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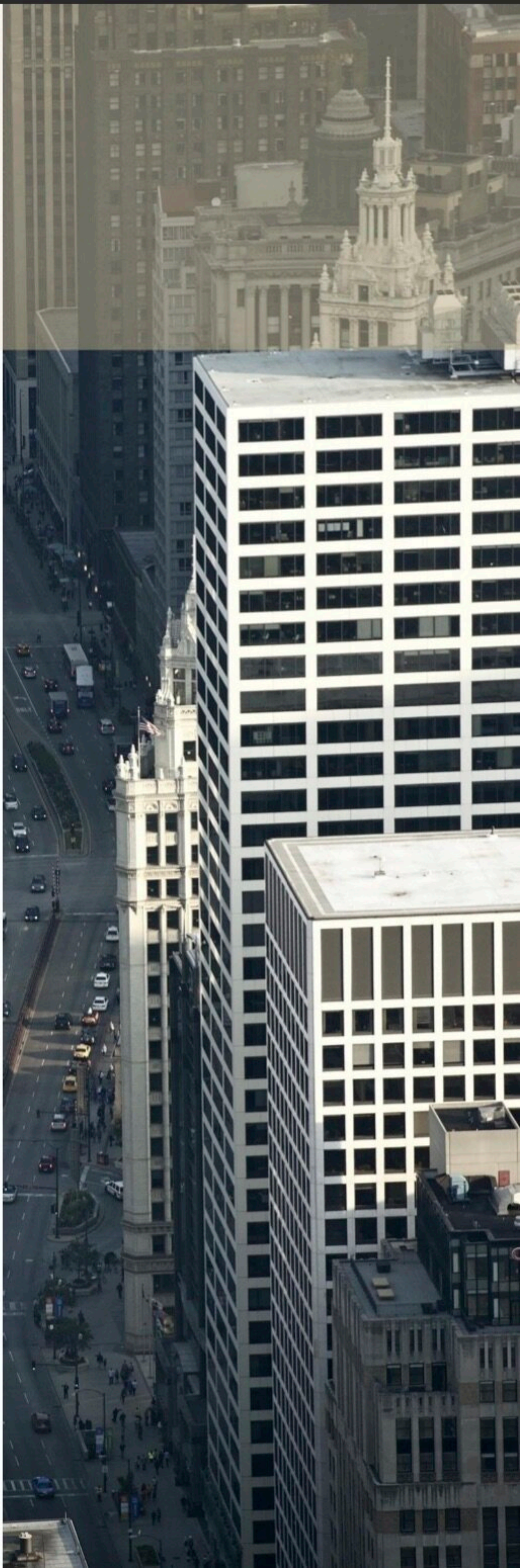
Channing Capital Management LLC

The Wisdom of Experienced Investing



Small-Mid Cap Portfolios– An Asset Class Grows Up

- Portfolios of small-mid cap companies continue to attract institutional and individual investors seeking the benefits of small cap stocks while, at the same time and in one portfolio, "letting winners run" into the mid cap arena.
- Small-mid portfolios also offer enhanced opportunities for active managers to add alpha over their benchmarks by identifying and investing in companies that may be less-followed by sell-side analysts than large cap stocks.
- The smid asset class is a logical extension of Channing's intrinsic value investment process and philosophy that seeks companies with strong business plans that may require a holding period of several years to be fully realized.

EXECUTIVE SUMMARY

In this paper, we discuss several advantages the small-mid cap (smid) asset class represents for investors, their consultants and plan sponsors. Smid stocks have shown a long-term pattern of outperformance at reduced levels of volatility compared to small cap stocks alone and offer the benefit of exposure to both small and mid cap companies in one portfolio, reducing the need for asset owners to select and monitor multiple small and mid cap managers.

Due to the characteristics of small cap companies, and to a lesser extent mid cap stocks, we find that managers in these asset classes have demonstrated strong track records in outperforming their benchmarks. The result is a wide selection of capable alternatives for investors seeking to allocate to the smid asset class.

The smid arena is also a natural fit for managers that employ an intrinsic value investment philosophy and process that views candidates for investment as “companies” rather than “stocks”.

ABOUT CHANNING

Founded over a decade ago, Channing Capital Management is a Chicago-based investment management boutique serving institutional investors. Today, under the leadership of the three founding partners, the firm remains committed to these original core values:

- Competitive Excellence
- Collaboration and Teamwork
- Strong Ethics
- Clients First
- Mutual Respect

Channing’s assets under management have grown to more than $2.3 billion (approximately as of 4Q 2015) since inception using a consistent and singular investment approach that focuses on identifying company Intrinsic Value and is available in Small-, Smid-, Mid-, Large-, and All Cap value implementations.

