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Unique Performance Features of the Mid-Cap Value Equity Universe

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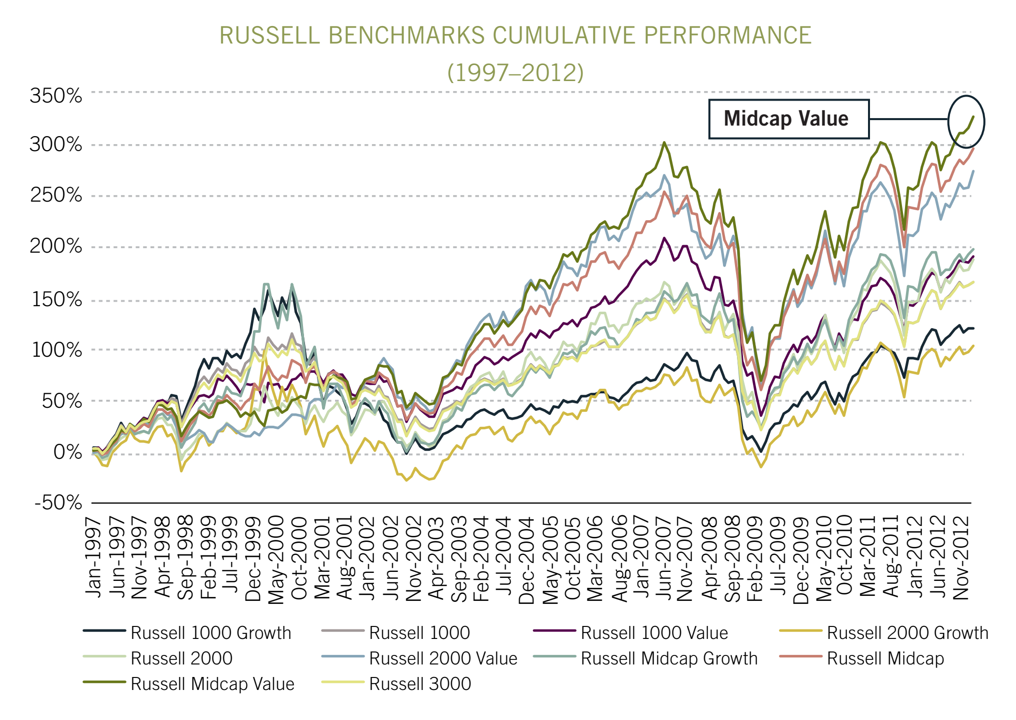
The Russell Midcap Value (RMV) Index is one of the less heralded U.S. equity benchmarks, so investors may be surprised to learn that it has registered one of the strongest long-term performance track records of any U.S. stock market index. During the past 15 years, for example, the RMV's cumulative return is higher than any other Russell market-cap or style-specific index (see Exhibit 1, below). And while past performance is no guarantee of future results, the RMV has posted an average annual return of 11.6% since its inception in 1985[1], one of the highest returns of any U.S. stock index.

Less evident, though, is *how* the index has managed to outperform over time. That will be the main focus of this paper. Specifically, we will detail how the RMV's annual rebalancing process has contributed to its absolute, relative, and risk-adjusted performance. We will also explain how the index is structurally affected by the rebalancing process, which can present active managers with opportunities to generate excess returns.

KEY TAKEAWAYS

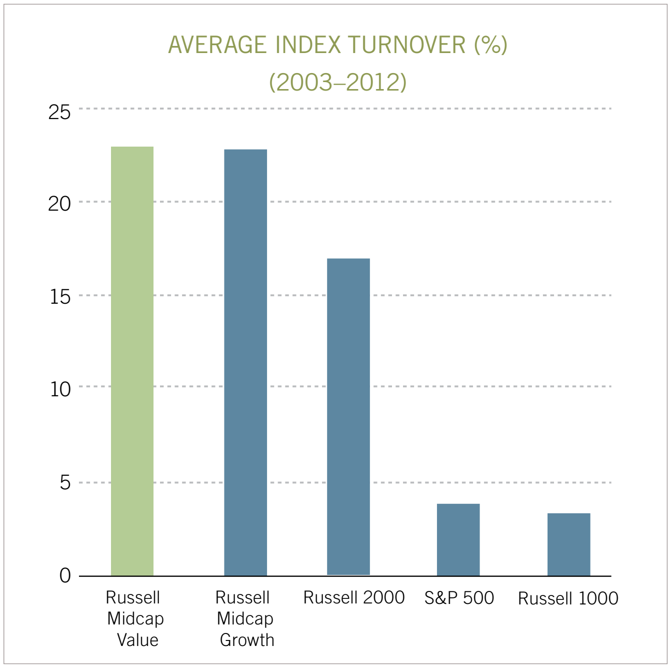
- The Russell Midcap Value (RMV) Index has registered one of the best long-term, risk-adjusted performance records of any U.S. equity benchmark.
- The RMV is one of the most actively rebalanced indexes, an annual practice that has helped to boost its total return over time by essentially automating the "buy low, sell high" process.
- Certain potential outcomes of the RMV's rebalancing, such as sector shifts and reduced valuation, may offer opportunities for actively managed mid-cap value portfolios to outperform the index.

