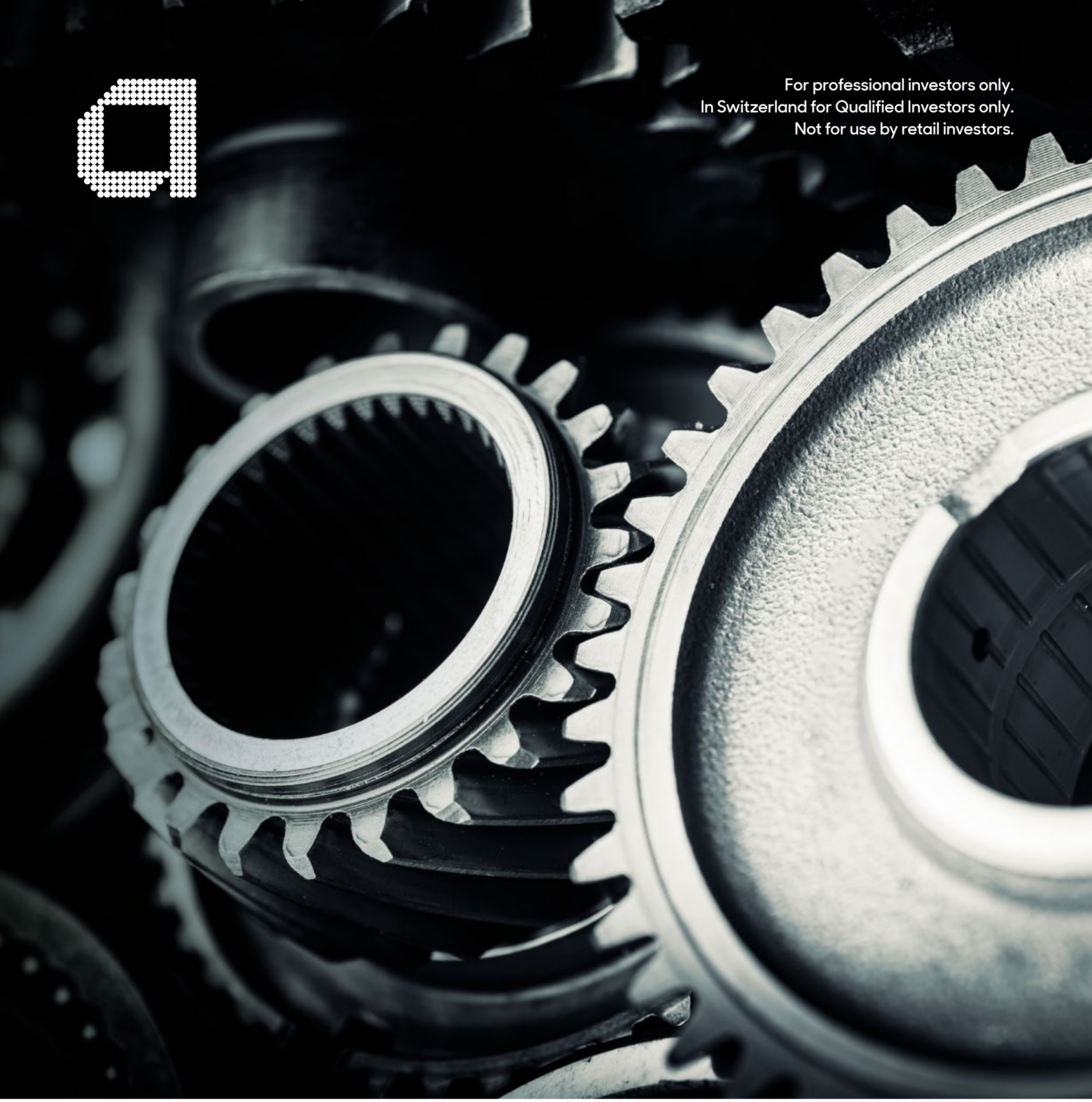


The compelling case for a dedicated allocation to global mid-cap equities

April 2023

abrdn.com

Summary overview

In this paper, we explain why we believe there's a compelling case for investors having a dedicated allocation to mid-cap equities within global equity portfolios.

