SMID Power

Casting a Wider Net over the Small-Stock Opportunity

IN THIS PAPER

By accessing a diverse collection of fundamentally stronger mid-cap companies, a SMID-cap strategy offers the diversification and return potential of small-cap stocks but with less volatility and fewer of the constraints associated with small-cap-only investing. We explore the SMID-cap opportunity and discuss why a SMID portfolio may be an appealing alternative to a small-cap mandate for certain investors.

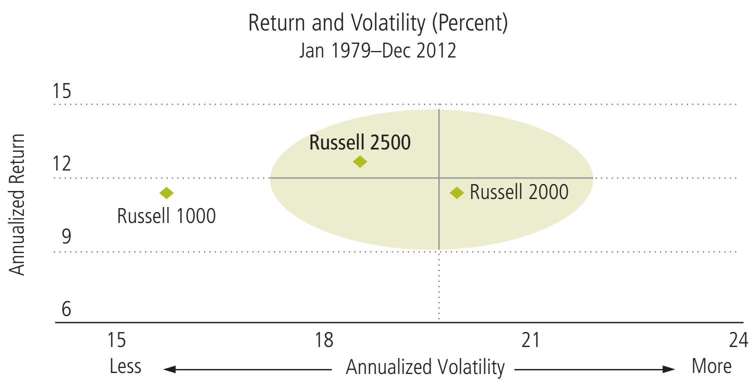
The potential merits of adding small-cap stocks to an overall investment portfolio are well known. Small stocks have been the star performers of equities historically, handily outpacing their larger peers. Small-caps don't always behave like large-caps, so they can also be helpful diversifiers of equity risk. And because small companies can get lost so easily in the grand sweep of the markets, they are great sources of alpha opportunities, especially for investors who take the time to get to know them well.

But small-cap investing also has its challenges. These stocks are less liquid than their bigger counterparts, making them more difficult and costly to trade. Small companies tend to be more sensitive to economic cycles than larger firms, and have fewer financial resources to draw on if they hit a rough patch. Consequently, small-caps are more volatile than large-caps and, thus, more vulnerable in risk-averse markets.

SMID-cap investing has fewer such impediments. The SMID universe unites the faster growth of small companies with the higher quality of mid-sized firms, so investors gain access to a fundamentally more resilient and less volatile collection of stocks.

(continued)

SMID-Caps Have Offered a Superior Risk/Return Profile



Past performance does not guarantee future results.
As of December 31, 2012
Since January 1, 1979, the inception of the Russell indices
Source: FactSet, Russell Investments and AllianceBernstein

Bruce K. Aronow, CFA
Team Leader and Portfolio Manager/Analyst—US Small/SMID Cap Growth

James MacGregor, CFA
Chief Investment Officer—Small and Mid-Cap Value Equities

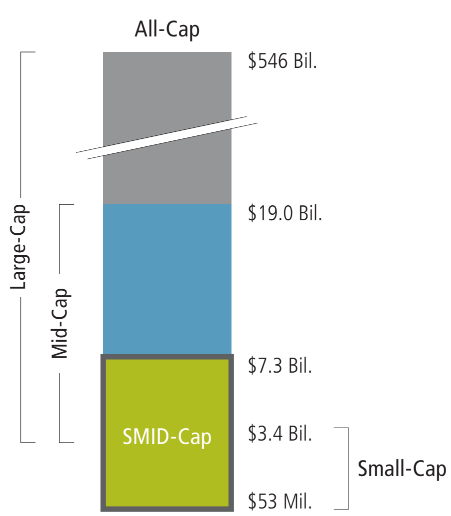
SMID-Caps Defined

As the name implies, SMID-caps are a cross between small- and mid-cap stocks. In the US, the most commonly used SMID-cap benchmark is the Russell 2500 Index, which straddles all of the stocks in the small-cap Russell 2000 Index plus the next 500 stocks comprising the smallest companies of the approximately 800-member Russell Midcap Index (*display, left*).