Small-Mid Cap Portfolios—An Asset Class Grows Up

While the small-mid cap (smid) asset class encountered some skepticism when managers began offering smid products in the early 2000's, smid strategies have grown dramatically as both institutional and retail investors have become comfortable with the idea of an investment strategy that does not fit neatly into the traditional capitalization and style grid. Managers worked hard to convince consultants and investors, who had become used to separate small and mid cap buckets, that smid offered unique advantages.

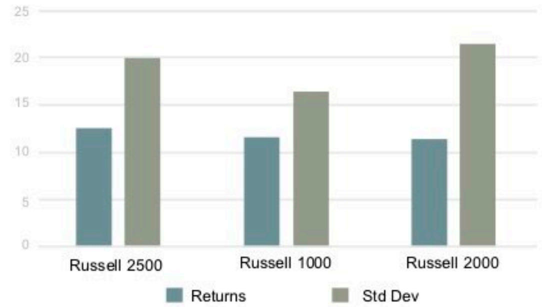
Now, with some $260 billion of smid assets under management in over 250 products ranging in size from $100,000 to $40 billion[1], smid has emerged as an asset class in its own right offering investors several advantages which we explore further in this paper:

- Many of the return benefits of small cap U.S. equities but with reduced volatility,
- Less manager selection and monitoring work for plan sponsors and other fiduciaries,
- A universe of managers who have indicated skill at beating their benchmark,
- The potential for "letting winners run" when fundamentals and valuation suggest further upside , and
- An asset class well-suited to an intrinsic value investment approach.

What Can Smid Do For You?

One reason smid assets have grown dramatically over the last several years is that the smid asset class, which combines small cap and mid cap stocks, offers return advantages over both small cap equities and large cap stocks and lower risk than small cap stocks alone.

Exhibit 1: Better Returns with Lower Risk



Source: eVestment since inception 1979 ending 3Q 15.

Exhibit 1 shows the since inception annualized returns of the most commonly-used smid index, the Russell 2500, the large cap Russell 1000 index and the small cap Russell 2000 benchmark.

From a long-term perspective, as shown in Exhibit 1, the smid asset class has outperformed,

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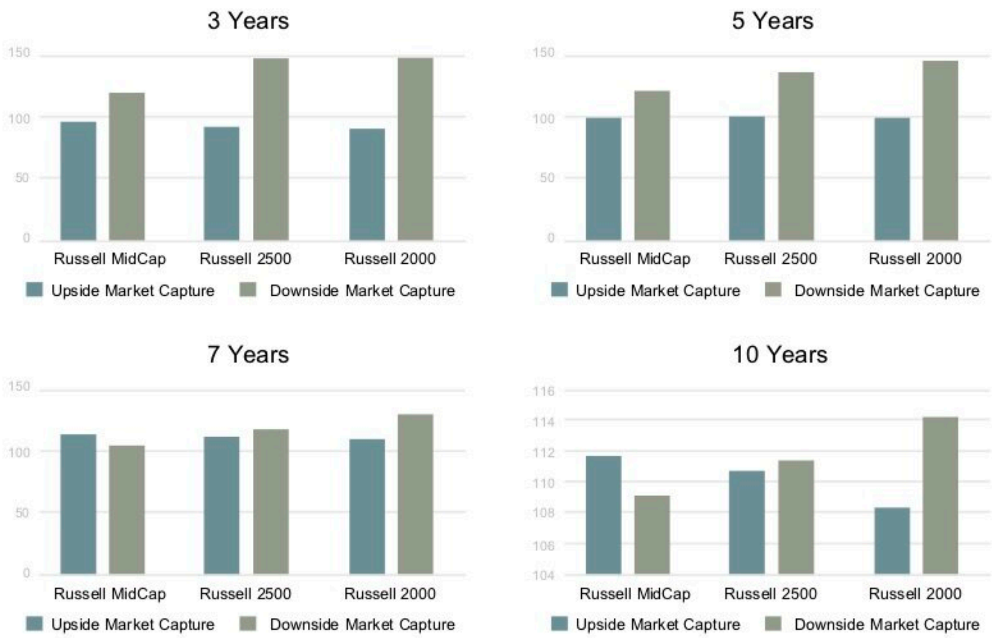
[1] eVestment database as of 3Q 2015

at lower risk, the small cap index and has outperformed large cap stocks. This has helped make the case that smid equities can offer many of the advantages of small cap stocks while “de-risking” the higher volatility small cap asset class. Defined contribution plans, in particular, have been attracted to the smid asset class which appears to offer a commensurate return, at lower risk, of small cap stocks by including mid cap equities.

