Kayne Anderson Rudnick
Investment Management

The Case for Mid-Caps

An Overlooked Opportunity Set

Large-cap stocks are the perennial attention-getters in equity markets, and small-cap stocks frequently grab some of the spotlight as a counterweight to what is, for most investors, a permanent large-cap exposure. Analysts and investors debate the relative merits of both ends of this size spectrum with the dedication of loyal fans of rival sports teams. While such discussions are (usually) worthwhile, the debate ignores the fact that a good portion of the total stock market does not fall into either camp.

We are, of course, referring to mid-cap stocks, an important area of the market that receives less attention than we think it deserves. We believe overlooking mid-caps neglects a big slice of the market, one that can offer some of the advantages of both large and small-cap stocks while presenting its own unique set of opportunities.

In this article, we describe what we feel are some of the advantages of investing in mid-cap stocks, and why we believe this is an area where active management can be particularly beneficial. Our goal is not to argue against holding large and small-caps; rather, we aim to shed light on the mid-cap universe as a frequently overlooked segment of the market, and how it can play an important role in an investor's portfolio, as mid-caps have characteristics that can, in our view, complement both small and large-cap exposures.

DEFINING "MID-CAP"

What, specifically, qualifies as "mid-cap"? A quick search shows that mid-cap stocks are typically defined as having market capitalizations between $2 billion and $10 billion. To adhere strictly to this definition, a mid-cap portfolio would be forced to sell its holdings in a stock whose market cap rose above or fell below those cut-off points on any given day. That could generate excessive turnover with potentially negative tax implications for portfolios that hold stocks at either end of this range—a portfolio tethered to that definition might therefore avoid holding stocks with a market cap below, say $2.5 billion or above $9 billion, narrowing its investable universe.

In our view, an alternative is to define the mid cap universe as the stocks in the Russell Midcap Index, which consists of approximately 800 of the smallest securities in the Russell 1000 Index, based on a combination of market cap and current index membership. As of June 30, 2024, these securities represent 21% of the total market capitalization of the Russell 1000 Index (which means, of course, that the 200 largest companies in the Russell 1000, just one-fifth of its total positions, represent approximately 79% of the combined large-cap and mid-cap universe's total market value). Since the Russell 1000 rebalances annually, we believe this definition provides ample opportunity to anticipate when a stock is likely to fall out of the mid-cap universe as the rebalancing date approaches.

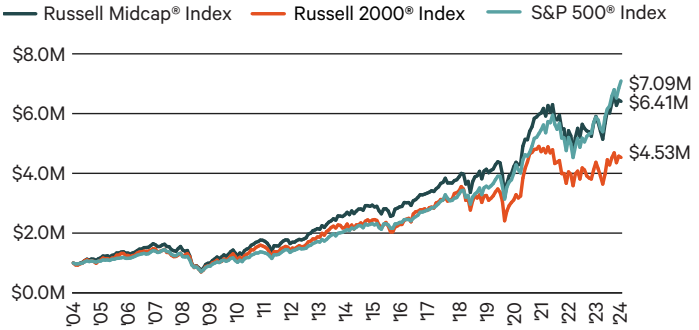
Using the Russell Index-based definition gives mid-cap investors approximately 800 securities from which to choose. The range of companies in the mid-cap space thus represents a large opportunity set (60% greater than the S&P 500).

SAME EXTENDED FAMILY, DIFFERENT DNA

However we choose to define the mid-cap universe, it will be similar in some respects to a large-cap universe, and in other respects to a small-cap universe—after all, it sits between the two. It is the differences that make mid-caps intriguing. If asked which size category—large, small or mid-cap stocks—had delivered the highest total return over the past 20 years, most investors would likely assert that large caps, represented by the S&P 500, had easily captured that trophy. They would be wrong.

Looking at cumulative returns in five-year increments over the past 20 years tells an interesting story—or more than one.