The **structural** case is supported by:

- the mid-cap equities segment being **under-researched, with global equity investors potentially under-allocating to the asset class**
- mid-caps' **attractive long-term returns** on both a gross and risk-adjusted basis
- the **example of the US equities market**, where the mid-cap segment is thriving and has outperformed even small caps on a gross and risk-adjusted basis
- the **numerous attractive traits of mid-caps** and their prevalence on the so-called company **lifecycle 'sweet spot'**
- the superior growth and value potential of **investing in 'tomorrow's winners'**
- improved diversification potential within global equity portfolios and **reduced risk of overexposure to large caps and particular sectors.**

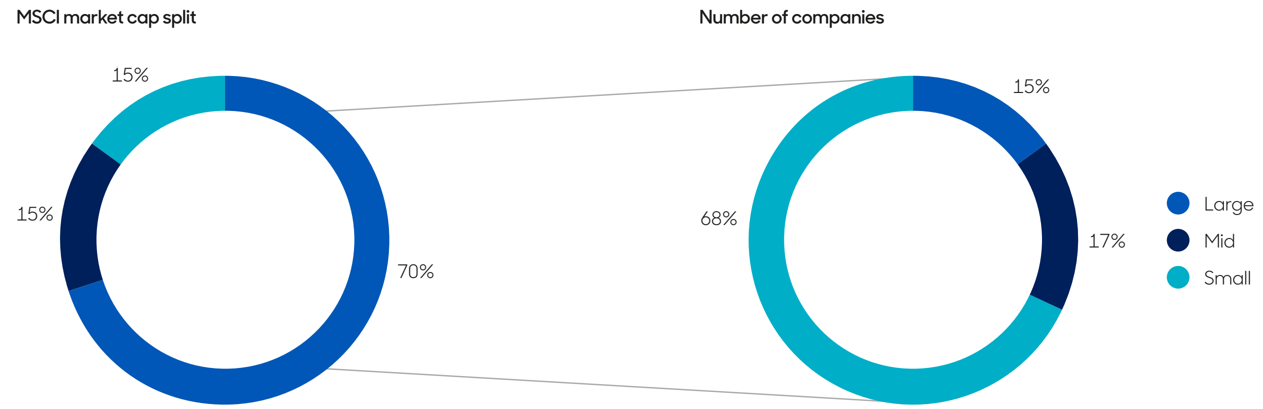
From a more **tactical** perspective, the case for a dedicated allocation to global mid-caps within global equities **in today's environment** is supported by:

- the historical pattern of **mid-caps outperforming for several years** following big market corrections
- relatively **attractive valuations**
- the existence of numerous high-quality global mid-caps with strong fundamentals and resilient **pricing power** - valuable traits in the current elevated inflation and increased interest-rate environment.

Key background – defining small-cap, mid-cap and large-cap equities

As the name suggests, mid-cap equities are in between large caps and small caps in terms of market capitalisation (cap). Using MSCI's classification method, as applied to its broadest global equity index, the All Country World Index (ACWI), large caps represent the biggest segment – 70% of the total market cap. As shown Figure 1, at the other end of the scale, small caps represent 15% of the total index market cap, with mid-caps accounting for the middle 15-30th percentile of the entire global equity market cap.

Figure 1 – global equity segments by market cap



	Market cap	No. of companies
MSCI AC World Large Index	70%	1357
MSCI AC World Mid Index	15%	1538
MSCI AC World Small Cap Index	15%	6268

Source: MSCI Indices, 31 December 2022.

Smaller but not small

In terms of conceptualising the size of mid-caps, it's important to understand that while they are smaller than large caps, they are by no means small. Indeed, in the global equities context, the average market cap for global mid-caps is US$6.1billion (bn). This is more than four times the size of the average global small cap of US$1.3bn, but just a fraction of the average global large-cap market cap of US $32.6bn. Indeed, the global mid-cap universe contains many sizeable, well-established companies, with well-known products and brand names.

Source: MSCI ACWI Large Cap, MSCI ACWI Mid Cap and MSCI ACWI Small Cap index factsheets, 28 March 2023.