Adding mid cap companies to small cap equities to create smid also “de-risks” the volatility of small cap from the perspective of upside market capture and downside market capture. As shown in Exhibit 2, when compared to the S&P 500 as a proxy for the broad equity market, mid cap companies participate in fewer down markets than the small cap index and participate in more up markets as well over the most recent three-, five-, seven- and 10-year periods. Smid stocks occupy the middle ground between small and mid in terms of participation in up and down markets.

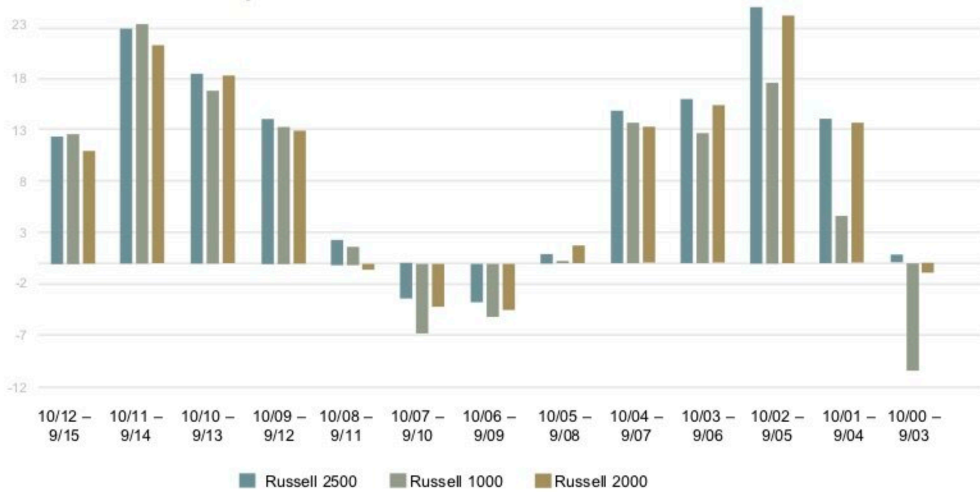
Exhibit 2: Better Upside Than Downside



Source: eVestment as of 3Q 15

While mid cap companies appear to have met investor expectations in terms of balancing small and large cap companies, small cap stocks by themselves have struggled somewhat over recent time periods as shown in Exhibit 3.

Exhibit 3: Small Cap Swoon?



Source: eVestment, periods ending September 30, 2015

As small cap stocks have underperformed large cap stocks over the last several years, the smid space has also underperformed large cap companies. Over the last two rolling three-year periods, the large cap Russell 1000 has outperformed both the small cap and smid cap Russell benchmarks.

Over the full 10-year period however, results look encouraging for smid as the asset class has outperformed large cap equities eleven times versus small cap outperforming large cap eight times. Of course, as noted above and discussed by behavioral economists, the concept of the "recency effect", i.e. focusing more on shorter-term patterns than longer ones, is certainly alive and well in the minds of investors of all stripes. It is always important to consider long-term returns for strategic asset allocations.

If the case for smid cap investing, as either an extension of small cap allocations into the mid cap space or as a replacement for both small and mid cap managers, is less likely to be supported based solely on attractive recent returns, what are some of the other possible attractions of smid?

One (or More) Fewer Headaches

Given the array of potential investment strategies and vehicles available to asset owners and their advisors, it is not surprising that plans of all sizes have greatly increased the number of managers in their stables. A recent study by the Investment Company Institute found that the average defined contribution plan offered 19 options, counting target date offerings as one fund, with smaller plans in the $500 million to $1 billion range offering an average of 30 investment options to participants, including small cap and mid cap funds[2]. Consultant Callan Associates notes that plans had a total of 25 options (up from 17 choices in 2006) as of mid-2015.

Other types of institutional investors have also increased the number of managers and asset categories. For many of these investors, the job of selecting, monitoring, and, potentially, replacing managers can strain the time and energy of plan sponsors and advisors. The decision to “go passive” and allocate to index managers is one response and tends to be supported by the difficulty active large cap managers have in generating alpha versus their benchmarks. But, as we discuss in this paper, the case for passive indexing in the small cap space is less apparent.