FIGURE 1: GROWTH OF $1 MILLION
20 Years Ending June 30, 2024

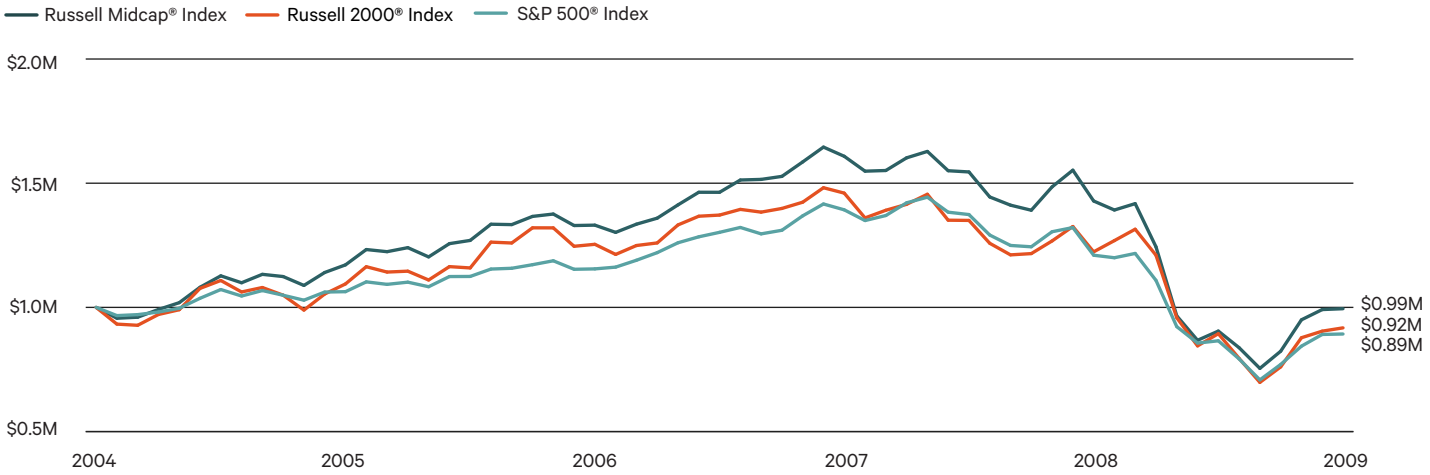


Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. ***Past performance is no guarantee of future results.***

As Figure 1 shows, measured over the last 20 years, the mid cap index achieved comparable returns to large caps as measured by the growth of $1 million. **In fact, large caps only exceeded mid-caps with respect to returns in the past ten years, with the bulk of that being driven by slower overall economic growth and a select group of very large companies dominating the markets.** We are not suggesting that investors should put all or even most of their eggs into the mid-cap basket; however, we are pointing out the importance of "taking off the blinders" to examine the data instead of simply adopting commonly held beliefs without scrutiny.

We believe this is also a good example of the need to be conscious of, and work to avoid "recency bias"—in other words, forming conclusions that are too heavily influenced by what has happened in the recent past. From 2004 through 2009, cumulative returns for the S&P 500 lagged far behind both the mid-cap and small-cap indices. Mid-caps and small-caps showed similar return patterns but the former outperformed the latter.