The Russell 2500 includes market capitalizations between $53 million and $7.3 billion, with a median capitalization of $2.5 billion. This is significantly above the Russell 2000's median of $1.1 billion but well below the Russell Midcap's $7.7 billion. In practice, most SMID managers focus on companies with capitalizations of $7 billion and below.

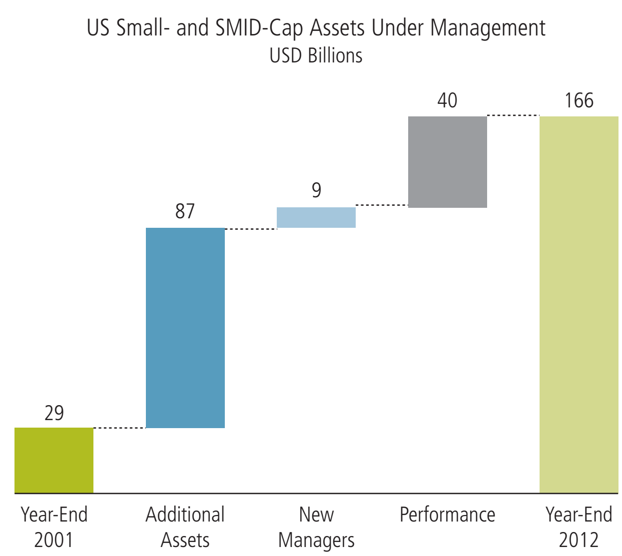
SMID-cap investing has been rapidly gaining ground in recent years. Over the past decade, the number of US SMID funds has grown nearly fivefold, reaching 229 in 2012. Institutional assets under management in the US reached $166 billion by the end of 2012, a sixfold gain since 2001. A significant portion of this growth reflected market appreciation, but more than half came from new flows into the category, as shown in the *display on the right*.

SMID Bridges Small- and Mid-Cap Equities



As of June 30, 2012, following the latest annual Russell reconstitution
All-cap universe represented by the Russell 3000 Index; large-cap stocks represented by the Russell 1000 Index; mid-cap stocks represented by the Russell Midcap Index; SMID-cap stocks represented by the Russell 2500 Index; small-cap stocks represented by the Russell 2000 Index. Security size based on a combination of market cap and current index membership
Source: Russell Investments and AllianceBernstein

New Assets Drove SMID AUM Growth



As of December 31, 2012
US institutional small- and SMID-cap assets under management using eVestment Alliance classifications; numbers do not sum due to rounding.
Source: eVestment Alliance and AllianceBernstein

(continued from cover) SMID's extended market-cap parameters greatly improve its liquidity and trading efficiencies. As a result, SMID-caps offer many of the same potential benefits as small-caps, but also some distinct attractions of their own.

SMID vs. Small: Similar but Distinct Appeal

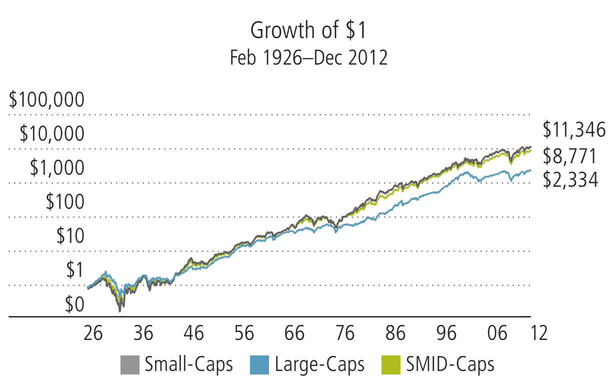
The SMID- and small-cap asset classes have much in common. Companies in both groups tend to be pure plays, with a much keener focus on a niche market or an exciting growth theme than is typical for larger companies. They also typically have leaner, less hierarchical organization structures, which make them more flexible and enable them to respond more quickly than big firms to changing business conditions or competitive threats. Despite their diminutive size, they often hold leading market positions.