Smid investing offers a single asset class with attractive features of both small cap and mid cap stocks.

Smid investing offers plan sponsors and advisors a single asset class that combines attractive features of both small cap investments and mid cap stocks; namely the opportunity to add alpha in a market segment marked by less available information than large cap stocks along with the greater liquidity and scope of mid cap companies.

While many asset owners have allocated to large cap and small cap stocks as separate holdings, fewer have included mid cap managers in their rosters: for them, smid cap investing may accomplish both goals with fewer managers to keep an eye on[3]. Plan sponsors and advisors, having covered the small and mid cap space with smid, can then require their large cap managers to focus on stock selection within his or her space.

In addition to the benefits of allocating to smid to have fewer managers to keep an eye on, mid cap companies can offer several compelling advantages of their own. There is a reason mid cap companies are often micro cap and small cap stocks that have gained sufficient investor attention to move into the mid cap arena: often these companies feature more experienced management teams with long-term operating experience and a proven track record of delivering earnings. Many of the performance and risk benefits of smid versus small cap alone result from including these stronger companies.

On the flip side, mid cap companies can also be “fallen angels”; large cap names that have fallen out of favor, often due to a change in the business environment or a short-term controversy, and have moved into the mid cap space. These companies can be excellent candidates for a value-based investment philosophy as their difficulties may be overstated, and mispriced, by the market.

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[2] The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, December 2014

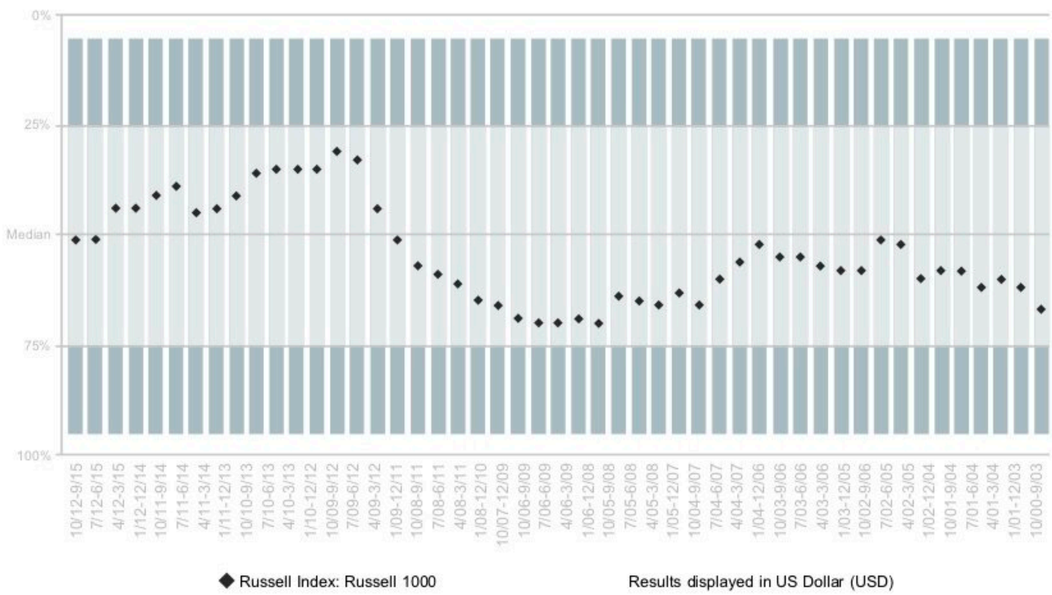
[3] The popularity of small cap managers versus mid cap strategies is reflected by the number of participants in eVestment’s universes: while there are 676 products included in the broad small cap equity universe, there are roughly half as many mid cap capabilities with 359 managers in the mid cap category.

Easier Needles to Find in the Haystack

Once an asset allocation program has been developed, defined benefit and defined contribution plan sponsors, along with fiduciaries at foundations and endowments, are confronted with the unenviable task of selecting an active manager or managers from the hundreds of choices available.

For many of these stewards of capital, finding large cap core managers with strong long-term track records of adding alpha to their benchmark can be a challenge. Exhibit 4 shows the quartile ranking of the Russell 1000 benchmark over rolling three-year periods since 1990 in eVestment's large cap core database. While over 50% of the universe outperformed the benchmark during the periods ending around 2011, recent periods have not been as kind to active large cap managers and the large cap index has been a consistent second quartile performer for 13 of the last 15 rolling three-year periods.

