Kayne Anderson Rudnick
Investment Management

Discovering Mid Caps

The mid-cap segment of the equity market is an overlooked category, falling between headline-grabbing and widely followed large caps and small caps known for their high growth potential. Mid-caps—generally defined as companies between $2 billion and $10 billion in market capitalization, with some reaching north of $30 billion—have historically outperformed both small and large caps, but don't get much investor attention. The lines between market-cap categorizations can be blurry, which could lead many investors to believe that owning stocks in the large and small categories provides sufficient exposure across the overall spectrum. In fact, data point to a clear underrepresentation of the mid-cap asset class. Mid caps make up about 26% of the overall equity market[1], but actual investments into the asset class only account for about 14% of all invested assets[2].

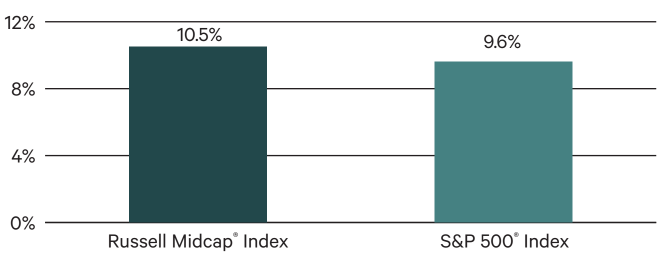
Those investors lacking a dedicated allocation to mid caps may be missing a crucial segment. Mid-cap stocks haves had an impressive run over the past couple of decades and they have proven to be a positive addition to a mixed portfolio of equities, both in terms of boosting portfolio return and lowering risk.

HISTORICAL LONG-TERM OUTPERFORMANCE DRIVEN BY FUNDAMENTAL STRENGTHS

Mid-cap stocks have strong fundamental characteristics that position the asset class as having some of the best attributes of its large- and small-cap counterparts. Large caps may be well established and more likely to pay dividends but may have limited growth potential. Small caps may come with the allure of outsized growth but may exhibit more volatility and greater dependence on debt. Mid caps find their place in between: they are small enough to be experiencing relatively high growth rates but mature enough to have proven business plans, more stability and more experienced management.

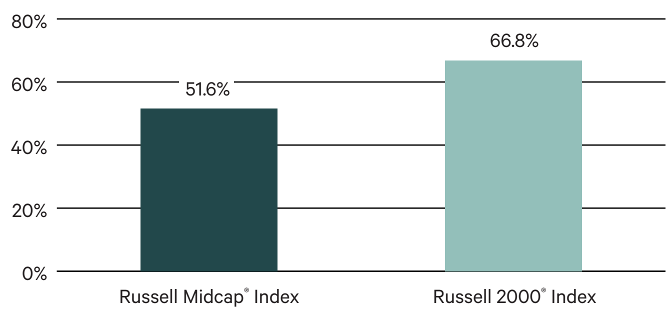
Mid caps have better historical earnings-per-share growth statistics than large caps.

EARNINGS PER SHARE GROWTH - PAST 10 YEARS



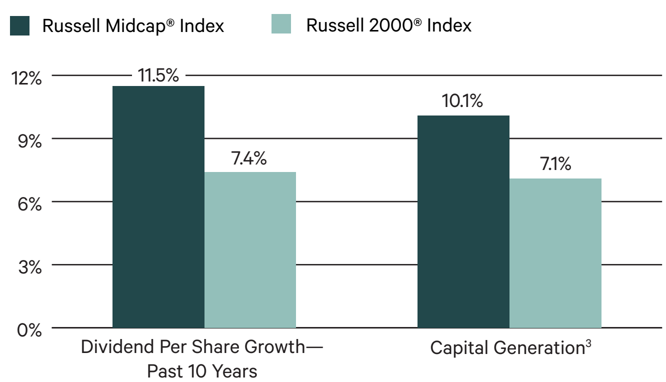
The comparison of earnings variability shows that mid-cap companies exhibit more consistency in profitability relative to their small-cap peers.

