Kayne Anderson Rudnick
A VIRTUS INVESTMENT PARTNER

Mid Caps: At the Center of Attention

The mid-cap segment of the equity market is often overlooked, falling between headline-grabbing and widely followed large caps and small caps known for their high growth potential. Mid caps—generally defined as companies between $2 billion and $10 billion in market capitalization, with some reaching north of $30 billion—have historically outperformed both small- and large-cap stocks, but don't get much investor attention.

The lines between market-cap categories can be blurry, leading many investors to believe that owning both large and small stocks provides sufficient exposure across the market-cap spectrum. In fact, data point to a clear underrepresentation of the asset class. Mid caps make up about 26% of the overall equity market, according to a breakdown of the Russell indexes, but actual investments into the asset class only account for about 13% of all invested assets, as represented by Morningstar asset flows.

Investors lacking a dedicated allocation to mid caps may be missing exposure to a crucial segment. Mid-cap stocks have proven to be a positive addition to a diversified portfolio of equities, both in terms of boosting portfolio return and lowering risk.

Historical Long-Term Outperformance Driven by Fundamental Strengths

Mid-cap companies have strong fundamental characteristics with more favorable attributes compared to their large- and small-cap counterparts. Large-cap companies may be well established and more likely to pay dividends, but may have limited growth potential. Small companies offer the allure of outsized growth, but may exhibit more volatility and greater dependence on debt. Mid caps occupy a place squarely in between—small enough to experience relatively high growth rates, but mature enough to have proven business plans, greater stability, and more experienced management.

In our view, the fundamental characteristics of mid-cap stocks are key to their steady outperformance, relative to their larger and smaller peers, over the past 20 years (Figure 1).[1]

FIGURE 1

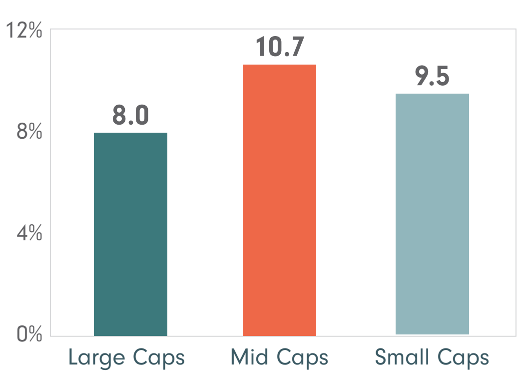
GROWTH OF $10,000 BY MARKET CAP CATEGORIES—20 YEARS

Past performance is not indicative of future results. As of 9/30/18. Source: Bloomberg. For all Figures, Large Caps are represented by the S&P 500® Index, Mid Caps are represented by the Russell Midcap® Index, and Small Caps are represented by the Russell 2000® Index. The indexes are not available for direct investment. See page 7 for market capitalization and index definitions and disclosures.

Mid caps have exhibited better historical earnings-per-share growth than large caps and small caps (Figure 2).

FIGURE 2

EARNINGS-PER-SHARE GROWTH—PAST 5 YEARS



Past performance is not indicative of future results. As of 9/30/18. Source: Characteristics data (Figures 2-6) is obtained from FactSet Research Systems and BNY Mellon and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information.

[1]Stocks of small- and mid-cap companies may be subject to more erratic market movements than stocks of larger, more established companies.

In addition, mid-cap companies have had healthier balance sheets than small caps, as measured by the historical ratio of debt to profitability (Figure 3). A comparison of earnings variance (Figure 4) shows that mid-cap companies have demonstrated more consistency in profitability.

FIGURE 3

TOTAL DEBT/EBITDA

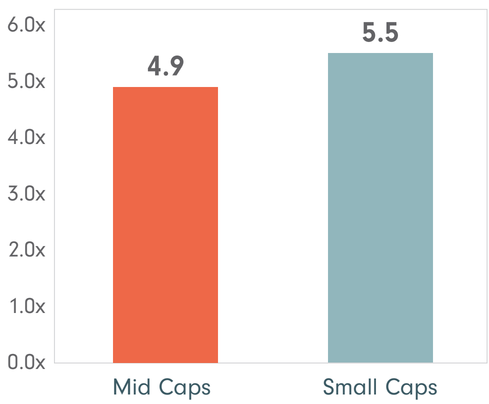
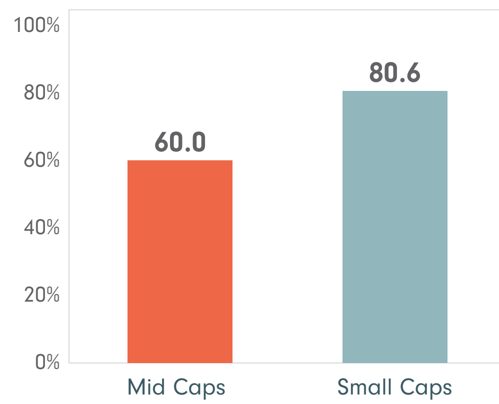


FIGURE 4

EARNINGS VARIANCE—PAST 10 YEARS



Mid caps also have shown higher income potential than small caps, as measured by dividend-per-share growth (Figure 5), while exhibiting greater ability to generate capital (Figure 6), another indication of their strong financials.