Superior Risk/Return Profile

Given their extensive overlap, it is not surprising that the two asset classes have similar performance records. Over long periods, small-caps have historically done better than SMID-caps, as would be expected given the trade-off between risk and reward over time (*Display 1*). According to data from the Center for Research in Security Prices, US small-caps have posted an annualized return of 11.3% since 1926, exceeding gains of 11.0% for SMID-caps and 9.3% for large-caps.

Display 1

Smaller-Cap Stocks Have Outperformed Historically



Past performance is not a guarantee of future results.
Through December 31, 2012
Small-caps represented by deciles six to eight of capitalization of all US stocks, SMID-caps by deciles three to seven and large-caps by deciles one and two
Source: Bank of America Merrill Lynch, Center for Research in Security Prices and AllianceBernstein

Since the inception of Russell indices in 1979, the annualized return of the Russell 2500 Index, the most commonly used proxy for the SMID category, has outpaced that of the small-cap Russell 2000 Index. Notably, however, the SMID index achieved these gains with less volatility than the small-cap index, resulting in a superior risk/return trade-off (*cover Display*). Moreover, even though the SMID index has performed better than the small-cap index in the eight bull markets since 1979, it has lost slightly less in the seven bear markets since then. All told, while SMID-caps have posted comparable returns to small-caps over the full period, the ride along the way has been less rocky.

Because of their common traits, SMID- and small-caps also tend to behave alike. Monthly return correlations of the Russell 2500 and the Russell 2000 have averaged 0.99 since 1979. And, because of their dissimilarities with large companies, both asset classes have been useful diversifiers versus large-caps. The average correlation of Russell 2500 and S&P 500 Index returns has been 0.88 since 1979, versus 0.83 between the Russell 2000 and S&P 500. It is worth noting, however, that current figures understate the benefit somewhat, as both comparisons have been elevated by the postcrisis rise in market correlations generally. We expect this trend to normalize over time. Strategies that actively invest in smaller-cap stocks, especially those that follow a growth or value style, can be even more diversifying.

Stronger Fundamentals

SMID's attractive risk/return profile versus small-caps largely stems from the addition of fundamentally stronger mid-cap companies. As illustrated in *Display 2*, *next page,* the roughly 500 Russell 2500 stocks that are not in the Russell 2000 bring significant improvements in profitability and return on equity, while maintaining an earnings growth history that is only slightly less robust.

This cohort is a special breed of companies. They can be early-stage, high-growth stars that have ascended from the multitudes of publicly traded small- and micro-cap businesses, or they can be larger firms that have fallen into mid-cap territory because of a change in business conditions or controversy. In both cases, they are generally more established than their smaller peers, and benefit from greater economies of scale. More of them are generating earnings.

Although many of these companies are still relatively young, they have often reached a point in their lifecycle when they can start harvesting profits from their earlier business investments. As such, this subset is more profitable than its smaller-cap counterpart and, as our research found, it is also generating considerably higher returns on investment across most sectors of the economy. Earnings growth forecasts for the Russell 2500 subset trail those of the small-cap index, but these companies have done a better job of living up to these expectations, as their reported earnings growth has actually surpassed that of the small-cap index.

While this subset makes up only 20% of Russell 2500 stocks, it accounts for 56% of the index's capitalization weight and provides much of the SMID-cap performance firepower.

The Active SMID Opportunity

The SMID universe is a rich hunting ground for active managers, where research can play a valuable role. Like their smaller brethren, SMID-caps aren't as well followed or understood as big stocks. The typical Russell 2500 stock is covered by only eight sell-side analysts, versus 13 for the typical Russell 1000 name. Even those that get coverage don't get much. As measured by a "mindshare" index—which tallies the average number of earnings-estimate changes per analyst and the number of each broker's published research notes—large-cap stocks got three times more research attention than SMID-cap stocks (*Display 3*).