EARNINGS VARIABILITY - PAST 10 YEARS



Mid caps also have shown higher income potential than small caps while exhibiting greater ability to generate capital, another indication of their strong financials.

HIGHER INCOME AND GROWTH POTENTIAL

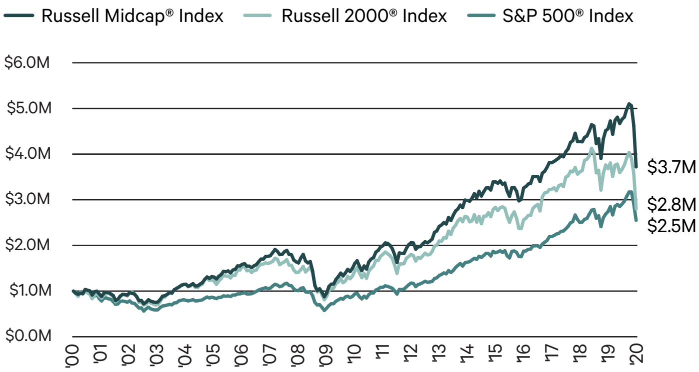


1. *Data as of May 10, 2019. Data is obtained from FTSE Russell and is assumed to be reliable.*
2. *Data as of March 31, 2020. Data is obtained from Strategas and is assumed to be reliable.*
3. *Capital generation represents the rate at which companies generate equity capital.*

Data presented in the charts above is for the period ending March 31, 2020. Data is obtained from BNY Mellon and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Past performance is no guarantee of future results.

These fundamental characteristics of mid-cap stocks are, in our view, key reasons behind their steady outperformance over the past 20 years relative to their larger and smaller peers.

GROWTH OF $1 MILLION



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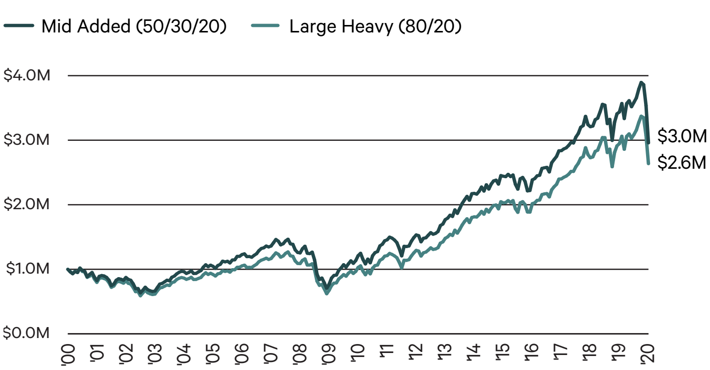
A POSITIVE ADDITION TO A DIVERSIFIED PORTFOLIO

Not only do mid caps hold their own as an individual asset class, but they also serve as a positive addition to a portfolio comprising large and small stocks. Historical data show the risk-return profile of a base portfolio experiences substantial improvement when mid-cap exposure is added.

We will observe two hypothetical portfolios: (1) a base portfolio of an 80/20 allocation to large and small stocks, and (2) a 50/30/20 allocation to large/mid/small caps, representing a shift of a portion of the first portfolio's large-cap exposure to mid caps.

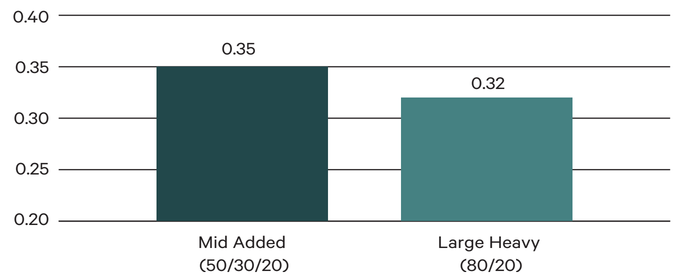
Not only does the addition of mid caps improve the cumulative gain, but it also boosts risk-adjusted returns.