FIGURE 2: GROWTH OF $1 MILLION
Five Years Ending June 30, 2009



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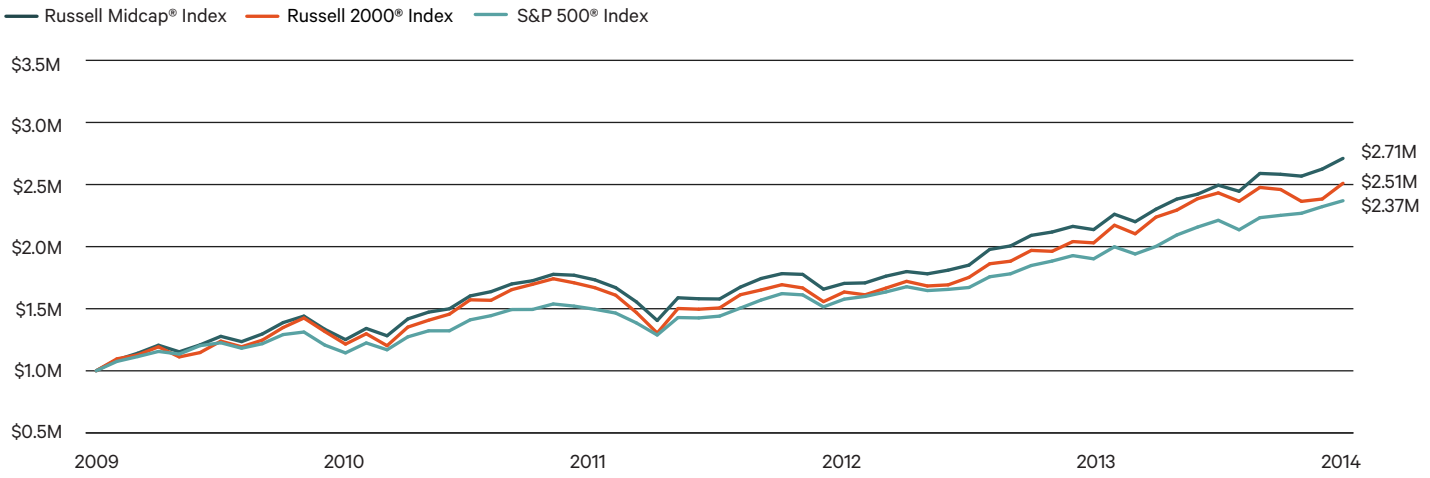
Over the next five years, the three segments moved together much of the time but large-caps fell behind as a result of the global financial crisis while mid and small-caps recovered more quickly and provided the best returns over this period as well.

FIGURE 3: GROWTH OF $1 MILLION
Five Years Ending June 30, 2014



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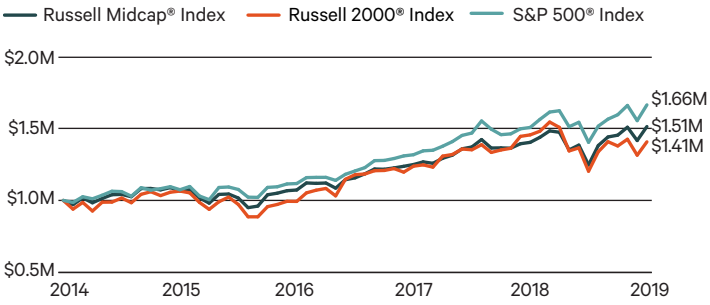
All three segments offered similar returns for much of the five years from 2014 through 2019, with small-caps making a strong showing for a brief part of that period but then lagging for much of the remaining period. The S&P 500 caught up to mid-caps by the end of this 5-year period but from our perspective was far from dominant.

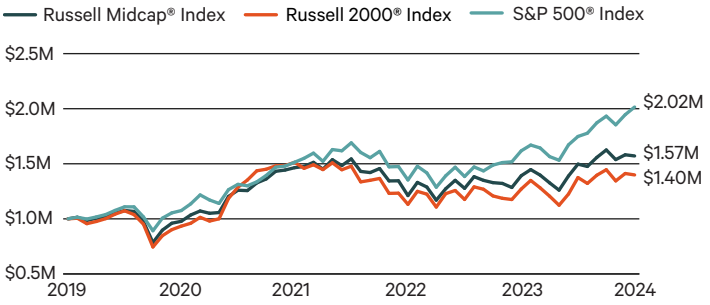
FIGURE 4: GROWTH OF $1 MILLION
Five Years Ending June 30, 2019



Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. ***Past performance is no guarantee of future results.***

The most recent five-year period does show a different result. The S&P 500 outperformed both small and mid-caps, although the returns for all three were quite similar up until March of 2020, when the COVID-19 pandemic hit. We note that at that time, the Fed dropped short-term interest rates to zero, which benefited the high-growth tech stocks that comprise a large part of the S&P 500.