Because the information flow is so thin, it is easy for the market at large to overlook smaller companies or have an incomplete—even faulty—view of their prospects. This knowledge deficit is most apparent in the variation around earnings estimates, which on average has been nearly 45% higher for Russell 2500 companies than for Russell 1000 companies (*Display 4*).

Bigger differences in forecasts have contributed to greater dispersion in SMID-cap returns and more risk versus large-caps: the potential upside is larger, but so is the potential downside. Over the past decade, the best-performing Russell 2500 stocks averaged a total return of roughly 98%, beating the Russell 1000 winners by 14 percentage points; however, the worst-performing SMID stocks fell 35% over that same period, trailing the large-cap losers by 11 percentage points.

The scarcity of coverage and wider range of potential outcomes also increase the chances for active managers to add value. In the pursuit of SMID alpha, however, dodging disasters is at least as important as picking winners, so forecast accuracy is critical: as shown in *Display 5*, smaller companies are punished more

Display 2

SMID Includes a Subset of Fundamentally Stronger Companies

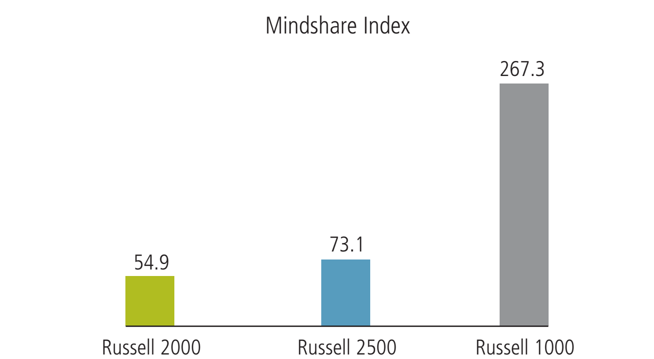
Index Component Characteristics

	Russell 2000	Russell 2500 Subset*
Number of Stocks	2,002	502
Percent of Stocks with Earnings	85.2%	95.4%
Operating Margin†	7.6	11.8
Cash-Flow Return on Investment	6.4	16.0
Forecasted Long-Term EPS Growth	15.5	13.3
Trailing Three-Year EPS CAGR†	12.4	17.0

As of June 30, 2012, following the latest annual Russell reconstitution
**Stocks in the Russell 2500 that are not in the Russell 2000*
†Median
Source: FactSet, Russell Investments and AllianceBernstein

Display 3

Smaller Companies Don't Get Much Research Attention



As of December 31, 2011
Average number of estimate changes per analyst plus average number of research notes published by brokers for each index shown for the year ended December 31, 2011
Source: Bank of America Merrill Lynch, Citi Research, FactSet, Russell Investments, UBS and AllianceBernstein

severely for earnings disappointments than they are rewarded for upside surprises. The stakes just aren't as high for big stocks. Having the research resources and ability to develop differentiated insights on companies that others may be missing can significantly improve the odds of success, in our view.

Ripe with Growth and Value Opportunities

The research inefficiencies and pure-play nature of the SMID market create abundant opportunities that both value and growth managers can exploit. But they do so from different angles, focusing their research on companies at different times in their earnings cycles and targeting different fundamental characteristics to drive performance.

For a growth manager, the key research goal is to determine whether a company will live up to the market's expectations, exceed them or fall short. Since growth stocks are generally priced at a premium, reflecting a relatively high degree of investor confidence in their outlook, companies that disappoint get trounced, while those that do better than expected are typically richly rewarded.