GROWTH OF $1 MILLION



Data presented is for the 20 years ending March 31, 2020. Mid Added is composed of 50% S&P 500® Index, 30% Russell Midcap® Index and 20% Russell 2000® Index; and Large Heavy is composed of 80% S&P 500® Index and 20% Russell 2000® Index. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

RETURN PER UNIT OF RISK



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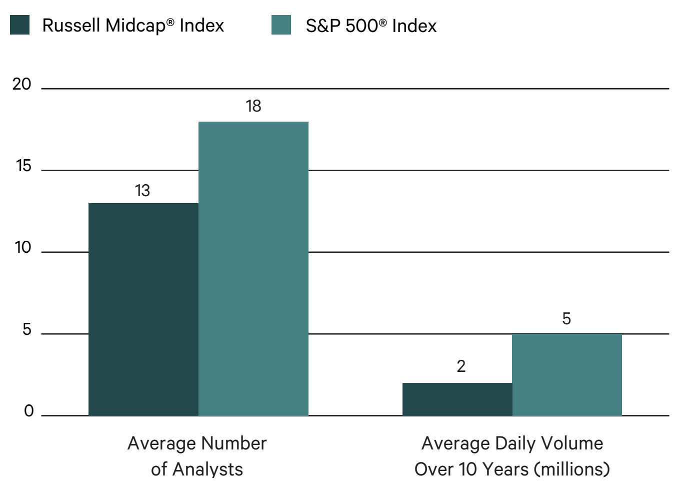
THE VALUE OF ACTIVE MANAGEMENT

Data indicate that mid-cap equities constitute an overlooked area of the stock market, creating opportunities to add value with active management. Mid caps, for instance, receive significantly less research coverage than large caps, as measured by the number of analysts covering member companies of the respective indices. Trading activity echoes this notion, as large caps experienced average daily volume of 4.7 million shares over the past 10 years, more than double that of mid caps at 2.0 million.

LESS COVERAGE, ACTIVITY IN MID SEGMENT



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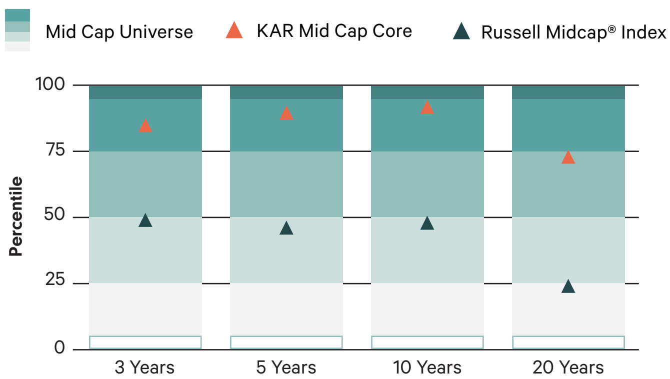
Furthermore, the analysis on the following page compares passive investing in the mid-cap category, represented by the Russell Midcap® Index, against active investing, with manager return breakdowns shown in quartiles. It is clear that the passive approach lags at least half of all active managers across the time periods.

MID CAP UNIVERSE COMPARISON - ANNUALIZED RETURNS



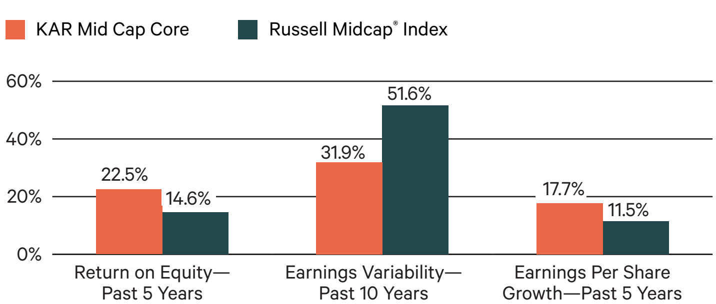
Data presented is based on monthly data for the periods ending March 31, 2020. The Mid Cap Universe includes all managers categorized in the Mid Cap asset class by eVestment. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

For instance, over the past 20 years, the index gained 6.79% versus the median return of 8.33% among the 112 managers studied. That suggests there is the potential for greater returns in active management than in passive participation. This chart also includes the returns of the KAR Mid Cap Core strategy across the relevant time periods since inception. For the 5-year period, passive investment via the index gained 1.85%, while the KAR Mid Cap Core strategy returned 7.58%. This clearly illustrates there is room for higher performance in active management and particularly via the KAR strategy.

