning performance underscoring their potential, however, investors should at least recognize that there are times when tactical allocations to this sector can considerably boost portfolio performance.

Mid-Caps Win the Performance Derby

Since April, the FTSE Mid-Cap 250 has returned 43.7%, while the FTSE 100 has posted a return of 17.1%, the FTSE All-Share, 20.9%, and the FTSE Small-Cap, 48.0%. Across the Channel, the FTSE EuroMid ex U.K. Index has returned 46.8% since April, compared to 29.4% for the broad FTSE Europe ex U.K. Index (which includes the mid-cap sector).¹

While the magnitude of the disparity in the recent performance between mid- and large-caps is striking, mid-caps have also outperformed both large- and small-cap stocks over a longer period—although it is important to stress that such comparisons are acutely beginning and end-point sensitive and do not take into account the higher costs of trading less liquid securities. Since 1986 (the commencement date of the FTSE 250 Index), mid-caps have posted a cumulative annual average compound return (AACR) of 11.9%, compared with 10.5% for the FTSE 100, and 9.5% for the FTSE Small-Cap Index (see Tables A and B). Similarly, continental European mid-cap equities have returned 14.0% annually since 1986 (FTSE EuroMid ex U.K. Index), compared to 8.0% for the broader FTSE European ex U.K. Index as a whole since 1994.

However, the superior performance of mid-caps has come with the volatility of small-cap stocks. In the United Kingdom since 1986, the annualized standard deviation of the FTSE 250 has averaged 19.1 percentage points, compared to 19.2 for the FTSE Small-Cap, and 17.0 for the FTSE 100. Continental mid-cap stocks have been substantially more volatile, with a mean standard deviation of 24.3 percentage points since 1986, compared to 19.2 for the broader FTSE Europe ex U.K. Index since 1994.

Distinct in the U.K., A Blend on the Continent

While the FTSE Small-Cap Index is dominated by financials and non-cyclical consumer stocks and the FTSE 100 Index is dominated by financials, non-cyclical services, and natural resources, the FTSE 250 is more heavily exposed to cyclical services, financials, and basic industries (see Table E). On the Continent, however, the composition of the mid-cap sector is less distinctly different from that of the broad market, although non-cyclical consumer stocks and basic industries are relatively overweighted.

¹ FTSE does not have a large- or small-cap Europe *ex U.K.* index. Its EuroTop 100 Index includes the United Kingdom.

Time to Overweight Mid-Caps?

Despite this year's brisk rally, mid-caps in the United Kingdom still appear to offer fair-to-attractive value on an absolute and relative basis. On an absolute basis, the FTSE 250 is currently comparably priced to its ten-year price-to-earnings (P/E) and dividend yield averages. Its current P/E is 19.9 compared with its post-1993 average multiple of 20.6, while its 2.8% dividend yield is slightly less attractive than its 3.1% average. Based on relative dividend yields, mid-caps offer slightly better value than small-caps, though they are substantially more expensive than large-caps (see Table C). On the Continent, the EuroMid ex U.K. Index is fairly priced based on its dividend yield relative to its four-year average as well as to the FTSE 250, though findings about its value are inconclusive given the paucity of valuation data for EuroMid ex U.K. (see Table D).