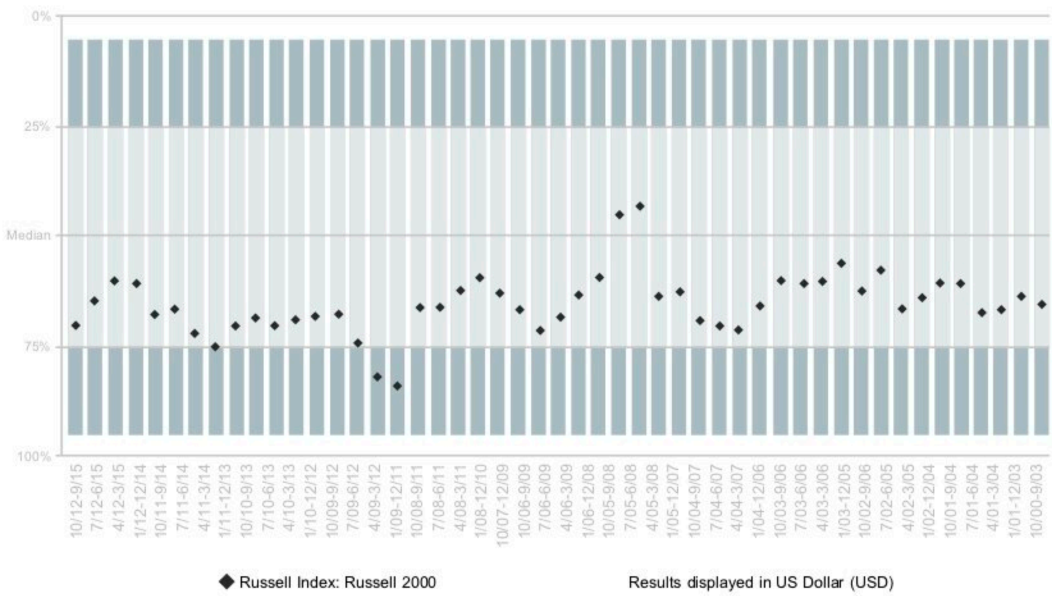
Exhibit 4: Tough Times for Active Large Cap Managers…



Source: eVestment

On the other hand, small cap managers, as shown in Exhibit 5, have a strong track record of outperforming the Russell 2000 benchmark. On a rolling three-year basis, there are only two periods where the median manager underperformed the benchmark and, in fact, the benchmark is at or near the fourth quartile break in many others. In the case of small cap equities, the "dartboard" approach may have merit—investors have a better than 50% chance of hiring a manager who will beat the index.

Exhibit 5: But Easier Pickings for Small Cap Managers



Source: eVestment

There are several possible reasons for small cap managers to have racked up impressive track records versus the benchmark: the fact that fewer analysts issue reports for small firms because they total less than 10% of total U.S. market capitalization and have lower trading volumes than their larger brethren is one. When information is less available to portfolio managers, there are greater inefficiencies in stock prices and more opportunities for managers to exploit them.

Many of these small cap advantages accrue to smid managers. In fact, according to a study by Bank of America Merrill Lynch, the average stock in the Russell 2000 is covered by six analysts versus 24 analysts for the 200 largest stocks in the Russell 3000. The Russell 2500 has on average seven analysts covering each stock[4].

Another opportunity small and smid managers have, in addition to the fact that the 2,000 or 2,500 companies in their benchmarks offer many more stock selection opportunities than the S&P 500 or Russell 1000, is the skewing of capitalization weighted benchmarks towards the largest stocks. In the Russell 1000, for example, the largest stocks in the index are 300 times bigger in terms of market capitalization than the smaller stocks and tend to dominate overall index returns. For the S&P 500, the difference around 250 times. Within small capitalization and smid indices, however, the difference is much smaller—about 20 to 1 and 60 to 1, respectively.