WHY KAYNE ANDERSON RUDNICK?

The KAR Mid Cap Core strategy, since its inception in January 2000, has been capturing that very opportunity for greater risk-adjusted returns in active management by sticking to a disciplined research process and strict guidelines for quality investments. We believe that the quality of the underlying businesses owned create a portfolio with solid fundamental characteristics that can lead to strong relative performance in both good and bad markets.

FUNDAMENTAL CHARACTERISTICS



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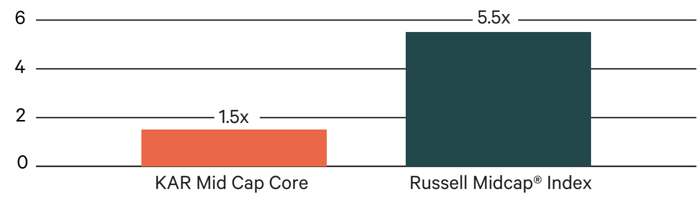
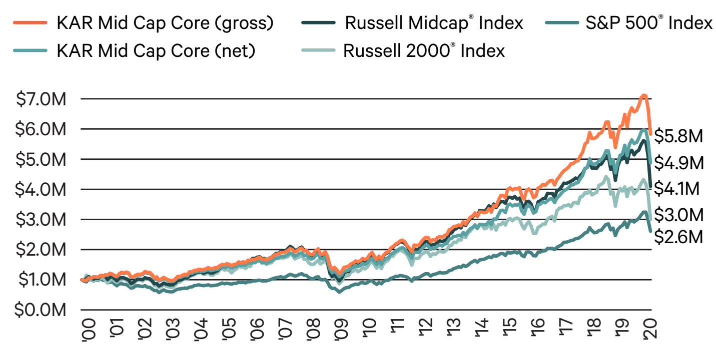
TOTAL DEBT/EBITDA



Data presented is for the period ending March 31, 2020. Data is obtained from FactSet Research Systems and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Past performance is no guarantee of future results.

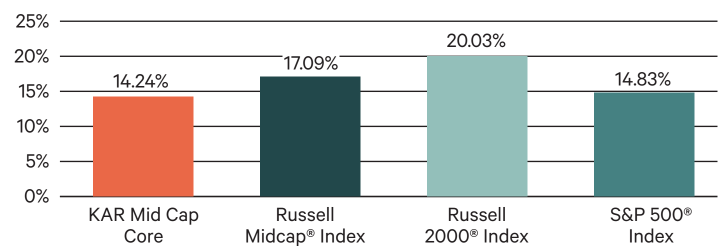
We believe that we are laying the groundwork for greater returns for our investors when we concentrate on finding quality businesses and constructing a strong portfolio. Such commitment has allowed the KAR Mid Cap Core portfolio to exhibit meaningful outperformance with less risk since inception relative to its benchmark and the large- and small-cap indices.

GROWTH OF $1 MILLION



The chart reflects cumulative returns for KAR Mid Cap Core since inception of January 1, 2000 through March 31, 2020. Data is obtained from FactSet Research Systems and is assumed to be reliable. This material is deemed supplemental and complements the performance and disclosure presented below. Past performance is no guarantee of future results.

STANDARD DEVIATION



Data presented is for the period since inception of January 1, 2000 through March 31, 2020. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

CONCLUSION

The risk-return profile provided by the mid-cap segment is far from middling. The analyses exhibit the strong fundamentals of the asset class, which help to contribute to greater returns. We believe mid-cap stocks merit a meaningful allocation in any well-diversified equity portfolio.

