Wespath

JUNE 2020

The Small and Mid-Cap Stock Advantage

Wespath Benefits and Investments (Wespath) and its subsidiaries, including Wespath Institutional Investments (WII), offer a range of investment funds designed to help our stakeholders meet their financial goals. For pension plan participants, that might mean generating enough income for retirement, while institutional investors may want to ensure their endowment is funded well into the future.

Specific investment objectives and financial needs vary widely by investor. Wespath and WII have constructed an offering of well-diversified funds that, through investments made primarily by third-party managers, have exposure to an array of investment instruments.

One such example is publicly traded company stocks, also known as public equities. These are commonly used investment vehicles for participants and institutional investors alike. The public equity market is broad, accounting for thousands of companies of all shapes and sizes.

Company size, measured by market value or market capitalization (market cap), is an important factor when analyzing and selecting stocks. A public company's market cap is determined by multiplying its current share price by the total number of available shares. Large-cap companies typically have market caps greater than $10 billion, while mid-cap companies normally range between $2 billion and $10 billion, and small-cap companies fall below $2 billion.

These categories are useful to investors because companies of similar sizes tend to share other characteristics that influence how their share prices are affected by financial data, news, macroeconomic trends and shifts in global markets. This also suggests that small-cap, mid-cap and large-cap companies have measurably different return and risk potentials.

Wespath's U.S. Equity Fund (USEF) has maintained a 15% to 20% overweight to small- and mid-cap stocks compared with the fund's benchmark, the Russell 3000 index, for over ten years (**Figure 1, page 2**). This means that USEF has maintained an allocation to small- and mid-cap companies that was, on average, 15% to 20% greater than the allocation within the Russell 3000.

> "Company size, measured by market capitalization (market cap), is an important factor when analyzing and selecting stocks."

Mark Warren, CFA, CIMA
Manager, Public Equities

Mark joined Wespath in August 2015. He is responsible for overseeing the public equity investment program for Wespath and its subsidiaries. Previously, Mark held senior level positions with The Boeing Company, where he was responsible for public and private equity investments within the pension group. Prior to joining Boeing, Mark was vice president with HighMark Capital Management, where he evaluated investment allocations with outside money managers. Prior to that, Mark worked at the Abu Dhabi Investment Authority (ADIA) as an assistant fund manager and at Deloitte & Touche Investment Advisors as a senior consultant. Mark received a bachelor's degree from Purdue University. He is also a CFA Charterholder and a Certified Investment Management Analyst (CIMA).

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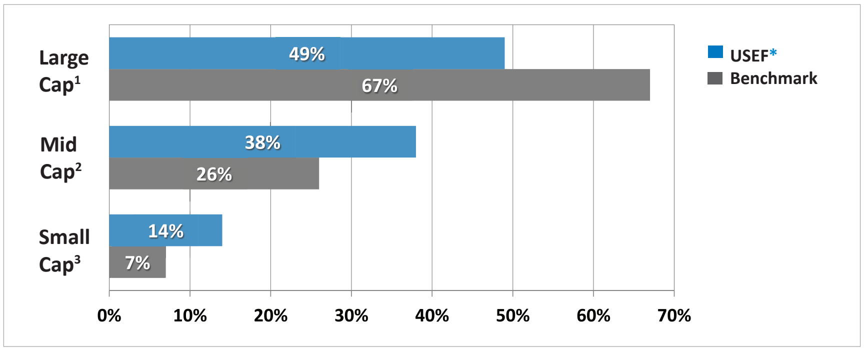
The Small and Mid-Cap Stock Advantage (continued)

Market Cap Weighting: USEF vs. Benchmark

FIGURE 1 (As of June 30, 2019)



[1] Large Cap Benchmark: Russell Top 200
[2] Mid Cap Benchmark: Russell Midcap
[3] Small Cap Benchmark: Russell 2000

** USEF is a P Series fund. Certain investors may be ineligible from investing in P Series funds. For more information on who is eligible to invest in P Series funds, please refer to the Investment Funds Description - P Series.*

This small- and mid-cap "bias" was an intentional decision by Wespath and was implemented based on our belief that these companies offer a more favorable risk/return profile as compared to large-cap stocks. Wespath believes the small- and mid-cap bias is a long-term benefit to our U.S. Equity Fund supported by favorable historical trends, the influence of active management and an underlying inefficiency in the market's pricing of these companies.