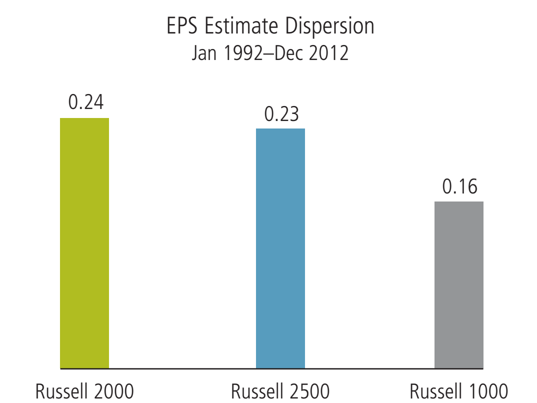
Our growth approach explicitly searches for changes or events such as a new marketing strategy, new product cycle or management shift that could drive faster earnings growth than the market anticipates. We focus on such indicators as earnings revisions, earnings surprises and relative stock-price momentum, which have proven to be reliable drivers of outperformance over time (*Display 6*, *next page*). These growth signals have historically been more effective in helping managers ferret out winners in the SMID-cap world than in the large-cap world.

Value managers are typically hunting among stocks that have come under pressure because of a controversy that has raised doubts about the company's earnings potential. The chief research mission is to determine whether the market's reaction is valid or not. This typically entails evaluating whether a company can overcome its near-term difficulties and return to normal profitability. Thus, broadly speaking, value research tends to focus on factors that will affect the long-term cash-generating ability of a company's assets and that may influence how the market will value those cash flows in the future.

But controversies can take a while to resolve, and a cheap stock can get even cheaper. Timing matters. Hence, our value approach emphasizes attractive valuations based on such metrics as cash flow, sales and earnings, but also seeks a catalyst or corporate event—such as a restructuring or the

Display 4

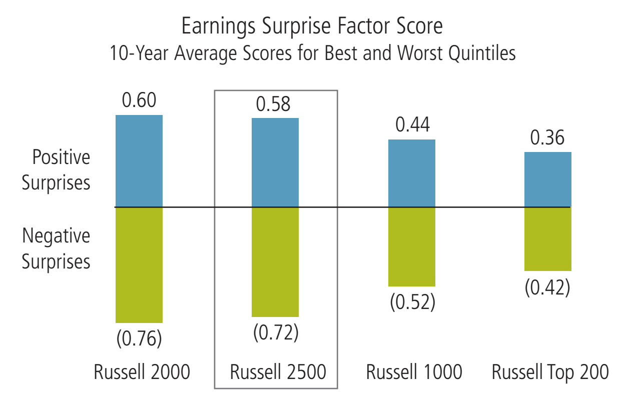
Forecast Disparities Give Research-Driven Strategies an Edge



As of December 31, 2012
Standard deviation of the consensus estimates for a stock divided by the average estimate
Source: FactSet, Russell Investments and AllianceBernstein

Display 5

Earnings Shortfalls Hurt More than Upside Surprises Help



As of December 31, 2012
The average factor score of the first and fifth quintiles within each index since January 2003, based on earnings surprise factor scores, which measure relative stock performance within a range from 1.0 to (1.0) two days before and five days after a company's quarterly earnings release
Source: Russell Investments and AllianceBernstein

initiation of a stock buyback program—that has the potential to enrich shareholder value and spur greater investor awareness. We also look for signs of corporate quality, such as current profitability. These valuation and quality factors have also generated strong long-term outperformance in the SMID realm (*Display 7*).

A Wider Opportunity Set

Many of the best SMID growth ideas tend to be small-cap darlings that have graduated to mid-cap status. Accordingly, we find that small-cap growth managers have an advantage over mid- and large-cap managers in the SMID space. That's because small-cap managers have likely gotten to know these companies at earlier stages and, thus, are less likely to miss the investment opportunities as these stocks advance to the next phase of development. This longer history and deeper understanding can also help managers determine if a SMID growth idea has run its course and it's time to move on.

For the growth investor, the SMID universe offers access to higher-quality, mid-cap stocks and the ability to stick with small-cap champions at the sweet spot of their growth and stock-market potential.