DISCLOSURE

Kayne Anderson Rudnick Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Kayne Anderson Rudnick Investment Management, LLC has been independently verified for the period from January 1, 1999 through December 31, 2018.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The Mid Cap Core Composite has been examined for the period from January 1, 2000 through December 31, 2018. The verification and performance examination reports are available upon request.

Kayne Anderson Rudnick Investment Management, LLC, a wholly owned subsidiary of Virtus Investment Partners, Inc., is a registered investment advisor under the Investment Advisers Act of 1940. Registration of an Investment Advisor does not imply any level of skill or training. Kayne Anderson Rudnick Investment Management, LLC manages a variety of equity and fixed-income strategies focusing exclusively on securities the firm defines as high quality.

The composite includes all fully discretionary institutional and pooled Mid Cap Core Portfolios. Mid Cap Core Portfolios are invested in equity securities with market capitalizations consistent with the Russell Midcap® Index, that have market control, rising free cash flow, shareholder-oriented management, strong consistent profit growth and low-debt balance sheets. For comparison purposes, the composite is measured against the Russell Midcap® Index. The Russell Midcap® Index is a market capitalization-weighted index of the 800 smallest companies in the Russell 1000® Index, which comprises the 1,000 largest U.S. companies. The index is calculated on a total-return basis with dividends reinvested. Benchmark returns are not covered by the report of the independent verifiers. The composite was created in January 2000. Previously, only institutional accounts were included. A list of composite descriptions and policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

Prior to January 1, 2011, the composite minimum was $250,000. As of January 1, 2011, the composite was redefined to include both institutional and mutual fund [or pooled] accounts. Prior to January 1, 2011, accounts that experienced a significant cash flow, defined as aggregate flows that exceeded 25% of the account's beginning of period market value, were temporarily removed from the composite.

The standard management fee schedule currently in effect is as follows: 0.75% for the first $25 million; 0.65% on the next $25 million; 0.55% on the next $50 million; 0.50% on the balance. Actual management fees charged may vary depending on applicable fee schedules and portfolio size, among other things. Additional information may be found in Part 2A of Form ADV, which is available on request. The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary among accounts. The U.S. dollar is the currency used to express performance. Returns are presented net of transaction fees and include the reinvestment of all income. Gross returns will be reduced by investment management fees and other expenses that may be incurred in the management of the account. Model net returns have been calculated by deducting 1/12th of the highest tier of the standard management fee schedule in effect for the respective period from the gross composite returns on a monthly basis.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns for accounts in the composite for the entire year. For those years when less than five accounts were included for the full year, no dispersion measure is presented. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended at the following dates:

3-Yr Annualized Standard Deviation (%)		
December 31	**Composite**	**Benchmark**
2011	17.51	21.86
2012	15.39	17.44
2013	12.53	14.23
2014	10.29	10.29
2015	11.96	11.00
2016	12.31	11.72
2017	10.76	10.51
2018	11.33	12.15

Year	Total Firm Assets ($ Millions)	Total Composite Assets ($ Millions)	Accounts at Year End	Gross Annual Return (%)	Net Annual Return (%)	Russell Midcap® Index Annual Return (%)	Internal Dispersion
2009	4,010	8	9	21.11	19.92	40.48	0.40
2010	4,729	8	7	20.23	19.06	25.48	0.31
2011	5,232	10	14	4.52	3.76	(1.55)	0.26
2012	6,545	11	15	16.58	15.72	17.28	0.18
2013	7,841	15	15	28.54	27.62	34.76	0.48
2014	7,989	17	12	18.17	17.28	13.22	0.13
2015	8,095	40	15	3.37	2.60	(2.44)	0.44
2016	9,989	79	22	12.32	11.49	13.80	0.36
2017	14,609	170	72	26.13	25.21	18.52	0.23
2018	17,840	352	181	(3.21)	(3.93)	(9.06)	0.30

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800.231.7414