"Investors often have greater familiarity with large-cap equities but can sometimes underestimate the typical size profile of mid-caps, which contains many sizable and well-known companies. This includes the likes of the $21bn market cap US-listed insulin pump manufacturer, Insulet, €17bn European luxury goods company, Moncler, and the RMB50bn Chinese skincare company, Proya Cosmetics."

Anjli Shah

Portfolio Manager, abrdn

Underfollowed and under-allocated

A lot of market focus, including in the financial media, tends to focus on global large-cap equities. By contrast, there's much less attention paid to the mid-caps segment. One indicator of this is less sell-side analyst coverage of global mid-cap equities relative to large caps. For example, the average global mid-cap is followed by 15 analysts, versus 41 analysts covering the 10 biggest global large caps.[1] Additionally, out of 2,019 global equity funds in the eVestment database, only 16 were dedicated mid-cap funds.[2]

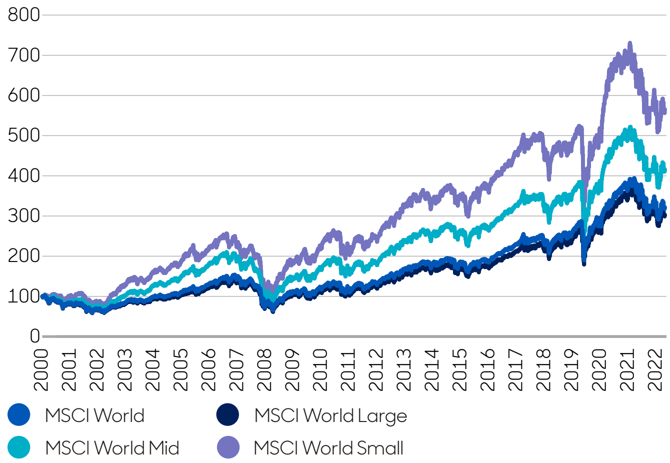
These factors suggest that global mid-caps are a less widely followed and potentially under-allocated segment within global equities, which could be an indicator of significant untapped investment opportunity.

Favourable risk/return features

As shown in Chart 1, over the last 22 years global mid-caps (MSCI World Mid) have outperformed global large caps (MSCI World Large) and broader global equities (MSCI World) on both a gross and risk-adjusted (Sharpe ratio) basis.

Chart 1 – long-term performance comparison of global equity segments

Rebased to 100 (from end-2000)



	Annualised Sharpe ratio (2000-2022)
MSCI World	0.33
MSCI World Large	0.31
MSCI World Mid	0.38
MSCI World Small	0.45

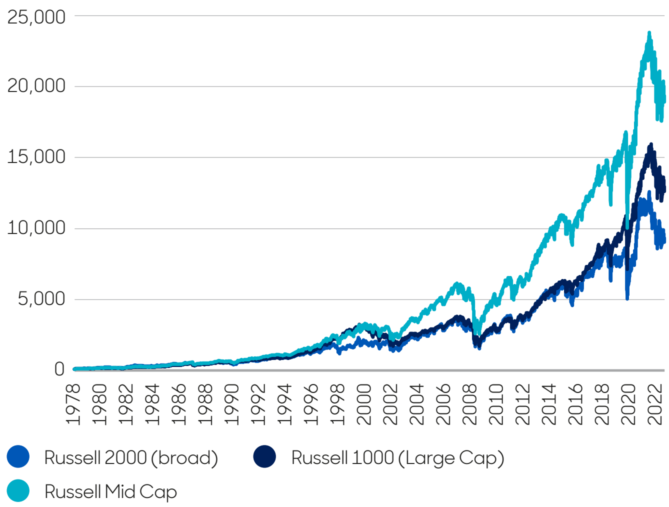
Source: Morningstar Direct, 31 December 2022.

Chart 1 also shows that versus global small caps, global mid-caps have not performed quite as well on both a gross and risk-adjusted basis over the last 22 years.