FIGURE 5: GROWTH OF $1 MILLION
Five Years Ending June 30, 2024



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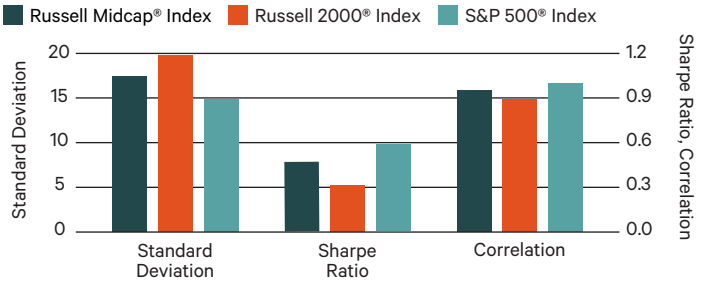
HIGHLY CORRELATED, BUT NOT THE SAME

The returns of the S&P 500 and Russell Midcap Index are highly correlated (the Russell Midcap has a 0.95 correlation to the S&P 500 over the last 20 years ending June 30, 2024). While useful for good reasons, we believe passive strategies do not exploit important differences that exist among these indices, differences that can be seen when we look beyond statistics. The question is whether those differences translate into opportunities for active investing, and if so, whether they are greater within the large-cap versus mid-cap space. **We believe the most compelling reason to take a closer look at the mid-cap space is because of the opportunities it offers for active management** that we think are greater than what exists in the large-cap arena. We believe this can be demonstrated based on various characteristics of these indices.

FIGURE 6: RISK STATISTICS
20 Years Ending June 30, 2024



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First, not surprisingly, the standard deviation of returns across the stocks in the mid-cap index is greater than that of the S&P 500 and less than that of the Russell 2000. We believe that this is an indication there is a greater probability of finding stocks whose returns are higher than the average of the stocks in the index (not the same as the index's return) by focusing on mid and small-cap stocks as opposed to large-cap stocks.

Further, in our view, active managers who over/underweight the wrong stocks in the S&P 500 are highly likely to underperform the index. As of June 30, 2024, the 10 largest names in the S&P 500 (~2% of the total) accounted for 36% of its market value, with the Magnificent 7 stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) capturing 32% of the market value, driving much of the outperformance in the large cap space. This is not true in the mid-cap space. For the Russell Midcap Index, we believe there is less risk when deviating from the index weights. In fact, the top 2% of stocks in terms of market cap in the mid-cap universe represented just 7% of the total value of the index as of June 30, 2024, and included not just technology stocks but also financial, industrials, energy, and others.

Speaking of sectors, the sector weightings for the S&P 500 have become more concentrated over time—32% of the index is now in the Information Technology sector. The mid-cap universe offers active investors a greater opportunity to diversify across sectors while seeking to outperform the index.