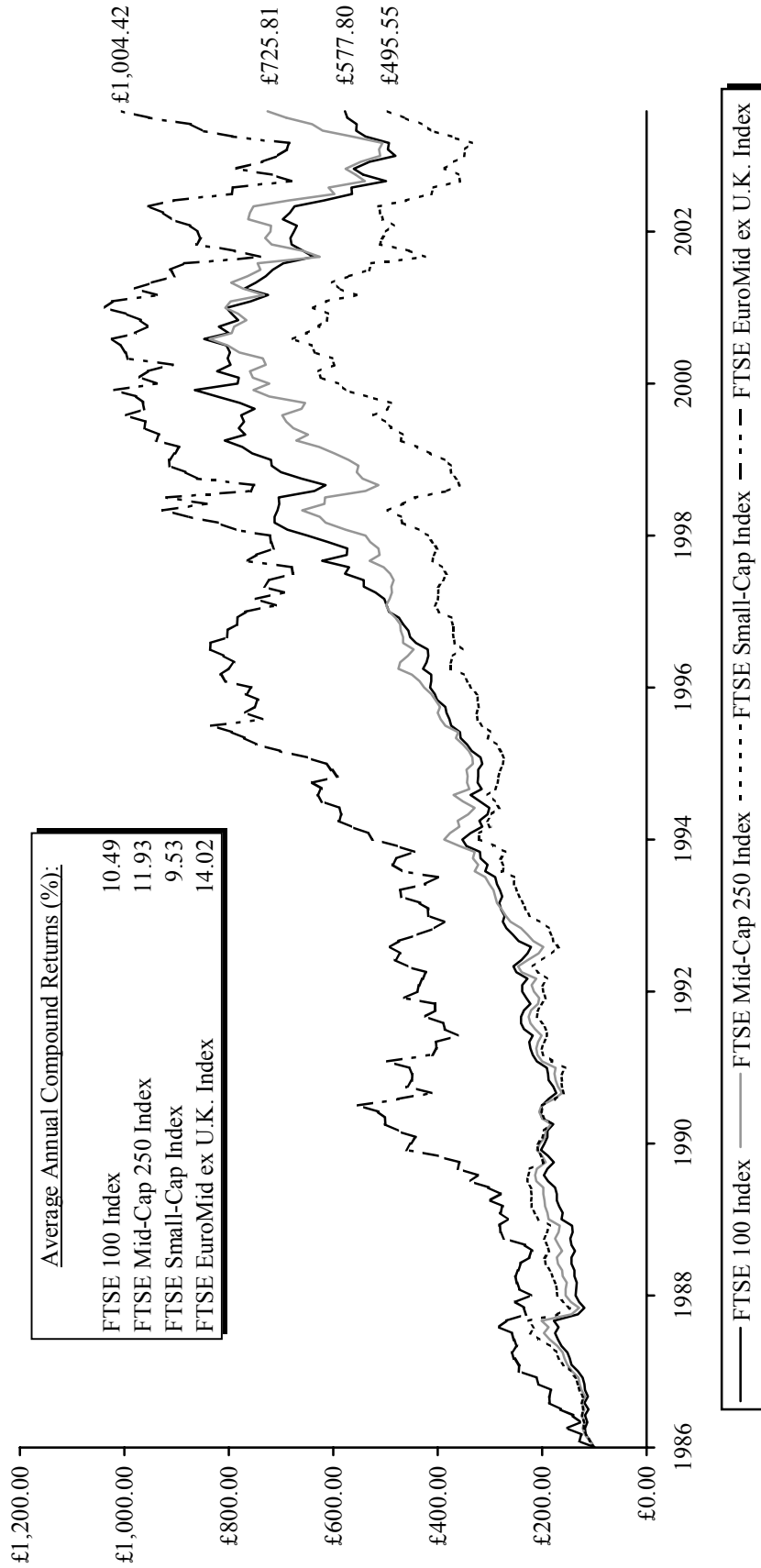
Obviously, the *relative* performance of mid-caps in any given period will depend on the influence of underlying conditions on different economic sectors. For example, coming out of a recession, one would expect cyclical stocks to post relatively strong results as the companies rebound from cyclical troughs in earnings. In general, therefore, we tend to advocate tactical over-allocations to one sector or another of the broad market on the basis of relative valuations: in other words, when there are distinct valuation disparities, we would advise overweighting whatever sector appears relatively cheap and underweighting whatever appears relatively expensive. This is not particularly the case today—although there is no compelling reason to avoid mid-caps, they are not a screaming buy.

At the policy level, there is no case to be made for a *permanent* over-allocation to one or another capitalization sector, since the long-term correlation of returns across sectors is far too high for an investor to reap diversification benefits, and theory dictates that the expected returns across sectors, after adjusting for risk, will be the same.