EXHIBIT 1: The RMV has outperformed all other Russell U.S. equity indexes during the past 15 years.



Source: FactSet, as of Dec. 31, 2012. See endnotes for index definitions. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance includes reinvestment of dividends.

EXHIBIT 2: The RMV has a higher annual turnover rate than many other popular U.S. equity benchmarks.



Source: FactSet, as of Dec. 31, 2012.

Defining the Russell Midcap Value Index

The RMV measures the performance of the mid-cap value segment of the U.S. equity universe. It includes companies in the Russell Midcap Index that have lower price-to-book ratios and lower forecasted growth values relative to others in the mid-cap space. As of Dec. 31, 2012, there were 564 stocks in the RMV, which is constructed to provide a comprehensive, unbiased barometer of the mid-cap value market.[2] The market cap of stocks in the index generally ranges from roughly $2 billion to $19 billion.

Annual rebalancing may help boost the RMV's performance

Automating the "buy low, sell high" process for investors

The RMV is one of the most actively rebalanced U.S. equity benchmarks, with an average annual turnover rate of nearly 25% during the past 10 years, well above many other domestic indexes (see Exhibit 2, above). Each June, the RMV is reconstituted (based on market cap and, to a lesser extent, valuation) to ensure larger stocks do not distort the performance and characteristics of the true mid-cap value market. The RMV must also keep its holdings for at least one year, allowing time for many undervalued stocks to reach their intrinsic value.

When the RMV is rebalanced, stocks can enter or exit the index by various means that, in some ways, automate the "buy low, sell high" process.

1. Stocks that appreciated above the $19 billion market-cap ceiling are "sold high" and moved to a Russell large-cap index.
2. Out-of-favor large-caps that fit the mid-cap value criteria are "bought low" and fall into the RMV.
3. Stocks falling below the $2 billion threshold are dropped down to a Russell small-cap category.
4. Entirely new stocks that fit the RMV's market-cap and valuation parameters are added to the index.

How "drops" and "adds" contribute to total return

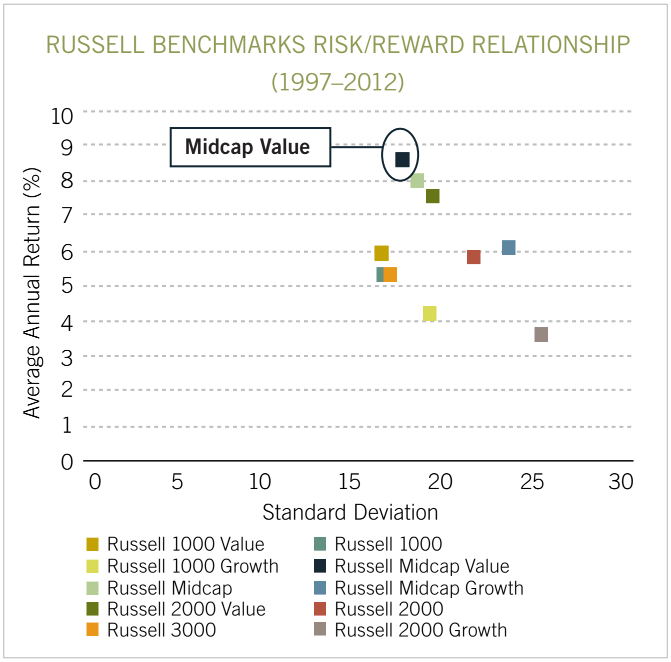
In the vernacular of rebalancing, "drops" are stocks that are completely removed from the RMV and have a zero weighting after the rebalance. Drops typically occur when a stock becomes very successful and is reallocated to a growth or larger-cap index, or when they perform so badly that their reduced market cap drops them down to a small-cap index. "Adds" are stocks that are completely new to the RMV. These are stocks that go from a zero weighting in the index prior to the rebalancing to something other than zero after the rebalance.