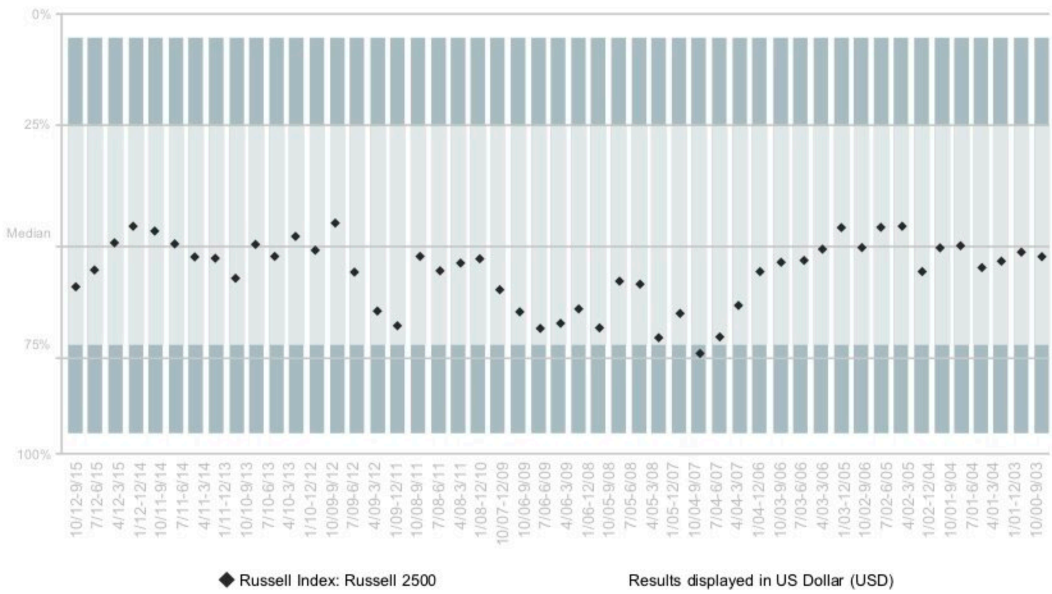
[4] Source: BofA Merrill Lynch, Small-Cap Study, September 25, 2015, 2015 through August 31.

Due to the fact that the capitalization weight of large cap stocks in core indices like the S&P 500 and Russell 1000 are concentrated in just a few names, the range of opportunity for active core managers to outperform can be significantly reduced and many managers may hold a sampling of the largest stocks to avoid significant downside risk should these stocks outperform. This hurdle is much less onerous for small cap and smid managers.

So it should not be surprising that smid managers share the ability of dedicated small cap managers in outperforming the index as shown in Exhibit 6.

Asset owners may need more than a dartboard to select a successful smid value manager.

Exhibit 6: SMID Managers Versus the Russell 2500

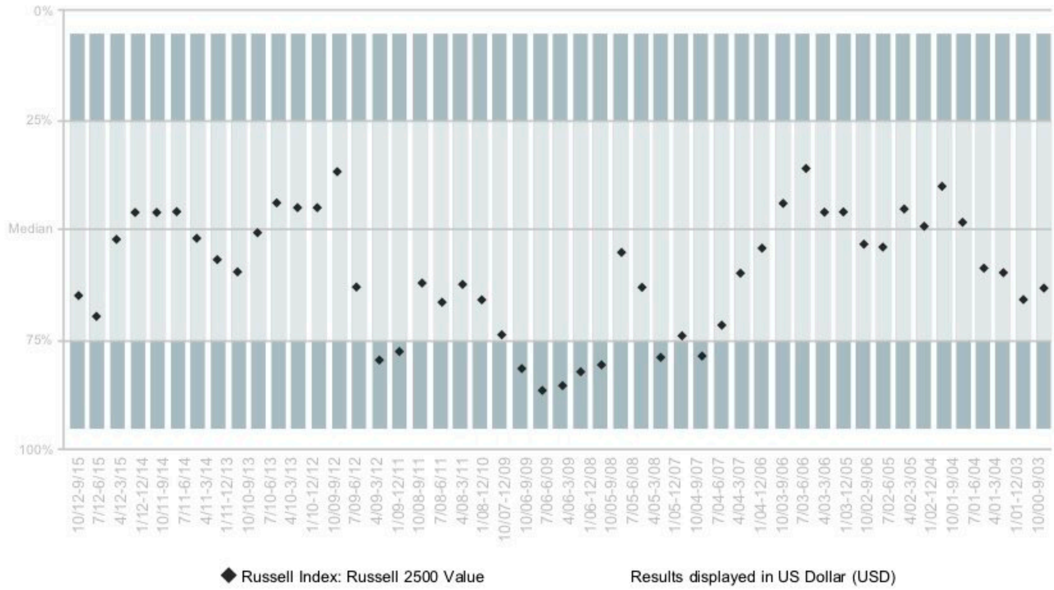


Source: eVestment

While Exhibit 6 shows returns for the index versus the range of managers in eVestment's smid core universe, the smid value data, on the other hand, highlights the need for asset owners to use more than a dartboard to select a candidate. Whereas the median smid core manager underperformed the index 11 times over the review period, the median smid value manager underperformed 15 times, often by greater degrees with greater volatility[5].