However, data from the key US market (which goes back much further than the MSCI World Index) suggests that US mid-caps have not only outperformed US large caps on both a gross and risk-adjusted basis – but have also outperformed their small-cap counterparts on a gross and risk-adjusted basis. This is perhaps reflected in a comparatively thriving number (almost 300) of dedicated mid-cap fund offerings in the US equity space.[3] In UK equities, which is another market with longer historical data, it's also notable that, over the longer term, UK mid-caps have outperformed both UK large caps and small caps on a gross and risk-adjusted basis.

Chart 2 – long-term performance comparison of US large cap, small cap and mid-cap

Rebased to 100 (from end-1978)



	Annualised Sharpe ratio (1979-2022)
Russell 2000 (Broad)	0.41
Russell 1000 (Large Cap)	0.52
Russell Mid Cap	0.54

Source: Morningstar Direct, 31 December 2022.

[1] Bloomberg, January 2023. [2] eVestment database. 28 March 2023.
[3] eVestment database. 28 March 2023.

The value of investments and the income from them can go down as well as up and investors may get back less than the amount invested. Past performance is not a guide to future results.

Stronger recoveries following major market drawdown periods

Another positive feature of global mid-caps is the relative strength of subsequent recoveries following major drawdown periods, such as the 'TMT' bust, the Global Financial Crisis (GFC) and Covid-19 sell-off. For example, as shown in Chart 3, in the case of the GFC-related drawdown period, global mid-caps (MSCI World Mid Cap) underperformed broader global equities (MSCI World) by a relatively modest 6.5 percentage points (pp).

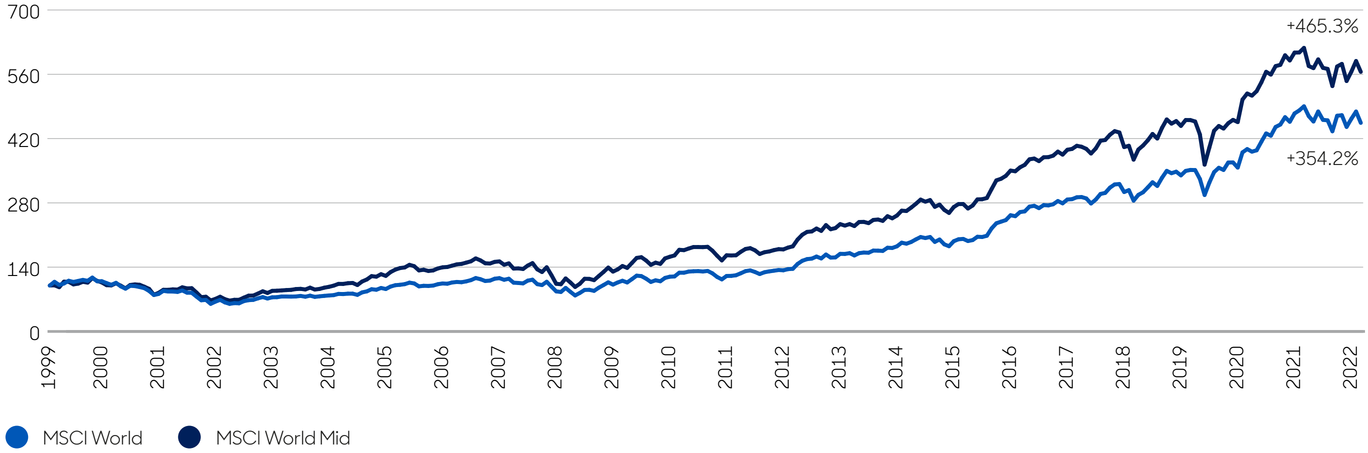
However, in the subsequent one-year recovery period, they outperformed by 8.7pp, with the gap growing to 18.0pp over the longer three-year (post-GFC) period.

We believe that stronger, extended post-drawdown recoveries help explain the longer-term outperformance of global mid-caps versus both broader global equities and global large-cap equities.