For the value investor, the SMID universe offers a deeper reservoir of higher-quality value candidates than the small-cap universe does. This is an important distinction because some of the best SMID value ideas are likely to be found among misunderstood mid-caps or larger-cap fallen angels that are in better shape and/or recovering faster than the market realizes. A sound balance sheet and other signs of fundamental quality can serve as a counterbalance to the risks inherent in buying out-of-favor, controversial stocks.

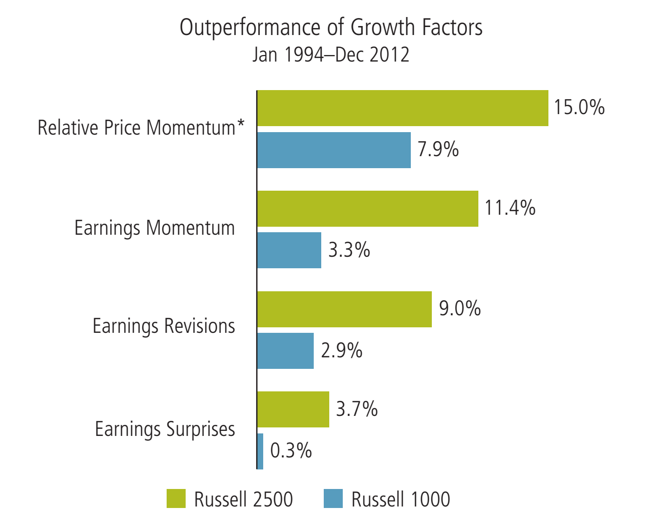
Trading Efficiencies Enhance Alpha Potential

Because SMID-caps are more liquid and less volatile than small-caps, executing trades in a SMID portfolio is easier and less costly (*Display 8*). These attributes also improve the ability of active SMID investors to put their own insights to work in portfolio exposures.

By our analysis, the typical order in a hypothetical $1 billion Russell 2500 portfolio accounted for 2.8% of the portfolio's average daily

Display 6

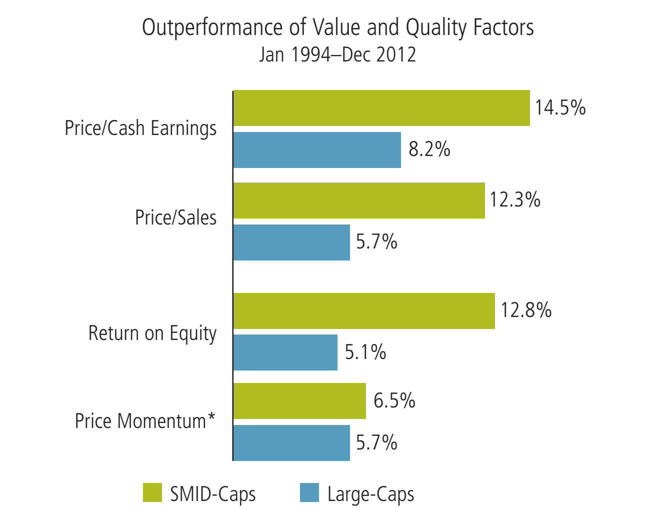
Our Growth Strategy Targets Earnings Momentum



As of December 31, 2012
Relative returns of the highest versus the lowest quintile of stocks in the Russell 2500 Growth and Russell 1000 Growth indices based on the factor shown since January 1, 1994
**Nine-month relative returns of a stock divided by the standard deviation of those returns*
Source: Russell Investments and AllianceBernstein

Display 7

Our Value Strategy Targets Value at the Right Time



As of December 31, 2012
Relative returns of the most attractive versus the least attractive quintile of stocks in the Bernstein US small- and mid-cap universe and in the Bernstein US large-cap universe based on the factor shown since January 1, 1994
**12-month price momentum*
Source: Russell Investments and AllianceBernstein

volume. This was five times more liquid than a comparable Russell 2000 portfolio (at 14.5%) and closer to that of the Russell 1000 portfolio (at 1.2%). SMID trading was also significantly more efficient. The spread between the bid and ask prices was about 35% tighter for the typical SMID order than for the average small-cap trade.