[5] Attribution would be needed to determine how much of this resulted from differences in relative style or industry weights versus stock selection.

Exhibit 7: Not So Clear-Cut for SMID Value



Source: eVestment

If investors and their advisors agree that smid is an asset class worth pursuing, what should they look for when reviewing candidates, particularly in the smid value space where manager selection appears to be critical?

Finding Value in the Smid Space

At Channing Capital Management, we believe successful smid managers, particularly those who are value-focused, need to have shown evidence of a successful stock selection track record in both small and mid-cap companies. In the case of small cap, having a deep knowledge of companies helps to both "let the winners run" from small cap into mid-cap status and to know when the investment thesis has met expectations and the position needs to be reduced or eliminated. In the case of mid cap companies, having experience in both mid cap value and large cap value names is invaluable in determining whether "fallen angels" deserve to fall out of favor or have been unfairly judged by the market.

We also believe that an investment process which embraces an intrinsic value approach is best suited to identifying small and mid-cap companies which the equity market has undervalued. By adopting the mindset of a private equity investor who asks him or herself "Is this a good business?", rather than focusing on current stock market valuations and prices, Channing's portfolio managers can take a long-term, asset-owner point of view akin to company managers or members of a firm's board of directors towards the goal of unlocking long-term value.

As discussed above, stocks which fall into the smid definition tend, on average, to be covered by fewer analysts and, while this can be a challenge for portfolio managers who rely on sell-side analysts to help them identify good candidates for investment, for Channing it is an advantage.

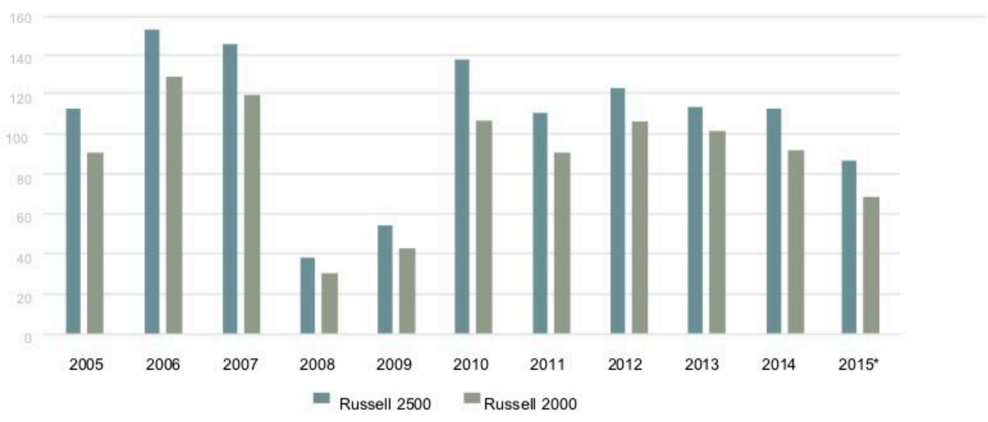
For over 10 years, we have followed small and mid-cap stocks which meet our criteria for representing strong intrinsic value; specifically whether the company's growth strategy and long-term business plan have the potential to improve profitability. By following a "cash flow and/or asset valuation" methodology, Channing seeks to determine a firm's intrinsic value. This approach is critical in assessing a company's bottom-up value of all its underlying entities. Our goal at Channing is to consistently implement this intrinsic value process and philosophy up and down the entire market cap spectrum—from small cap stocks to smid companies to mid cap and large cap stocks. We believe this approach benefits our clients; rather than a narrow focus on an individual market cap segment, we follow companies as they move across multiple market cap categories.

Viewing companies and markets through a private equity lens is particularly important in the smid arena.

Using an intrinsic value approach can also lead to success in the smid space: many of these companies with multiple divisions and subsidiaries experience mergers, acquisitions, and spin-offs which impact valuations. Channing benefits from the fact that our research team has been following the universe of small and mid-cap stocks through their many cycles and permutations, all the while asking themselves "Would I invest significant capital into this company as an owner?"