Table A

CUMULATIVE WEALTH OF VARIOUS EUROPEAN FTSE INDICES

1 February 1986 - 31 August 2003
 (31 January 1986 = £100)

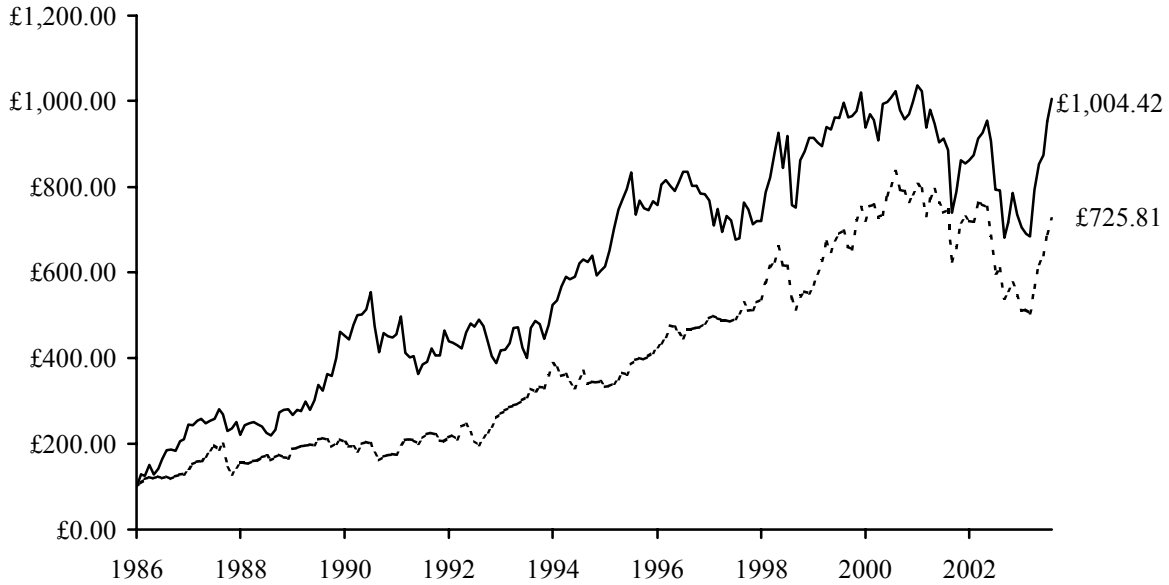


Source: Thomson Datastream.