Chart 3 – relative strength of mid-cap recoveries following major drawdown periods

Rebased to 100 (from end-1999)

% Total return



	MSCI World Mid Cap	MSCI World		MSCI World Mid Cap	MSCI World		MSCI World Mid Cap	MSCI World
TMT Period			**GFC Period**			**Covid-19 Period**		
May 01 – Mar 03	-32.80%	-38.00%	May 07 – Feb 09	-39.10%	-32.60%	Dec 19– Mar 20	-21.10%	-15.50%
Subsequent 1 year	33.90%	24.30%	Subsequent 1 year	54.00%	45.30%	Subsequent 1 year	49.40%	39.10%
Subsequent 3 year	110.60%	73.50%	Subsequent 3 year	85.40%	67.40%	Subsequent 3 year	N/A	N/A

Source: Morningstar Direct, 31 December 2022.

Prevalence in the growth 'sweet spot' of company lifecycle

One way in which many of the attractive traits of mid-caps relative to small caps and large caps can be conceptualised is in terms of the typical stylised 'company lifecycle'. From this perspective, mid-caps tend to be early-to-midlife companies (blue shaded area of Figure 2) – a stage where they are often sufficiently well-established to avoid some of the greater (including potentially existential) risks of smaller companies. They also have ample growth opportunities and less risk of demand obsolescence or saturation risk that is more likely issue for large companies.

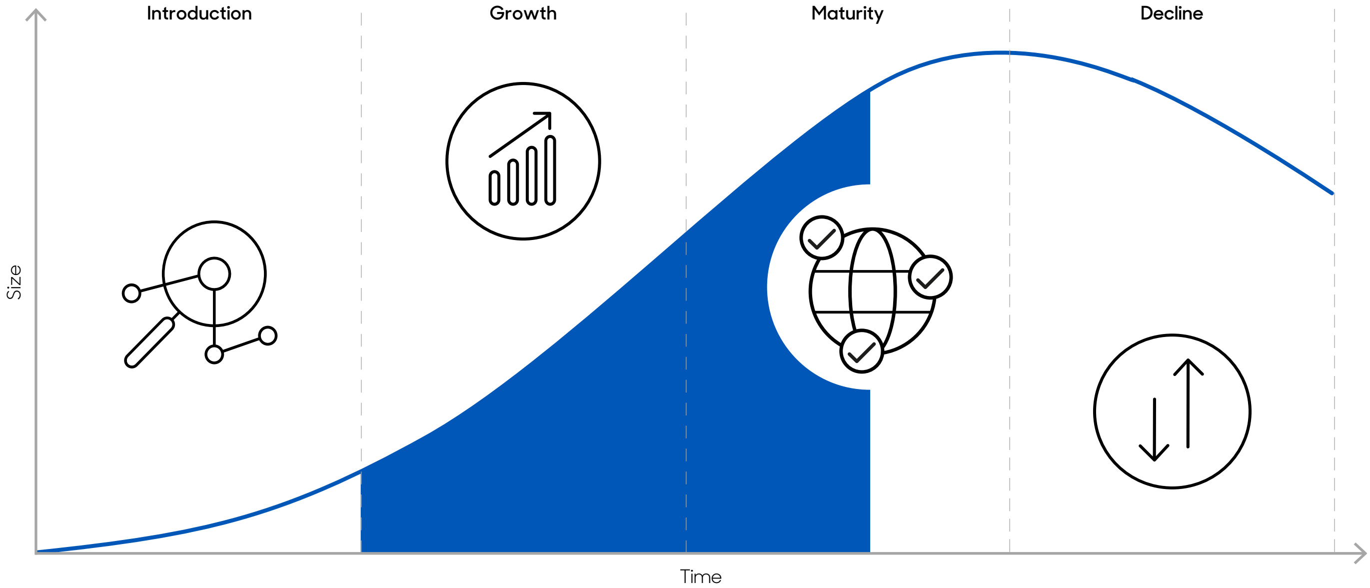
As such, it's often argued that mid-caps typically sit on the 'sweet spot' of the company lifecycle. They have higher growth potential compared to large caps with less risk than small caps – offering a distinct risk/return profile.

Investing in the global winners and large caps of tomorrow

Active investing is forward-looking, with a quest for discovering the successful sector leaders of tomorrow. However, we'd argue that investing in large caps is often the opposite of this, given their more limited growth potential. Furthermore, broad global indices and funds benchmarked to them can often have a bias towards large caps, owing to the market cap-based weighting of most indices.