Historical Performance

The rationale for an overweight to small- and mid-cap stocks begins with academic research analyzing long-term equity returns across market cap categories.

A seminal paper by Nobel economics laureate Eugene Fama and co-author Ken French studied equity returns from 1926 through 1992 and found that, over the long-term, small- and mid-cap equities have consistently outperformed large-cap equities.[1]

This outperformance continues when we extend Fama and French's study into recent years. The first column in **Figure 2** shows annualized returns for large-, mid- and small-cap equities from 1926 through 2018.[2]

Taken together, small- and mid-cap equities returned an average of 2.1 percentage points more per year than large-cap equities. While past performance is not a predictor of future outcomes, these studies provide a favorable historical foundation for our small- and mid-cap bias.

Total Stock Market: Key Metrics

FIGURE 2 (1926 – 2018)

	1926 – 2018 Annual Return	Risk*	Sharpe Ratio**
LARGE	9.7%	17.9%	0.432
MID	11.9%	26.2%	0.43
SMALL	11.6%	30.8%	0.39

* Standard deviation
** Risk-adjusted return

Source: Ken French Data Library, Center for Research in Security Prices (CRSP®) Wilshire Compass manager database

1 Fama, Eugene F. and Kenneth R. French. "The Cross-Section of Expected Stock Returns." The Journal of Finance, June 1992 referenced in Lazard Asset Management white paper.

2 Ken French Data Library at Dartmouth College, Center for Research in Security Prices (CRSP)

The Small and Mid-Cap Stock Advantage (continued)

Active Management

One factor that contributes to the historical outperformance of small- and mid-cap stocks and reinforces our belief that these stocks will continue to outperform is the influence of active management.

Active investment managers make specific investment and allocation decisions with the goal of outperforming a stated market benchmark, such as the previously mentioned Russell 3000 index. This is in contrast to passive management, which seeks to track and replicate the performance of a stated benchmark.

Figure 3 shows the performance of the median active manager from the Wilshire Compass database within the three market cap groups from 1999 to mid-2019. The key data point to examine in the table is the Sharpe Ratio, a common metric used to measure risk-adjusted performance.

The Sharpe Ratio was developed by Nobel laureate William Sharpe and measures the excess return over the risk-free rate (e.g., Treasury bonds) per unit of risk. A higher Sharpe Ratio is indicative of an investment that is earning a higher return per unit of risk taken to generate that return.

As we can see in Figure 3, the median active investment manager across both small- and mid-cap sectors has generated a Sharpe Ratio over 40% higher than the comparable figure for large-cap stocks. This indicates that small- and mid-cap companies are not only providing positive absolute performance, but also desirable performance when factoring in risk.

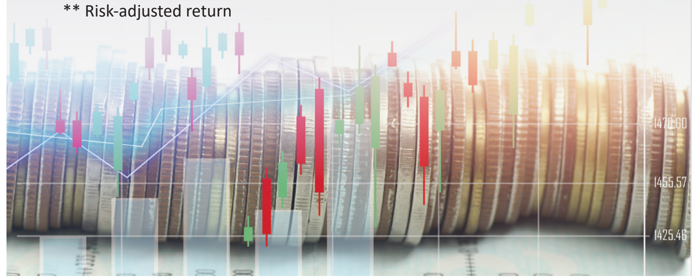
Active Management: Key Metrics

FIGURE 3 (Median Manager Performance)

	Return	Risk*	Sharpe Ratio**
LARGE	6.9%	16.0%	0.31
MID	9.9%	18.4%	0.43
SMALL	10.5%	19.4%	0.44

Large-cap category includes 101 managers. Mid-cap category includes 12 managers. Small-cap category includes 55 managers. Managers selected for the data in the table were those continuously reporting data to Wilshire from June 1999 to June 2019. Hence, the data excludes performance from managers that discontinued offering a fund prior to June 2019.

* Standard deviation
** Risk-adjusted return



Market Inefficiencies

One of the key advantages to employing active managers is their access to detailed industry and company information that may otherwise not be widely-available.