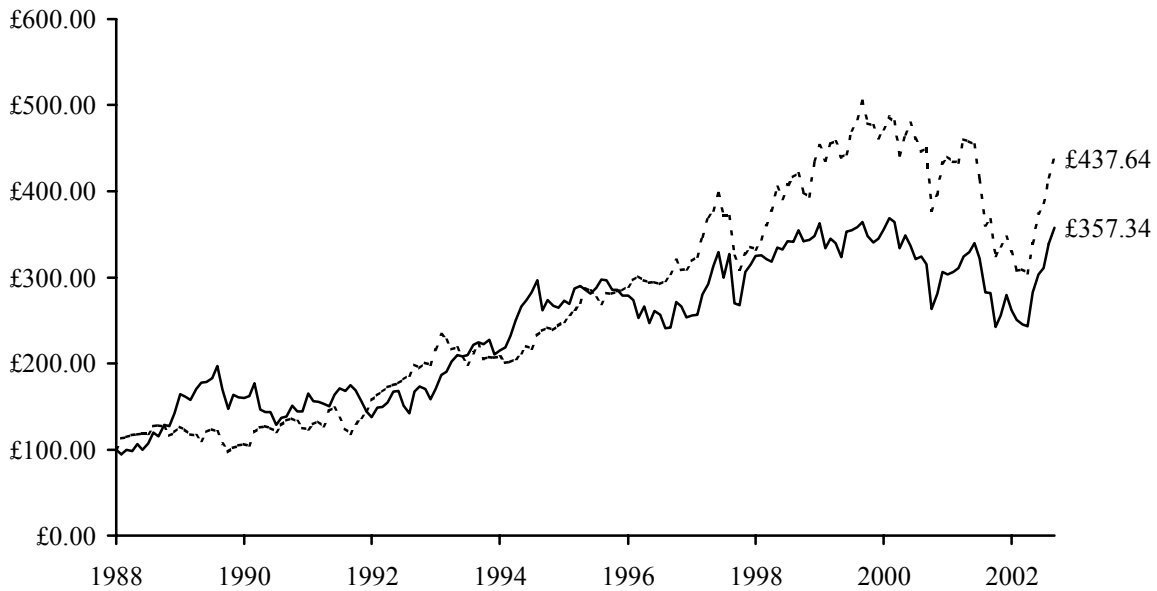
Table B

CUMULATIVE WEALTH OF THE FTSE MID-CAP 250 AND THE FTSE EUROMID EX U.K. INDEX

**1 February 1986 - 31 August 2003
(31 January 1986 = £100)**