The ability to view companies and markets through a private equity lens is particularly important in the smid arena. Many large cap companies seeking to enhance growth or product lines look to smid cap firms as acquisition candidates for mergers or acquisitions. As shown in Exhibit 8, M&A activity has recovered smartly from the Great Recession and is on track to return to long-term annual averages of 106 Russell 2500 companies and 87 Russell 2000 firms that are involved in mergers and acquisitions.

Exhibit 8: M&A Activity Bounces Back



Source: BofA Merrill Lynch, Small-Cap Study, September 25, 2015, 2015 through August 31.

As specialists in the value space, with strategies that span large cap to small cap, Channing has built deep knowledge of companies in several key sectors that are particularly subject to M&A activity, including industrial companies, materials firms, and consumer staples and discretionary stocks. These sectors are also well-represented in the Russell smid value index with consumer staples and consumer discretionary sectors among the five largest sectors in the index.

In keeping with Channing's in-depth analysis of companies from an intrinsic value perspective, we typically have longer holding periods (meaning lower turnover and therefore lower transaction costs) and more concentrated portfolios than other managers. In this context, determining the level of assets under management that will not strain the investment process by requiring too many stocks to hold, given liquidity constraints, is critical.

Estimates of "appropriate" smid product capacities range from $4 to $6 billion.

While the smid asset class offers advantages in terms of potential capacity due to greater trading volumes than small cap alone, managers need to be mindful of when the desire for increased assets under management and the resulting increase in revenue begins to erode the credibility they have built up with investors, advisors and consulting firms.

When Too Much Success May Hurt

The need to stay within the confines of separate account agreements, mutual fund prospectuses, or guidelines established by ratings companies like Morningstar or Lipper, can often lead small cap managers to sell, perhaps reluctantly, stocks which have run up in market capitalization.

This may be why many of the 257 smid products are managed by successful small cap managers like Channing which have applied their process into the mid cap space. Similarly, small cap strategies may be capacity constrained, leading growing managers to either hold more stocks or grow their size – and enter into mid cap arenas. While large cap portfolio management may focus more on risk management and deciding whether or not to hold the largest companies in the index, small cap management has much more scope to add value.

Small cap managers, however, often confront the challenge created by "letting the winners run", or allowing stocks to continue increasing in value even though they may cross the 9-box lines between small cap and mid cap and the requirement by investors to "do your job" and not overlap with stocks and characteristics that may be represented by other managers in their stables. Smid investing provides one solution to this dilemma.

Estimates of "appropriate" smid product capacities range from $4 to $6 billion based on the daily trading volume of the average Russell 2500 stock. This is heartening news for dedicated small cap managers who have reached the threshold of available capacity given their investment strategy and process. But these totals do not factor in constraints such as holding period or concentration levels within the portfolio.

In the case of Channing it may take a holding period of two to three years for a company to successfully implement a business plan which we have identified as conducive to growth and market appreciation. We also believe that concentrated portfolios, typically of less than 40 stocks, better represent conviction and the potential for alpha versus market benchmarks.

The liquidity advantage of smid stocks versus small cap stocks is also an important element for Channing's investment process given our longer holding period and belief in concentrated portfolios: simply put, we trade less often than many of our peers but require sufficient liquidity when we determine the appropriate time to add or exit a position. Given our investment philosophy, and keeping in mind the importance of aligning capacity with investment process, Channing has ample capacity to "let the winners run" from our small cap value product while combining the stock selection skills of our mid cap value offering.

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CONCLUSION

In this paper, we have argued that smid cap investments may deserve a place in many investors' portfolios from smaller individuals to large foundations, endowments and defined contribution plans. Smid investments offer many of the advantages of small and mid cap stocks in one portfolio; including fewer managers to oversee, the opportunity for active managers to add alpha over their benchmarks, better liquidity from mid cap companies, and the ability to "let the winners run".

For Channing, the smid value asset class is a logical extension of our intrinsic value investment process and philosophy. We specialize in identifying companies with strong business plans that can come to fruition over a holding period of several years. Often these firms are less followed by sell-side analysts and require extensive research before investment; as a result we tend to hold more concentrated portfolios than our peers reflecting the strength of our convictions. This philosophy may mean that the potential capacity of Channing's offering in the smid space is somewhat less than other managers, but, in our view, is more in keeping with our value-add potential for asset owners.

Channing Capital Management LLC

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