Historically, stocks that are added to the Russell Midcap Value Index have done substantially better than those that are dropped. From June 1991 through June 2012, stocks that were added to the RMV had an average annual return of 12.57% (see Exhibit 3, below). In comparison, stocks that were dropped from the index gained

EXHIBIT 3: Over time, stocks added to the RMV have significantly outpaced "drops."

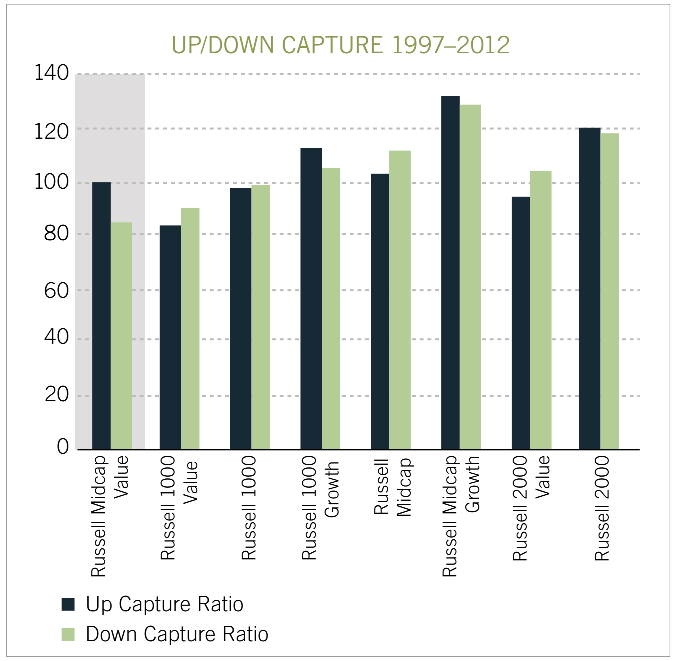
Source: FactSet, Jun 1991–Jun 2012. Past performance is no guarantee of future success. Index performance includes the reinvestment of dividends.

EXHIBIT 4: The RMV's risk-adjusted performance has been among the best in the U.S. equity universe.



Source: FactSet, as of Dec. 2012. Past performance is no guarantee of future results. Index performance includes the reinvestment of dividends.

EXHIBIT 5: The RMV has captured nearly all of the broad U.S. equity market's upside, but only 85% of its downside.



Source: Morningstar Direct, as of Dec. 31, 2012. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance includes the reinvestment of dividends.

less than half as much, returning 5.8%. The index overall had an annualized return of 11.1% during that time frame. Of course, this does not mean the rebalancing process has a positive effect on the RMV's performance every year. In the June 2008 to June 2009 time frame, for example, adds to the index declined roughly 24%, while drops lost nearly 18%. But over time, the cumulative effect of rebalancing has been overwhelmingly positive.

Compelling risk/reward profile

As previously shown, the Russell Midcap Value Index has outperformed large- and small-cap benchmarks over time. It has also held up well on a risk-adjusted basis. As shown in Exhibit 4 (above, left), the RMV's average annual absolute return is higher than any of the nine other indexes listed in the chart. But unlike many other high-return assets, it has had a relatively low level of risk, as measured by standard deviation.[3] Therefore, considering its history of high returns and lower volatility, mid-cap value can potentially serve multiple roles in an investment strategy. For example, it can serve as a core equity component in a long-term portfolio, provide diversification for shorter-term or risk-averse investors, and help to reduce risk in both short- and long-term portfolios.