An important study on small-cap stocks from Rolf Banz found that a lack of available information on small-cap companies—reflected by thinner equity analyst research coverage—may cause investors to demand excess returns for investing in these smaller, lesser-known companies.[3] This lack of information suggests that there is an underlying "market inefficiency" related to small- and mid-cap stocks. The existence of a market inefficiency implies that managers who work more diligently to track down information can achieve better-than-average returns based on their research and understanding of these companies.

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Conversely, other areas of the market are more efficient as a result of the abundance of information and analysis performed on these companies. It is much more difficult for active managers to gain an edge when investing in widely followed large-cap companies, which explains why Wespath and WII tend to partner more frequently with active managers in the small- and mid-cap space.

3 Banz, Rolf. "The Relationship Between Return and Market Value of Common Stocks". Journal of Financial Economics, 1981 reference in Lazard Asset Management white paper.

The Small and Mid-Cap Stock Advantage (continued)

Style and Quality

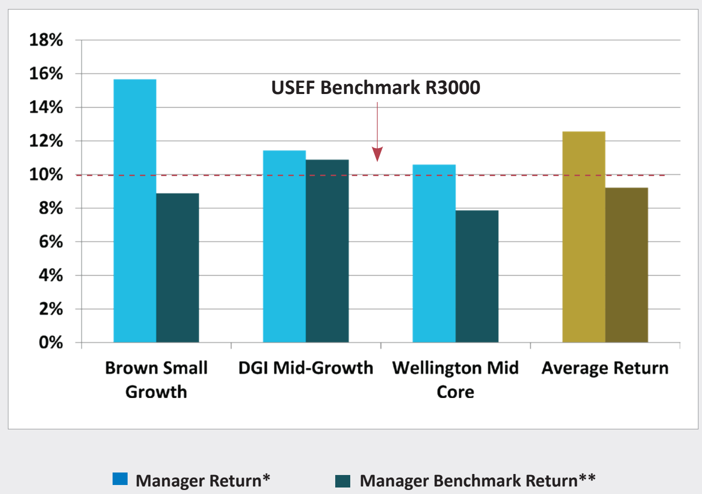
There are other views as to why small- and mid-cap companies tend to outperform. One popular notion is that small- and mid-cap companies tend to participate in less mature, more innovative and faster-growing industries—such as biotech, robotics or specialized software. In contrast, larger-cap equities tend to be in stable, lower-growth industries like healthcare, consumer staples and telecommunications.[4]

Another consideration, especially for active investment managers, is the quality of the small- and mid-cap equities. In a paper published by AQR Capital Management in the Journal of Financial Economics in 2018 that analyzed equity returns from 1926 through 2012, researchers found that small- and mid-cap outperformance exists, over long time periods and across global equity markets, especially when controlling for quality.[5] In this case, quality is defined using company financial data such as earnings stability, profitability, profit growth and low debt levels.

Naturally, it follows that active investment managers can help in the identification and selection of quality stocks using well-informed investment due diligence and analysis. This is another reason why Wespath and WII partner with a number of small- and mid-cap specialized managers that have proven to add value to our funds over the long-term (**Figure 4**).

USEF Manager Performance vs. Benchmark

FIGURE 4 (Select Managers and Strategies)



* Manager returns gross-of-fees for 10-year period ended March 31, 2020

** Brown Benchmark: Russell 2000 Growth
DGI Benchmark: Russell Mid-Cap Growth
Wellington Benchmark: S&P 400

This chart shows that our three longest-standing active small- and mid-cap active investment managers have each outperformed both their respective benchmarks as well as the U.S. Equity Fund benchmark during the most recent 10-year period.

4 "A Matter of Style", BlackRock Investment Institute paper, page 4

5 Clifford Asness, Andrea Frazzini, Ronen Israel, Tobias Moskowitz, and Lesse Petersen, "Size Matters, if You Control Your Junk", Journal of Financial Economics, 201

The Small and Mid-Cap Stock Advantage (continued)

The Challenges of Small- and Mid-Cap Investing

Investing in small- and mid-cap stocks can also present unique challenges. Namely, investors in small- and mid-sized stocks must be aware of the volatility associated with these companies.

One way to measure volatility is through a risk metric known as the standard deviation of returns, which is a measure of the variability of returns around an average historical number. In other words, the higher the standard deviation, the higher the risk in a portfolio.

