WHITE PAPER

MID CAPS ARE THE NEW SMALL CAPS

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Conventional wisdom has long held that investing in small capitalization stocks typically rewards investors with excess returns. Generally speaking, the historical record supports this principle as small caps have materially outperformed large caps over most extended market periods. However, structural changes have emerged in the small cap universe that imply that the returns of the past may not extend to the future.

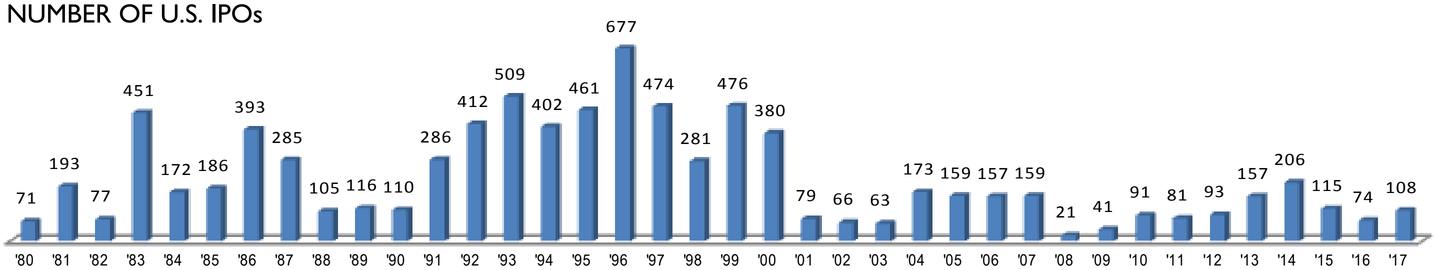
The small cap universe has traditionally been fertile ground from which relatively young, promising companies can raise capital. The public markets have typically offered depth, liquidity and valuations at a considerable premium not easily found in the private market. These benefits have outweighed the demands placed on public companies; reporting requirements, quarterly scrutiny and often steady pressure from investors to meet growth and profitability targets.

Over the past decade regulatory changes and a significant expansion of private equity funding has altered the cost/benefit profile of public equity. As companies remain private longer the small cap universe suffers a decline in the replenishment cycle. Historically, a steady influx of new companies has been instrumental in maintaining the small cap universe invigorated with opportunities. However, the supply of new public companies has slowed markedly.

From 1980 to 2000, the United States averaged 310 IPOs annually. Between 2001 and 2017, the average has declined to 108 IPOs.

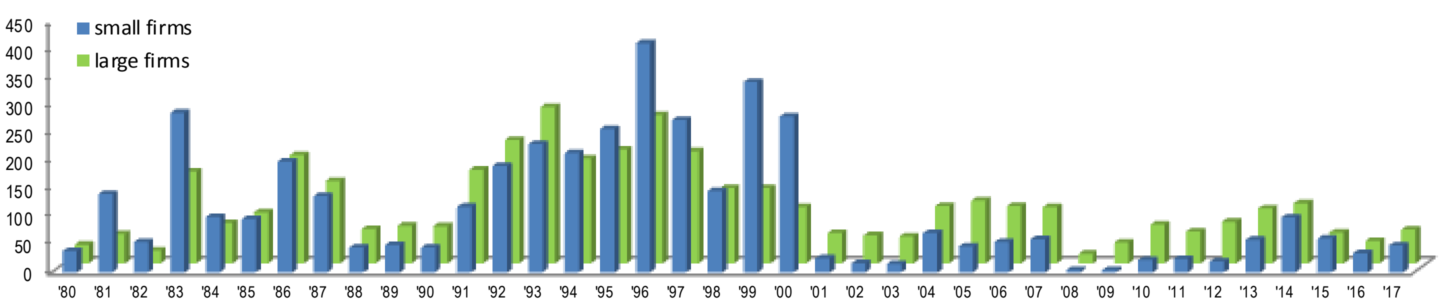
Furthermore, the composition of the IPO market has changed post 2000. From 1980 to 2000, small firms represented 56% of all IPOs. Between 2001 through 2017, only 32% of IPOs were comprised of small companies.

NUMBER OF U.S. IPOs



Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter, Cordell Professor of Finance, University of Florida, January 17, 2018

COMPOSITION OF IPOs



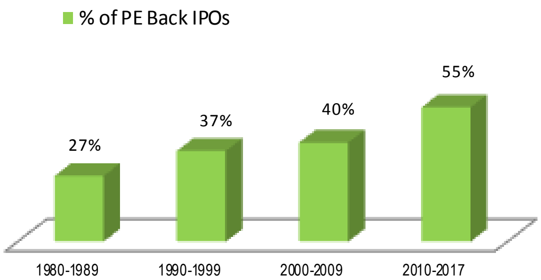
The number of U.S. IPOs by year, 1980-2017, with pre-IPO last twelve months sales less than (small firms) or greater than (large firms) $50 million (2005 purchasing power).
Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter, Cordell Professor of Finance, University of Florida, January 17, 2018

The private market has stepped in to fill the funding requirements of small companies. The mechanism by which a growing number of small companies are funded has shifted from the public market to a new asset class – Late Stage Private Equity.

Moreover, companies are now staying private longer. In 2017, the median age of a venture backed company going public is 11 years, 83% longer than 2000 (6 years).

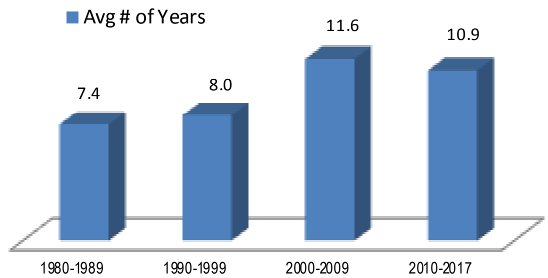
PRIVATE MARKETS ARE SUPPORTING LATE STAGE GROWTH

Private Equity Backed IPOs - 1980 to 2017



Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter, Cordell Professor of Finance, University of Florida, January 17, 2018

TIME TO IPO - 1980 TO 2017



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IMPLICATIONS

Investors seeking the absolute returns generated in the past by the small cap universe may be well served to pursue a barbell approach: allocate to late stage private equity and to mid cap public equity in lieu of small cap public equity. Dedicating capital to late stage private equity allows investors to gain access to those growing, valuable small companies now delaying their access to the public markets. Allocating to mid cap public equity provides the investor entry to these growing companies when they enter the public market as mid cap companies after bypassing the small cap public company stage altogether.

The mid cap space has traditionally offered a more attractive risk/return profile than the small cap universe due to superior quality companies (higher ROAs, better earnings growth). As the more alluring companies enter the public markets as mid caps, the mid cap space will likely increase in quality relative to small caps and the return differential may widen further. Due to these dynamics, public market investors should expect mid caps to outperform small caps in the current environment. Because of this we categorize the present phenomenon as "mid caps are the new small caps".