In this regard, global small caps offer the chance to invest early in the biggest winners of tomorrow. The same basic logic applies to global mid-caps. However, as they are typically further along in the lifecycle, they potentially offer less risky pathways to success and growth than small caps.

Figure 2 – company lifecycle growth 'sweet spot'



Source: abrdn. For illustrative purposes only.

The attractive traits of mid-caps

Aside from risk/return characteristics, mid-caps tend to combine some of the favourable traits typically associated with both large caps and small caps.

Diversification benefits – in keeping with large caps, mid-cap businesses tend to be quite diversified, with multiple products/ business lines, potentially spread across global regions. This provides an element of cashflow and earnings stability, which can provide resilience in more challenging economic conditions.

Likewise, another source of resilience for mid-caps comes from being relatively well-established, with longer operating histories, and therefore typically less debt and more stable balance sheets compared to small caps.

Adaptability/flexibility – relative to large caps, mid-caps tend to be operationally nimbler. This means they are often more adept at seizing new opportunities or can scale-down operations fairly quickly when needed.

Organic growth potential – relative to large caps, mid-caps typically have more unexplored organic opportunities and generally more 'room to grow'. Conversely, the same argument favours small caps over mid-caps, although importantly this usually comes at the expense of more risk.

Pricing power – more in keeping with large caps, the global mid-cap segment contains numerous well-established, high-quality global companies with proven, time-tested product and service offerings. This can afford a significant degree of pricing power and resilience in tougher economic environments, including in times of high inflation and rising interest rates.

Global equities and market cycles – a historical intra asset-class perspective

In terms of the well-known style factors, mid-caps have some correlation and similarity with the small size factor. However, they don't have a clear relationship with any of the other major style factors, such as quality or value.

Still, some patterns are more apparent over historical market cycles. During times of economic weakness and increased market volatility, large caps, which are widely perceived to be relatively safe and more resilient, have tended to outperform mid-caps. Conversely, whenever market conditions have stabilised and moved to the recovery phase, mid-caps have usually outperformed their larger equivalents. Chart 3 evidenced this for broader global equities. Nonetheless, the calendar year-based 'quilt' perspective in Figure 3 shows that in recovery cycles, mid-caps have also tended to outperform most other global equity strategy types for extended periods.

For example, following the post-tech bubble trough of 2002, mid-caps outperformed the global high-dividend, global value and the global growth equity segments, as well as the broader global equities market, for two consecutive years.

Figure 3 – annual global equity returns 'quilt' by asset class segment (2001-2022)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Small Cap 1.20%	High Dividend -9.80%	Small Cap 58.40%	Small Cap 24.70%	Small Cap 16.10%	High Dividend 28.90%	World Growth 15.10%	World Value -39.80%	Small Cap 44.80%	Small Cap 26.60%	High Dividend 4.80%	Small Cap 18.10%
High Dividend -8.00%	Mid -14.30%	Mid 41.40%	Mid 24.40%	Mid 16.10%	World Value 25.90%	World 9.60%	World -40.30%	Mid 38.50%	Mid 21.00%	World Value -4.90%	Mid 16.90%
Mid -11.90%	Small Cap -15.70%	World Value 39.00%	High Dividend 20.00%	World Value 10.30%	Mid 21.30%	High Dividend 7.30%	World Growth -40.90%	High Dividend 33.80%	World Growth 14.90%	World -5.00%	World Growth 16.60%
World Value -14.50%	World -19.50%	World 33.80%	World Value 19.30%	World 10.00%	World 20.70%	Mid 5.30%	Small Cap -41.60%	World Growth 33.80%	World 12.30%	World Growth -5.10%	World 16.50%
World -16.50%	World Growth -19.60%	High Dividend 30.50%	World 15.20%	World Growth 9.70%	Small Cap 17.60%	World Value 4.10%	High Dividend -42.40%	World 30.80%	World Value 9.80%	Mid -7.40%	World Value 16.40%
World Growth -19.20%	World Value -19.60%	World Growth 28.50%	World Growth 11.20%	High Dividend 8.50%	World Growth 15.50%	Small Cap 1.10%	Mid -43.70%	World Value 27.70%	High Dividend 7.20%	Small Cap -8.70%	High Dividend 13.30%