**1 January 1989 - 31 August 2003
(31 December 1988 = £100)**



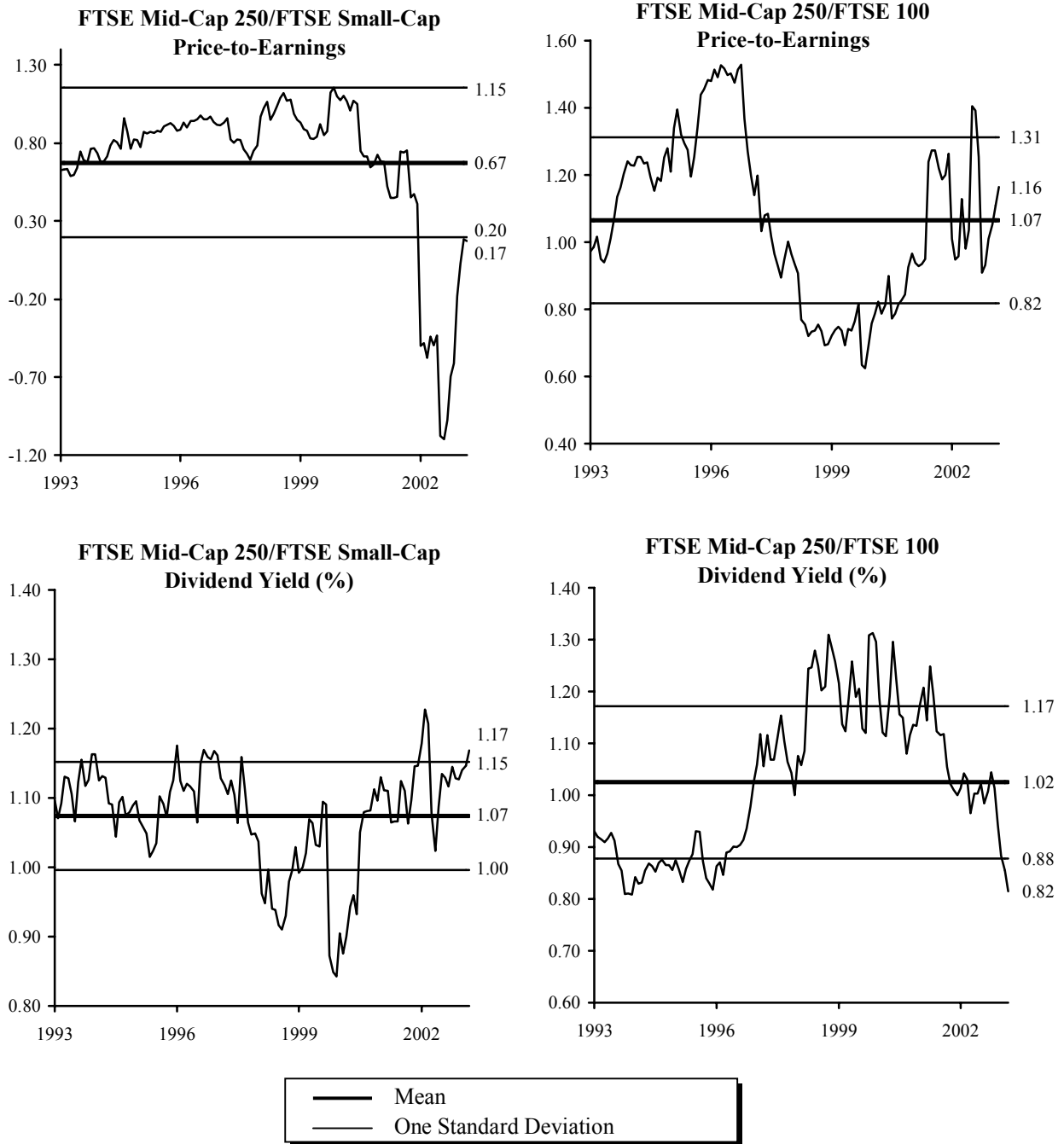
— FTSE EuroMid ex U.K. Index
- - - FTSE Mid-Cap 250 Index