Strong relative performance in up and down markets

In addition to its strong absolute and risk-adjusted results, the RMV has demonstrated strong relative returns in both up and down markets. This is reflected by a statistical measure known as the up/down market capture ratio. "Up-capture" compares the RMV's performance against a broad market benchmark (represented here by the Russell 3000 Index) when the market's performance is positive, while "down-capture" compares the RMV's performance versus the broad market benchmark when its return is negative. A value above 100 means that an investment or strategy captured more return than its benchmark, and a value less than 100% means it captured less return than the benchmark. As shown in Exhibit 5 (above, right), the RMV has captured 99.9% of the broad U.S. equity market's upside over the past 15 years, but only 85% of its downside. In essence, this means the RMV has provided virtually all of the market's positive returns, while still offering some protection during broad market downturns.

The active management opportunity

A passive mid-cap value ETF or index fund seeks to approximate the performance of the Russell Midcap Value Index, but an active management strategy may be able to generate returns in excess of the benchmark. In this section, we will discuss two active management opportunities (sector shifts and valuation declines) that are potential outcomes related to the RMV's rebalancing process, as well as one that is specific to the lack of analyst coverage within the mid-cap value universe.

Sector selection

The RMV's rebalancing criteria are sector-agnostic, so it is not uncommon for sector weightings to rise or fall by 300 to 400 basis

EXHIBIT 6: The RMV's annual rebalancing often causes its sector weightings to change sharply.

RMV'S Largest Sector Swings (%), 2008–2012		
Year	Sector	% Difference
2011	Energy	-4.21
2009	Industrials	3.89
2009	Consumer Discretionary	-3.08
2008	Financials	3.83
2008	Energy	-3.96

Source: Russell Investments, through Feb. 2012.

points when the index is reconstituted (see Exhibit 6, above). For example, when the RMV was rebalanced in June 2008, its energy sector weighting fell from 10.3% to 6.3%, as many energy companies benefited greatly from soaring oil prices and grew beyond the mid-cap value universe. Interestingly, oil prices reached an all-time high of $145 per barrel (West Texas Intermediate)[4] in July 2008—just a month after the index was rebalanced—before plummeting below $50 per barrel later that same year.

This historical example helps illustrate the potential advantages of active management. In a passive RMV product, investors would have been fully exposed to the dramatic decline in oil prices, which battered energy stocks in the second half of 2008. But an active manager—perhaps recognizing the RMV's energy sector shift as the peak of a bubble—could have strategically underweighted the sector to mitigate losses. From an active management perspective, the various outcomes of the RMV's reconstitution represent additional input in the security selection process. They provide valuable insights into how the market is moving, which gives active managers the opportunity to adjust their portfolio accordingly and express their best investment ideas.

Lower valuation

Historically, when the RMV is rebalanced in June, the overall valuation of the index becomes temporarily less expensive, which occurs for several reasons:

1. Stocks exiting the RMV for a large-cap, mid-cap core or growth index are more expensive on a price-to-earnings (P/E) basis.

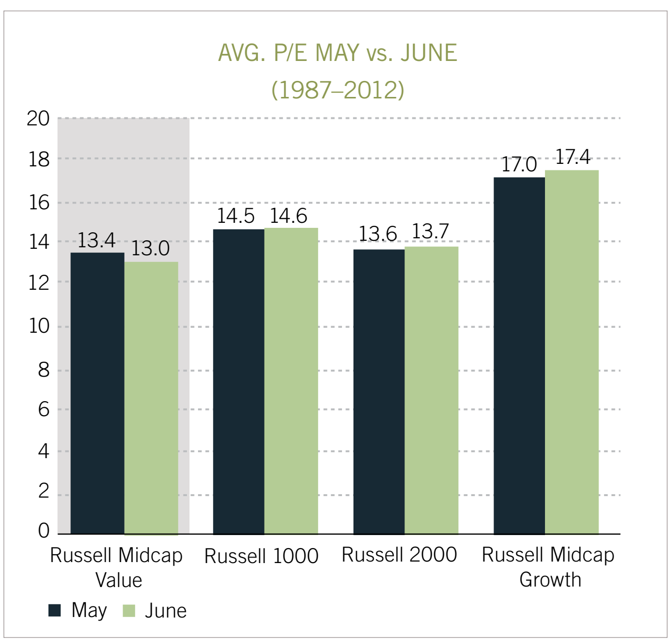
2. Stocks that enter the RMV for the first time tend to have lower P/Es than stocks already in the index.