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Jan 2001 - Dec 2022
Small Cap 32.90%	World Growth 6.50%	World Growth 3.50%	Small Cap 13.30%	World Growth 28.50%	World Growth -6.40%	World Growth 34.10%	World Growth 34.20%	World Value 22.80%	High Dividend -3.90%	Small Cap 8.60%
Mid 28.50%	Mid 5.60%	Small Cap 0.10%	World Value 13.20%	Mid 23.80%	High Dividend -6.70%	World 28.40%	Small Cap 16.50%	World 22.30%	World Value -5.80%	Mid 7.10%
World Value 27.50%	World 5.50%	Mid 0.00%	High Dividend 10.30%	Small Cap 23.20%	World -8.20%	Mid 28.00%	World 16.50%	World Growth 21.40%	World -17.70%	High Dividend 6.60%
World 27.40%	World Value 4.40%	World -0.30%	World 8.20%	World 23.10%	World Value -10.10%	Small Cap 26.80%	Mid 16.10%	Mid 18.10%	Small Cap -18.40%	World Growth 6.10%
World Growth 27.20%	High Dividend 3.30%	High Dividend -2.40%	Mid 8.00%	High Dividend 19.20%	Mid -12.90%	High Dividend 24.30%	High Dividend 1.00%	High Dividend 16.80%	Mid -18.70%	World 6.00%
High Dividend 22.90%	Small Cap 2.30%	World Value -4.10%	World Growth 3.20%	World Value 18.00%	Small Cap -13.50%	World Value 22.70%	World Value -0.40%	Small Cap 16.20%	World Growth -29.10%	World Value 5.60%

Source: Morningstar Direct, in USD using monthly data, January 2001 to December 2022.

The merits of a dedicated allocation to global mid-caps

Given the ubiquity of global large-cap and small-cap investment funds, the comparative paucity of dedicated global mid-cap funds looks anomalous. A possible explanation could be a widespread assumption that a combination of large- and small-cap global equity exposure might automatically provide a similar type of exposure to global mid-caps. In our view, however, such thinking would be misguided. Rather, we believe the attractive performance track record of global mid-cap equities, as well as their numerous attractive traits and potential to bridge the risk divide between large-caps and small-caps, merits a dedicated allocation to the asset class.

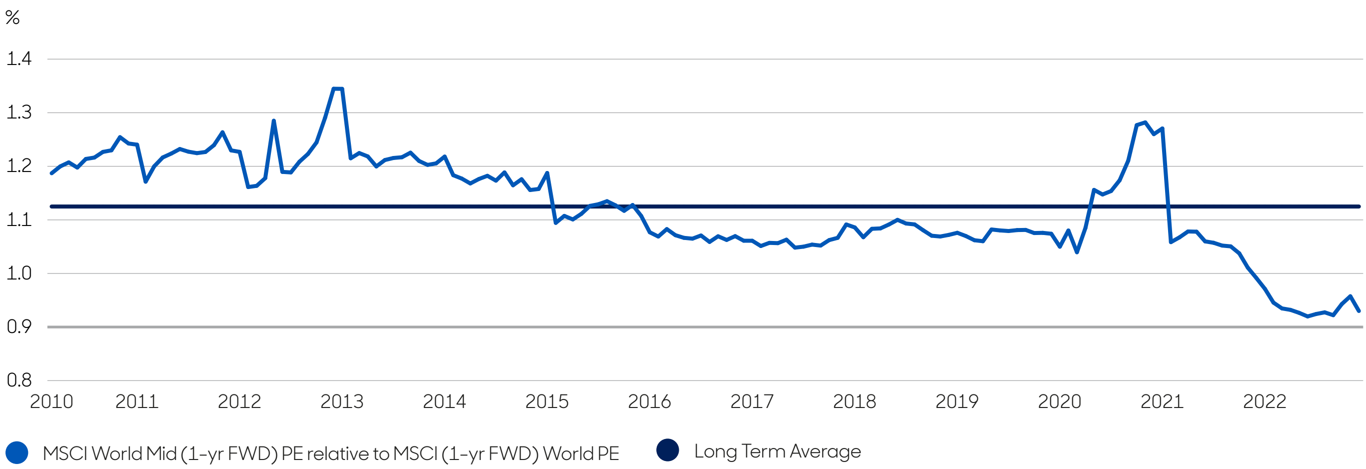
Another key advantage of a more dedicated allocation to global mid-caps is the reduced risk of overexposure to large-caps and specific sectors. Such biases can be beneficial when a handful of very large stocks, such as the so-called 'FAANG' group of US tech stocks – Facebook (now Meta), Apple, Google (now Alphabet), Amazon, and Netflix – are performing well and providing outsized positive contributions to index returns. Indeed, between 2014 and 2020, the five FAANG stocks contributed well over a fifth (21.9%) of the S&P 500 Index total return of 80.0%. But this can also work in reverse. Indeed, the FAANGs, and the richly valued tech sector more broadly, have underperformed markedly since late 2021.