FIGURE 7: SECTOR WEIGHTINGS

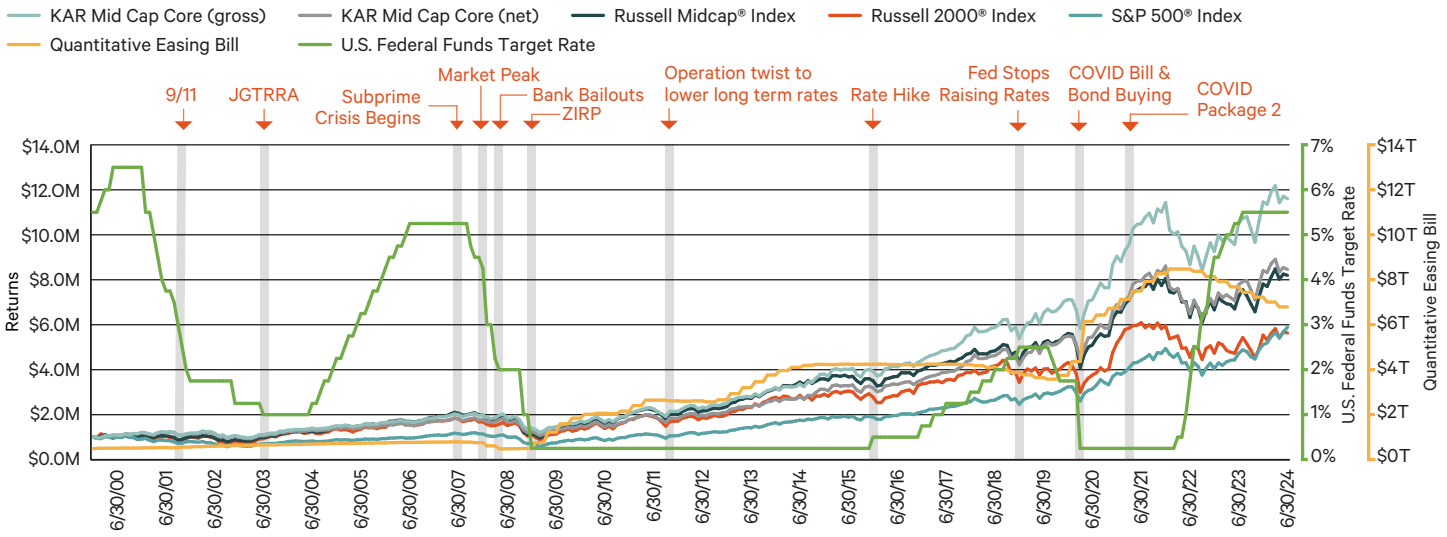
	December 31, 2011			June 30, 2024		
	Russell Midcap® Index	Russell 2000® Index	S&P 500® Index	Russell Midcap® Index	Russell 2000® Index	S&P 500® Index
Communication Services	3.32%	3.08%	7.43%	3.46%	2.20%	9.34%
Consumer Discretionary	12.13%	10.71%	7.19%	10.60%	10.45%	9.98%
Consumer Staples	7.04%	4.00%	11.46%	3.20%	3.52%	5.77%
Energy	7.50%	6.49%	12.10%	5.14%	7.48%	3.65%
Financials	13.91%	16.38%	13.28%	16.36%	15.98%	12.47%
Health Care	9.00%	11.80%	12.09%	9.34%	15.18%	11.72%
Industrials	13.05%	17.20%	11.15%	19.94%	16.89%	8.13%
Information Technology	11.86%	14.53%	16.07%	13.42%	15.29%	32.37%
Materials	6.55%	4.48%	3.14%	5.47%	4.78%	2.15%
Real Estate	7.73%	7.74%	2.13%	7.62%	5.63%	2.15%
Utilities	7.90%	3.61%	3.97%	5.45%	2.59%	2.26%

Data is obtained from FactSet Research Systems and is assumed to be reliable.

The distribution across sectors in the mid-cap space is less "lumpy" than in the S&P 500 (the three largest sectors represent 57% of the S&P 500, compared to 50% for the Russell Midcap). Again, this shows more diversity in the mid-cap opportunity set.

Finally, it is worth examining how the Federal Reserve's interest rate policies may affect these different segments of the market.

FIGURE 8: IMPACT OF FED POLICIES ON DIFFERENT SEGMENTS OF THE EQUITY MARKETS



ANNUALIZED RETURNS - As of June 30 2024

	1 Year	5 Years	10 Years
KAR Mid Cap Core (gross)	10.03%	12.19%	13.19%
KAR Mid Cap Core (net)	8.61%	10.75%	11.74%
Russell Midcap® Index	12.88%	9.46%	9.04%

Figure 8 includes cumulative returns for KAR Mid Cap Core since inception of December 31, 1999 through June 30, 2024. Data is obtained from FactSet Research Systems and is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. This material is deemed supplemental and complements the performance and disclosure presented above. Returns for the Kayne Anderson Rudnick composite are final. All periods less than one year are total returns and are not annualized. Fees presented on the Disclosure page could vary from the assumed fee in the net-of-fee calculation, as actual fees paid by a particular client account differ depending on a variety of factors including, but not limited to, business unit and size of mandate. The fee used on the Disclosure page utilizes an assumed maximum fee across the firm's business units, which is further detailed on that page. For further details on the composite, please see the disclosure statement in this presentation. The Russell Midcap®, Russell 2000®, and S&P 500® Indices are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

Recall that it was only over the past five years that the returns of the S&P 500 pulled ahead of the mid-cap index. As Figure 8 shows, the S&P 500 started to benefit from the Fed's Quantitative Easing some years after the Financial Crisis and was boosted by the zero interest rate policy put in place at the start of the COVID-19 pandemic. As the Fed has removed the support that has put downward pressure on long-term interest rates looking back at a time when rates were more "normal" is instructive.