3. Stocks remaining in the RMV become a larger percentage of the index, and since they have lower P/Es than those that "graduated" to other universes, the RMV overall gets cheaper.

Exhibit 7 (below, left) compares the P/E ratios of several well-known stock market benchmarks before and after they are rebalanced. Note how the RMV's average valuation has historically declined when it is rebalanced, while the average P/E ratios for the other benchmarks have increased.

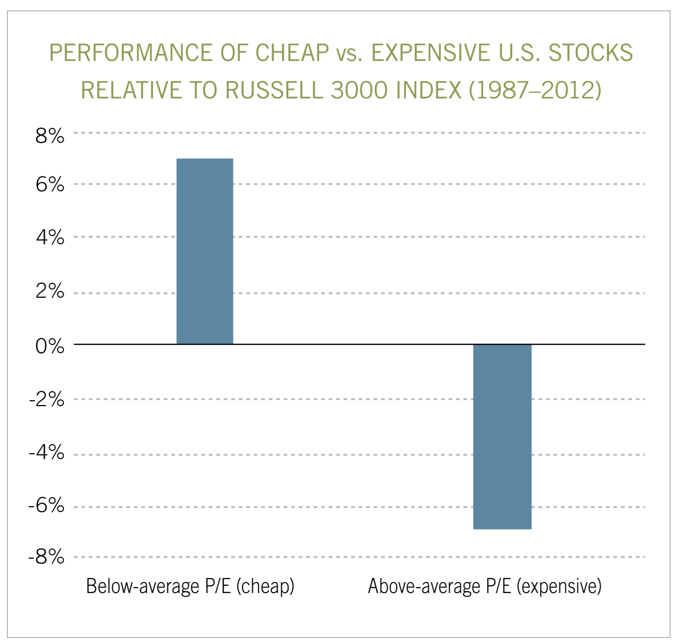
During periods when the RMV's valuation falls, this presents another

EXHIBIT 7: While many indexes become more expensive after they are rebalanced, the RMV has historically become cheaper.



Source: FactSet, as of Dec. 31, 2012. All Russell indexes are rebalanced on the same day each June.

EXHIBIT 8: Historically, cheap stocks (based on P/E ratio) have outperformed expensive stocks.



Source: FactSet, as of Dec. 31, 2012. Past performance is no guarantee of future results. Index performance includes the reinvestment of dividends.

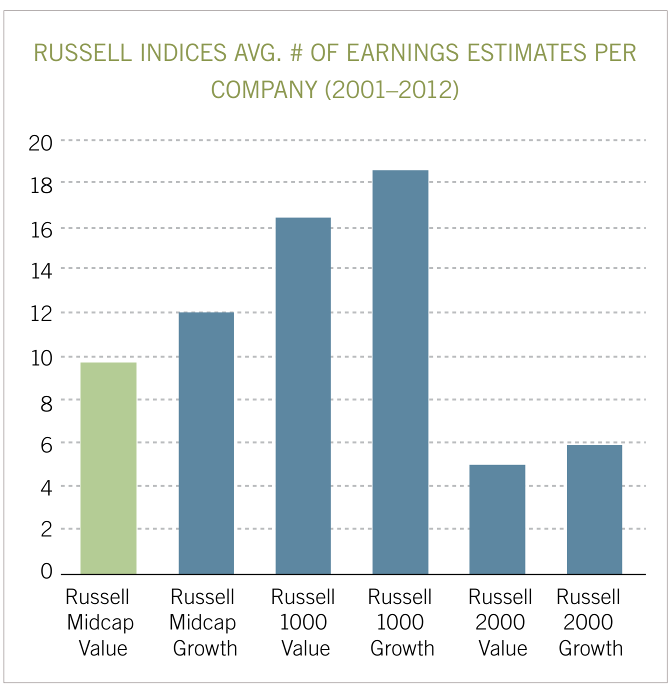
opportunity for active managers to outperform a passive mid-cap value investment. By overweighting stocks with cheap valuations, an active strategy has the potential to add alpha, or excess return, relative to the benchmark. In addition, cheap stocks have tended to outperform expensive stocks over time. During the past 25 years, for example, U.S. stocks with below-average P/Es have had an average annualized excess return of nearly 700 basis points (7.0%) over the broad market (as represented by the Russell 3000), while stocks with above-average P/Es have underperformed by nearly 700 basis points (see Exhibit 8, page 4).