As a result, the average trade in the Russell 2500 portfolio cost 22 basis points to execute, excluding commissions, about 45% less than the typical small-cap trade and only 7.4 basis points more than the average large-cap trade. These trading efficiencies can make a big difference in investment returns over time.

Superior Alpha Generation

Judging from history, active SMID managers have done a good job of beating the odds. Since 1990, the median SMID-cap manager has delivered an annualized return of 12.3%, outperforming the Russell 2500 by 200 basis points (*Display 9*). Although the median active portfolio has achieved these gains with more volatility than the index, it has been more than adequately compensated for this added risk, as reflected in its superior risk-adjusted return, or Sharpe ratio, which has averaged 0.44 since 1990, versus 0.35 for the median large-cap manager. Growth and value styles have impressive long-term records of success. But since style performance is episodic, they tend to lead at different times. Thus, for diversification purposes, it makes sense to have exposure to both approaches, as getting style wrong can erode much of the premium potential of even the most skillful growth or value manager.

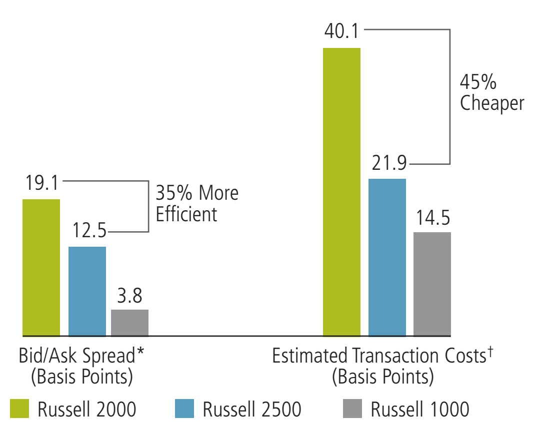
Conclusion: Attractive Asset Class in Its Own Right

By encompassing both small and mid-sized companies, SMID-caps offer the diversification and stock-market potential of smaller stocks with fewer of the liquidity and capacity constraints associated with small-cap-only investing. Over time, this asset class has delivered returns comparable to small-caps, with less volatility.

Adding to their appeal, SMID-caps also offer significant alpha potential. Active SMID portfolios can benefit from the considerable research inefficiencies that have made investing in smaller-cap stocks so rewarding, while also gaining access to a higher-quality cohort of companies. Active SMID has not only outperformed passive SMID historically but also posted materially higher risk-adjusted alpha than active large-cap strategies, providing a productive risk/reward trade-off. In our view, a SMID-cap strategy may be the way to go for investors seeking to capture the big opportunity in smaller stocks. ■

Display 8

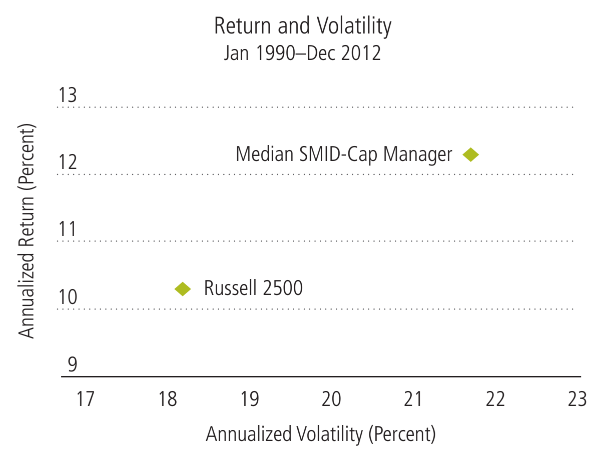
Greater Liquidity and Tighter Spreads Reduce Execution Costs



As of November 18, 2012
Based on hypothetical, capitalization-weighted $1 billion portfolios
**Trailing 30-day results*
†Based on Nomura Now/TradeSpex model transaction data for the past 12 months
Source: Nomura Securities and AllianceBernstein