History shows that mid-caps and small-caps outperformed the S&P 500 under those conditions. That raises the question, do investors believe the next 5-to-10 years will look more like the past 5-to-10 years, when extraordinary Fed policies were in place, or will the markets be less Fed-dependent in the coming years? Looking back at the early days of the pandemic, we believe that companies with durable balance sheets, higher variable costs than fixed costs, and a "moat"/competitive advantage, were able to respond to changing conditions and did well. From our perspective, this favors the broader, more diversified mid-cap universe.

WHY KAYNE ANDERSON RUDNICK?

As we see it, the KAR Mid Cap Core strategy, since its inception in January 2000, has been capturing greater risk-adjusted returns than the asset class by utilizing an actively managed strategy that sticks to a disciplined research process and strict guidelines for quality investments. We believe that the quality of the underlying businesses owned creates a portfolio with solid fundamental characteristics that can lead to strong relative performance in both good and bad markets.

FIGURE 9: FUNDAMENTAL CHARACTERISTICS

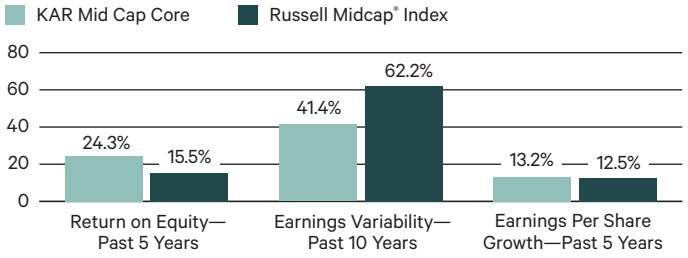
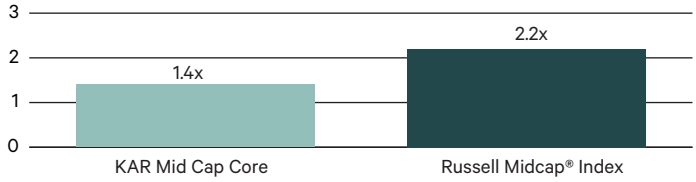


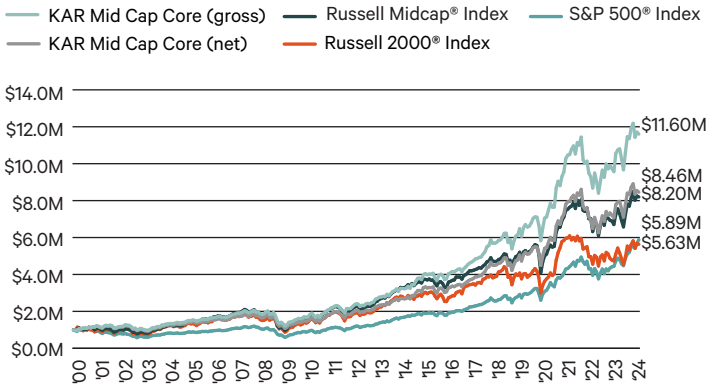
FIGURE 10: DEBT/EBITDA*



**KAR utilizes the interquartile method when calculating Debt/EBITDA. The interquartile method excludes outliers from an aggregate statistic such as weighted average. The interquartile method does not assume that data from the top or bottom of the distribution are outliers—only the extreme ends are excluded—and that it can be applied consistently as a quantitative method for most fundamental characteristics. Debt/EBITDA utilizes net debt for the calculation.*
Data is as of June 30, 2024, is obtained from FactSet Research Systems and BNY Mellon, and is assumed to be reliable. The statistics presented above are based on a representative portfolio. Actual results may vary. 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.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

In our view, we are laying the groundwork for stronger returns for our investors when we concentrate on finding quality businesses and constructing a strong portfolio. We believe 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.