Source: Thomson Datastream.

Table C

VALUATIONS OF THE FTSE MID-CAP 250 RELATIVE TO FTSE SMALL-CAP AND FTSE 100 INDEX

30 June 1993 - 31 August 2003

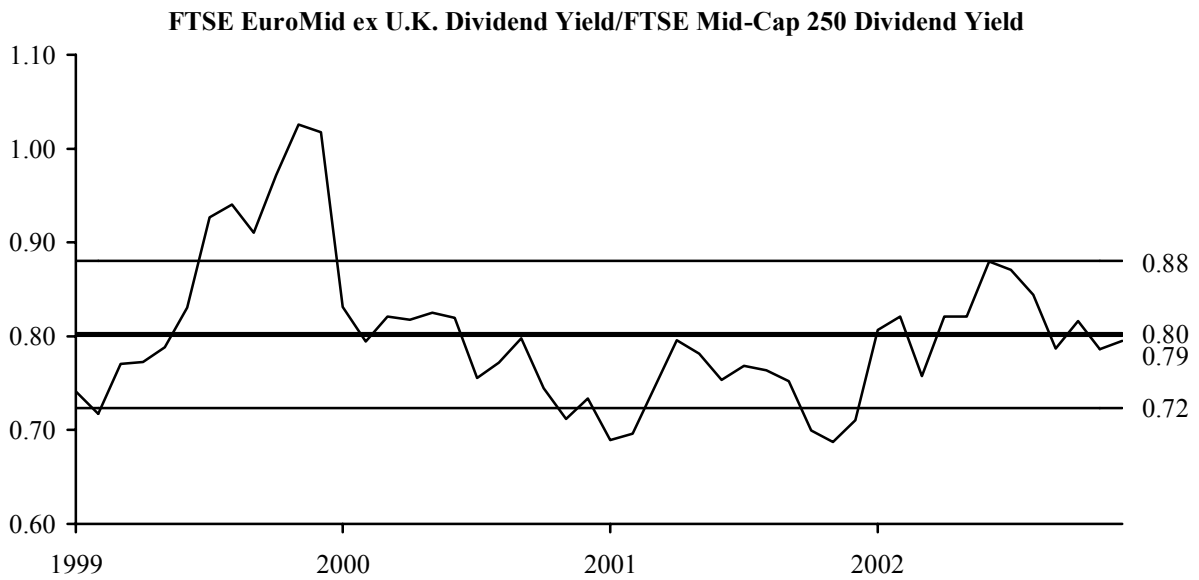
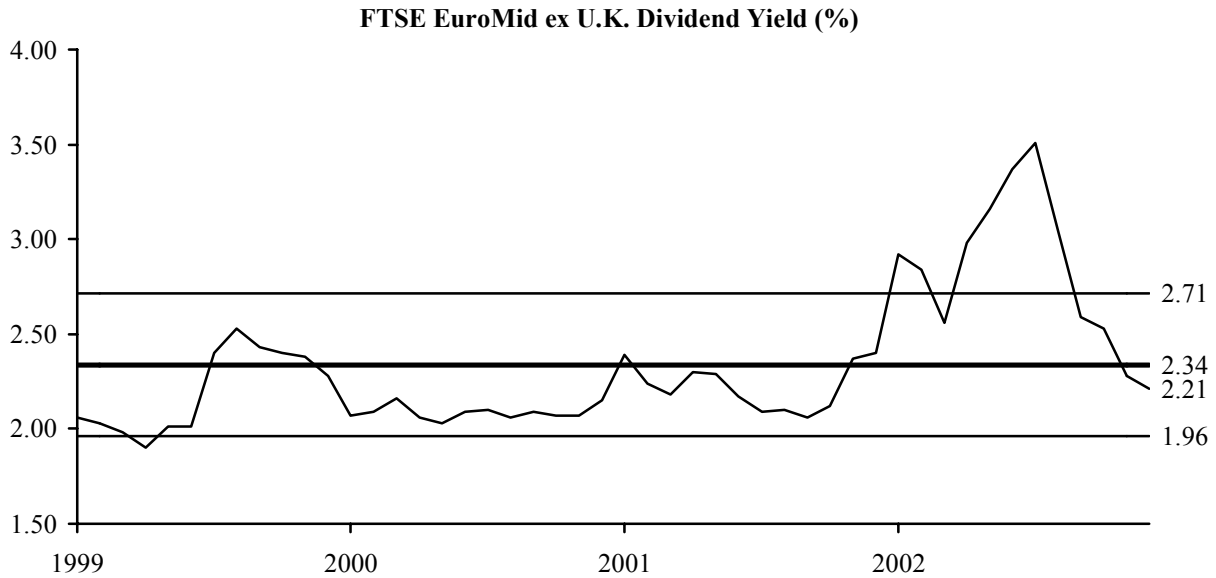