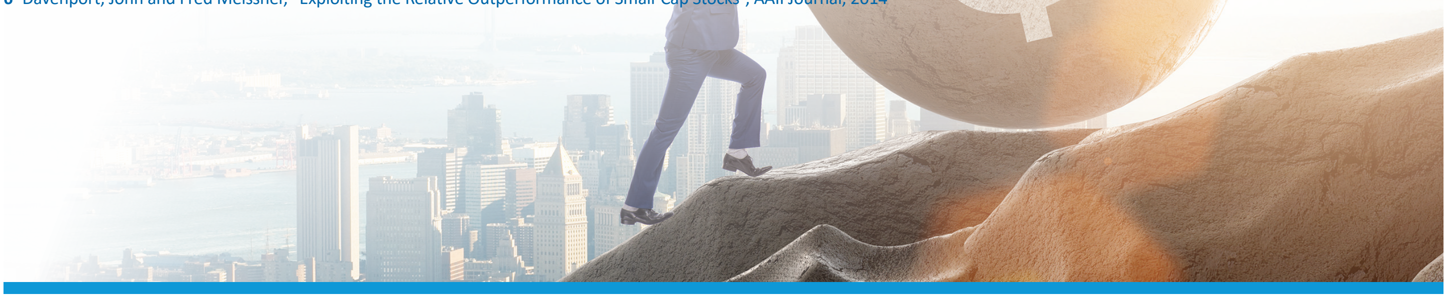
If we look back to **Figure 3**, the risk / standard deviation column indicates that small- and mid-caps tended to be more volatile than their large-cap counterparts. While the measure of risk-adjusted returns—the aforementioned Sharpe ratio—is also higher for actively managed small- and mid-cap stocks, more dramatic up and down swings in stock prices may be hard for some investors to navigate.

Beyond the potential for higher volatility, historically not all market environments have provided equal opportunities for small- and mid-cap outperformance. For example, research suggests that small-cap stocks in particular tend to outperform large caps during periods of improving economic growth and underperform during periods of negative or sluggish growth.

Additionally, a study by Davenport/Meissner examined ten periods of declining U.S. GDP growth dating back to 1948.

The data showed that small-cap equities outperformed in the ensuing four quarters of economic recovery in nine out of the ten recessionary periods.[6] This demonstrates what we probably already know about small- and mid-cap stocks belonging to cyclical and high-growth industry, but it also reminds us of the challenge posed by attempting to predict specific market cycles.

6 Davenport, John and Fred Meissner, "Exploiting the Relative Outperformance of Small-Cap Stocks", AAII Journal, 2014



Patience Is Rewarded

The difficulty of identifying periods of small and mid-cap outperformance suggests it makes little sense to rotate in and out of market cap sectors based upon observed or forecasted market conditions, particularly for large institutional investors.

Instead, Wespath believes that an important element of its investment approach is to maintain a long-term structural overweight to small- and mid-cap equities and work diligently to identify and hire best-in-class, diversified active managers with a demonstrated ability to select high-quality companies.

While small- and mid-cap equities may introduce higher volatility, Wespath strongly believes that our commitment to a small- and mid-cap overweight will be rewarded with higher returns relative to the broad market over time.

About WBI

Wespath Benefits and Investments (Wespath) is a not-for-profit agency that has been serving The United Methodist Church (UMC) for over a century. In accordance with its fiduciary duties, Wespath administers benefit plans and, together with its subsidiaries, including Wespath Institutional Investments, invests nearly $21 billion in assets on behalf of over 100,000 participants and over 130 United Methodist-affiliated institutions (as of March 31, 2020). Wespath funds invest in a sustainable manner that supports long-term value creation while having a positive impact on the environment and society and upholding the values of the UMC. Wespath maintains the largest reporting faith-based pension fund in the world.

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About WII

Wespath Institutional Investments (WII) is a not-for-profit subsidiary of Wespath Benefits and Investments (Wespath), a general agency of The United Methodist Church (UMC). WII provides investment solutions for institutional investors related to the UMC, including foundations, children's homes, older adult facilities, higher education institutions and healthcare organizations. WII offers diversified global exposure to its world-class investment managers through a family of daily priced funds. WII's investment process proactively incorporates the consideration of environmental, social and governance (ESG) factors into investments across asset classes and in the selection of external asset managers.

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