FIGURE 11: GROWTH OF $1 MILLION



The chart reflects cumulative returns for KAR Mid Cap Core since inception of December 31, 1999 through June 30, 2024. Data is obtained from FactSet Research Systems and is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. This material is deemed supplemental and complements the performance and disclosure presented below. Fees presented on the Disclosure page could vary from the assumed fee in the net-of-fee calculation, as actual fees paid by a particular client account differ depending on a variety of factors including, but not limited to, business unit and size of mandate. The fee used on the Disclosure page utilizes an assumed maximum fee across the firm's business units, which is further detailed on that page. ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

In summary, **we think the mid-cap space offers a large opportunity set for active managers.** We believe the range of companies in the mid-cap space in terms of size is enormous, which in our view provides an attractive hunting ground to finding opportunities. The mid-cap universe includes fairly small companies that are at the beginning of a big growth trajectory (it is easier for smaller companies to double their sales or market share than it is for large companies), and also larger companies that would be too small to have an impact on the S&P 500, but in our opinion are worthy of investors' attention. We believe the mid-cap universe offers many opportunities to participate in the upside of the broad market and the S&P 500 without being forced to invest heavily in mega-cap names that are highly correlated and dominate that index.

DISCLOSURE

Year	Composite Gross Return (%)	Composite Net Return (%)	Russell Midcap® Index Return (%)	Composite 3-Yr Std Dev (%)	Benchmark 3-Yr Std Dev (%)	Number of Accounts	Internal Dispersion (%)	Composite Assets ($ Millions)	Firm Assets ($ Millions)
2014	18.17	16.66	13.22	10.29	10.29	12	0.13	17	7,989
2015	3.37	2.03	(2.44)	11.96	11.00	15	0.44	40	8,095
2016	12.32	10.88	13.80	12.31	11.72	22	0.36	79	9,989
2017	26.13	24.53	18.52	10.76	10.51	72	0.23	170	14,609
2018	(3.21)	(4.46)	(9.06)	11.33	12.15	181	0.30	352	17,840
2019	32.17	30.50	30.54	12.49	13.08	323	0.39	700	25,685
2020	27.08	25.47	17.10	18.88	22.13	362	1.03	1,214	39,582
2021	26.42	24.82	22.58	17.65	20.84	467	0.27	1,946	47,269
2022	(19.04)	(20.11)	(17.32)	21.10	23.95	584	0.30	1,738	33,531
2023	23.75	22.17	17.23	18.95	19.38	692	0.54	2,799	41,186

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KAR (as defined below) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. KAR has been independently verified for the period from January 1, 1999 through December 31, 2023.

A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis.

The Mid Cap Core Composite has had a performance examination for the period from January 1, 2000 through December 31, 2023.The verification and performance examination reports are available upon request.

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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 inception date of the composite is January 2000. The composite was created in January 2000. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. The firm's list of composite descriptions, list of broad distribution pooled fund and the list of limited distribution pooled funds descriptions are available upon request.

The model management fee used for the net returns in this table is 1.30% for all periods presented. The standard Institutional 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. The maximum Wealth Advisory Services Fee in effect is 1.30% for all assets, which breaks out as follows: 1.00% for the first $3 million; 0.80% on the next $2 million; 0.70% on the next $5 million; 0.60% on the balance; with an additional 0.30% for any assets invested in separately managed accounts strategies. The standard investment advisory fee schedule currently in effect for clients not engaging in Wealth Advisory Services is 1.00%. 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.

GLOSSARY

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Earnings Variability (Past 10 Years): Measures the variability of annual earnings per share over the last 10 years. Earnings per share (EPS) is a company's net profit divided by the number of common shares it has outstanding. Debt/EBITDA: Debt/EBITDA leverages a top-down approach and is calculated based on operating income – cost of sales – SGA (selling, general and administrative expenses) – other operating expenses + depreciation & amortization.

INDEX DEFINITIONS

The Russell Midcap® Index is a market capitalization-weighted index of medium-capitalization stocks of U.S. companies. The index is calculated on a total return basis with dividends reinvested. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.