The case for global mid-caps today

When it comes to the current global economic environment of elevated inflation and significantly increased interest rates, global mid-caps offer ample opportunity to invest in resilient, high-quality companies with strong balance sheets and proven pricing power. Further, the weak performance of global equities in 2022, coupled with the improved performance in early 2023, could potentially be the incipient stages of a new recovery phase.

Relatively attractive valuations add to the tactical case for global mid-caps. As shown in Chart 4, global mid-caps have typically traded at a premium valuation relative to broader global equities. However, global mid-caps have mostly been trading at a discount since 2015, with a noticeable increase in the size of the discount in the past two years.

Chart 4 – relative PE ratio of global mid-cap versus broad global equities



Source: Bloomberg, 31 January 2023.

Conclusion

We believe there's a compelling case for a dedicated allocation to global mid-caps within global equity portfolios. Historically, global mid-caps have provided attractive returns on both a gross and risk-adjusted basis compared to global large caps and broader global equities. In terms of typical profile, mid-caps can offer numerous attractive traits and a chance to gain exposure to the superior growth potential of 'tomorrow's winners'.

At the same time, for certain investors, global mid-caps can help bridge the risk gap between large- and small-cap equities. A dedicated allocation to the asset class can also potentially improve diversification within global equities, while mitigating the risk of over-exposure to large caps and particular sectors.

From a more tactical perspective, we believe the case for an allocation to global mid-cap equities today is supported by relatively attractive valuations and the historical pattern of multi-year outperformance in recovery phases following big market corrections. Indeed, following a very tough 2022, global mid-caps have been performing well so far in 2023. Finally, it's worth remembering the global mid-cap space is full of high-quality companies with strong fundamentals and resilient pricing power – valuable traits in the current high inflation and increased interest-rate environment.

Important Information

For professional and institutional investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis, should not be taken as an indication or guarantee of any future performance analysis forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI" Parties) expressly disclaims all warranties (including without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages (www.msci.com) Morningstar ©2023 Morningstar. All Rights Reserved.

The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to: http://corporate.morningstar.com/us/documents/MethodologyDocuments/AnalystRatingforFundsMethodology.pdf The Morningstar Analyst Rating for Funds is a forward-looking analysis of a fund. Morningstar has identified five key areas crucial to predicting the future success of a fund: People, Parent, Process, Performance, and Price. The pillars are used in determining the Morningstar Analyst Rating for a fund. Morningstar Analyst Ratings are assigned on a five-tier scale running from Gold to Negative. The top three ratings, Gold, Silver, and Bronze, all indicate that our analysts think highly of a fund; the difference between them corresponds to differences in the level of analyst conviction in a fund's ability to outperform its benchmark and peers through time, within the context of the level of risk taken over the long term. Neutral represents funds in which our analysts don't have a strong positive or negative conviction over the long term and Negative represents funds that possess at least one flaw that our analysts believe is likely to significantly hamper future performance over the long term. Long term is defined as a full market cycle or at least five years. Past performance of a security may or may not be sustained in future and is no indication of future performance. For detailed information about the Morningstar Analyst Rating for Funds, please visit **http://global.morningstar.com/managerdisclosures**

For more information visit abrdn.com

GB-310323-190141-1

abrdn.com

STA0323155250-001