Display 9

Active SMID Has Generated Robust Alpha over Time



Through December 31, 2012
Based on eVestment Alliance SMID-cap manager classifications
Source: eVestment Alliance, Russell Investments and AllianceBernstein

AllianceBernstein L.P.
1345 Avenue of the Americas
New York, NY 10105
212.969.1000

AllianceBernstein Limited
50 Berkeley Street, London W1J 8HA
United Kingdom
+44 20 7470 0100

AllianceBernstein Australia Limited
Level 32, Aurora Place, 88 Phillip Street
Sydney NSW 2000, Australia
+61 2 9255 1299

AllianceBernstein Canada, Inc.
Brookfield Place, 161 Bay Street, 27th Floor
Toronto, Ontario M5J 2S1
416.572.2534

AllianceBernstein Japan Ltd.
Marunouchi Trust Tower Main 17F
1-8-3, Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9000

AllianceBernstein Investments, Inc.
Tokyo Branch
Marunouchi Trust Tower Main 17F
1-8-3, Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9700

AllianceBernstein Hong Kong Limited
聯博香港有限公司
Suite 3401, 34/F
One International Finance Centre
1 Harbour View Street, Central, Hong Kong
+852 2918 7888

AllianceBernstein (Singapore) Ltd.
30 Cecil Street, #28-08, Prudential Tower
Singapore 049712
+65 6230 4600

Sanford C. Bernstein & Co., LLC
1345 Avenue of the Americas
New York, NY 10105
212.969.1000

This document is confidential and proprietary information and should not be disclosed to any other person without the prior written consent of AllianceBernstein Limited. The contents are being provided to you solely for informational purposes and as an example of our internal research. It is not intended to be an offer or solicitation, or the basis for any contract to purchase or sell any security, product or other instrument, or for AllianceBernstein to enter into or arrange any type of transaction as a consequence of any information contained herein. The views and opinions expressed in this document are based on AllianceBernstein's internal forecasts and should not be relied upon as an indication of future market performance.

Note to All Readers: The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions.

Note to Canadian Readers: This publication has been provided by AllianceBernstein Canada, Inc. or Sanford C. Bernstein & Co., LLC and is for general information purposes only. It should not be construed as advice as to the investing in or the buying or selling of securities, or as an activity in furtherance of a trade in securities. Neither AllianceBernstein Institutional Investments nor AllianceBernstein L.P. provides investment advice or deals in securities in Canada.

Note to UK Readers: This information is issued by AllianceBernstein Limited, a company registered in England under company number 2551144. AllianceBernstein Limited is authorised and regulated in the UK by the Financial Services Authority (FSA – Reference Number 147956). This information is directed at Professional Clients only.

Note to Japanese Institutional Readers: This document has been provided by AllianceBernstein Japan Ltd. AllianceBernstein Japan Ltd. is a registered investment-management company (registration number: Kanto Local Financial Bureau no. 303). The firm is also a member of Japan Investment Advisers Association and the Investment Trusts Association, Japan.

Note to Australian Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is intended only for persons who qualify as "wholesale clients," as defined in the Corporations Act 2001 (Cth of Australia), and should not be construed as advice.

Note to New Zealand Readers: This document has been issued by AllianceBernstein New Zealand Limited (AK 980088, FSP17141). Information in this document is intended only for persons who qualify as "wholesale clients," as defined by the Financial Advisers Act 2008 (New Zealand), and should not be construed as advice.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers: This document is issued in Hong Kong by AllianceBernstein Hong Kong Limited, a licensed entity regulated by the Hong Kong Securities and Futures Commission. This document has not been reviewed by the Hong Kong Securities and Futures Commission.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia, China, Taiwan and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund-management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital-markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial-planning services in Malaysia.

INS–6902–0213

www.abglobal.com