Source: Thomson Datastream.

Table D

DIVIDEND YIELD OF FTSE EUROMID EX U.K. AND FTSE MID-CAP 250

1 September 1999 - 31 August 2003



—	Mean
—	One Standard Deviation

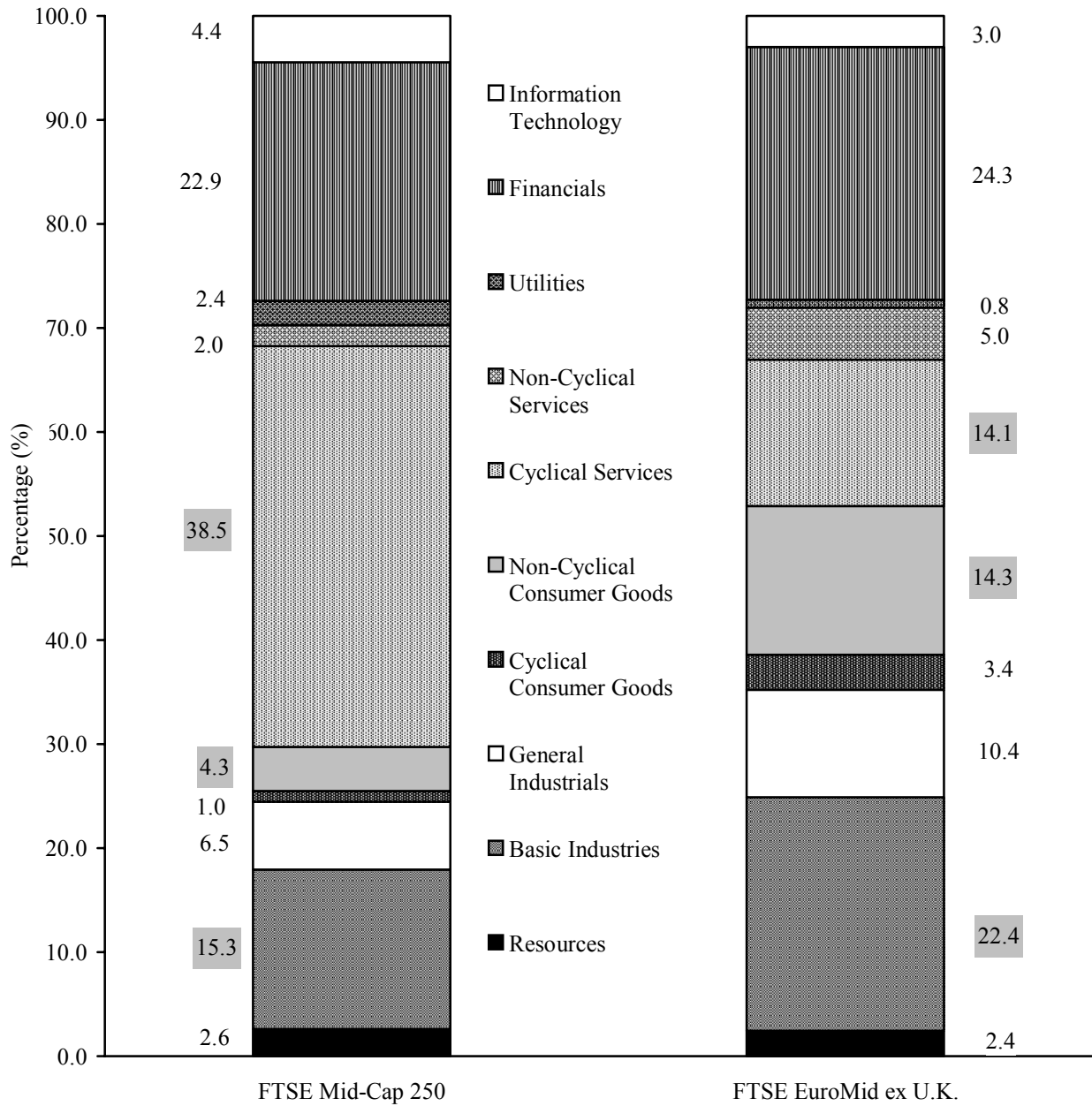
Source: Thomson Datastream.

Note: Prior to 1 September 1999 no dividend yield data are available for the FTSE EuroMid ex U.K.

Table E

FTSE MID-CAP 250 VERSUS FTSE EUROMID EX U.K.: ECONOMIC GROUP ALLOCATION

As of 31 August 2003



Source: FTSE International.

Table F**MARKET CAP RANGES OF VARIOUS FTSE INDICES****As of 31 August 2003**

	Market Capitalisation Range (Millions £)		
	From	---	To
FTSE All-Share Index	18.76	---	94,819.25
FTSE 100 Index	442.05	---	94,819.25
FTSE Mid-Cap 250 Index	110.32	---	2,024.83
FTSE Small-Cap Index	18.76	---	296.49
FTSE EuroMid ex U.K. Index	216.39	---	3,745.82

FTSE All-Share

Representing 98% to 99% of the U.K. market capitalisation, FTSE All-Share is the aggregation of the FTSE 100, FTSE Mid-Cap 250, and FTSE Small-Cap Indices.

FTSE 100

The 100 most highly capitalised blue chip companies, representing approximately 80% of the U.K. market. Used extensively as a basis for investment products, such as derivatives and exchange-traded funds. Recognised as the measure of the U.K. financial markets.

FTSE Mid-Cap 250

Comprised of mid-capitalised companies, not covered by the FTSE 100, representing approximately 18% of U.K. market capitalisation.

FTSE Small-Cap

Comprised of companies with the smallest capitalisation of the capital and industry segments. Represents approximately 2% of the U.K. market capitalisation.

FTSE EuroMid ex U.K.

A definitive benchmark for medium capitalisation pan-European equities excluding the United Kingdom.

Sources: FTSE International and Thomson Datastream.