Under-researched and under-allocated

While there are nearly 600 stocks in the RMV Index, many are under-researched or not covered at all by Wall Street analysts, who typically focus their attention on large-cap equities (see Exhibit 9, below). This relative lack of sell-side research opens the door for active mid-cap managers with deep analytical resources to seek well-positioned companies before their value is fully recognized. Small-cap stocks are the only group with less coverage, given their relative lack of transparency and liquidity compared with mid- and large-caps.

Similarly, mid-caps are under-allocated in many investor portfolios. As calculated by Morningstar through the end of 2012, mid-caps represented only 20% of the U.S. equity market's total capitalization, and only 14% of all U.S. equity mutual fund assets (see Exhibit 10, right). In comparison, large-caps represented 75% of fund assets, despite the superior historical returns of mid-caps on an absolute

EXHIBIT 9: The mid-cap value category is among the least followed by Wall Street analysts.



Source: FactSet, as of Dec. 31, 2012.

and risk-adjusted basis. Still, this 5-to-1 allocation disparity in favor of large-caps creates yet another opportunity for mid-cap managers to generate alpha by exploiting informational inefficiences through in-depth research and active investment management.

EXHIBIT 10: Investors allocate five times more mutual fund assets to large-caps than to mid-caps, despite mid-caps' historical long-term performance advantage.

U.S. Equity Mutual Fund Assets				
	Value	Blend	Growth	Total
Large	17.3%	33.8%	24.6%	75.7%
Mid	3.1%	5.1%	6.0%	14.2%
Small	2.1%	4.2%	3.8%	10.1%

Source: Morningstar, as of Dec. 31, 2012.

Investment implications

Mid-cap value is an underappreciated and often overlooked segment of the U.S. equity market. Nevertheless, a targeted allocation to the asset class may be appropriate for many investors. Its long-term, risk-adjusted performance has been shown to meaningfully enhance the returns of a broader U.S. equity portfolio. Incorporating a mid-cap value component within an asset allocation strategy may also provide important diversification benefits, such as reducing a portfolio's volatility. We believe an active management approach based on in-depth, original research resources can further amplify the opportunity to generate excess returns in this segment of the market.

In addition, many investors believe that a portfolio of large- and small-cap stocks will provide them with an aggregate exposure to mid-caps, but that theory is inaccurate and can potentially have negative consequences. Mid-caps have historically delivered higher returns and lower levels of risk (standard deviation) than both large- and small-caps. As we have demonstrated in this paper, much of this excess return can be attributed to the cumulative performance kick the RMV has received during its annual rebalancing process over time.

In my opinion, the mid-cap value space is one of the best-kept secrets on Wall Street. Considering the features and benefits of the asset class discussed in this paper, both long- and short-term investors could potentially benefit from a well-considered allocation to this segment of the market.

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Matt Friedman is a portfolio manager for Fidelity Investments. During his 13-year tenure with the firm, he has been responsible for managing multiple diversified, sector, and industry portfolios. Mr. Friedman joined Fidelity in 2000, responsible for following specialty pharmaceuticals and generics stocks. He also has covered the media, cable and satellite, chemicals, and energy industries. Mr. Friedman is a Chartered Financial Analyst (CFA) charterholder and a Certified Public Accountant (CPA).

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Diversification/asset allocation does not ensure a profit or guarantee against loss.

Past performance does not guarantee future results.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Investing involves risk, including risk of loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

The securities of smaller, less well-known companies can be more volatile than those of larger companies. Value and growth stocks can perform differently from other types of stocks. Growth stocks can be more volatile. Value stocks can continue to be undervalued by the market for long periods of time.

It is not possible to invest directly in an index. All indices are unmanaged.

Endnotes

[1] Index inception Dec. 31, 1985, through Dec. 31, 2012.

[2] Source: Russell Midcap Value Fact Sheet, as of Dec. 31, 2012.

[3] Standard deviation shows how much variation there is from the average (mean or expected value). A low standard deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data points are spread out over a large range of values.

[4] Source: U.S. Energy Information Administration, "Annual Energy Outlook 2012," as of Jun. 25, 2012.

Index definitions

Standard & Poor's 500 Index (S&P 500®) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.

The Russell Midcap Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell Midcap Value Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values

The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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