FIGURE 5

DIVIDEND-PER-SHARE GROWTH—PAST 10 YEARS

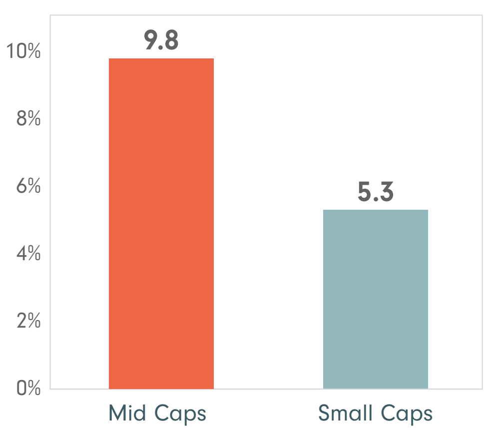
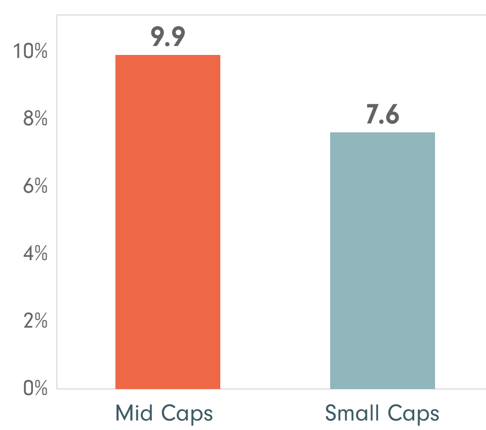


FIGURE 6

CAPITAL GENERATION—{ROE X (1-PAYOUT)}



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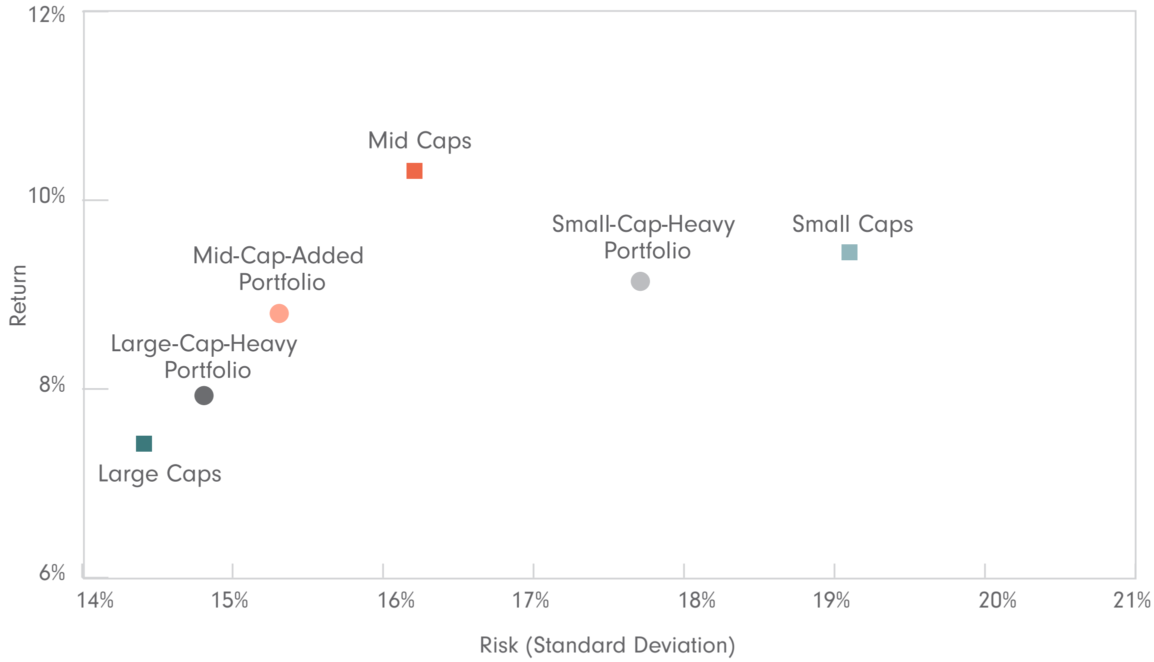
A Positive Addition to a Diversified Equity Portfolio

Not only do mid caps hold their own as an individual asset class, but they also can serve as a positive addition to a diversified equity portfolio. Historical data show that the risk-return profile of a portfolio of large and small equities substantially improved when mid-cap exposure was included.[2]

This is demonstrated by Figure 7, which presents the risk-return profiles of large-, mid-, and small-cap indexes, both individually and in hypothetical blended portfolios, based on 20 years of performance.

FIGURE 7

RISK-RETURN PROFILES—20 YEARS



Past performance is not indicative of future results. As of 9/30/18. Source: FactSet. Large-Cap-Heavy Portfolio consists of 80% large-cap and 20% small-cap indexes; Small-Cap-Heavy Portfolio consists of 20% large-cap and 80% small-cap indexes; and Mid-Cap-Added Portfolio consists of 50% large-cap, 30% mid-cap, and 20% small-cap indexes.

This analysis illustrates how the addition of mid caps to an equity portfolio improved risk-adjusted returns over time. Note how the Mid-Cap-Added Portfolio (15.31% standard deviation, 8.80% return) outperformed the Large-Cap-Heavy Portfolio (14.81% standard deviation, 7.93% return), while maintaining similar risk levels. The Mid-Cap-Added Portfolio also exhibited significantly less risk than the Small-Cap-Heavy Portfolio (17.71% standard deviation, 9.14% return), with about the same level of return.

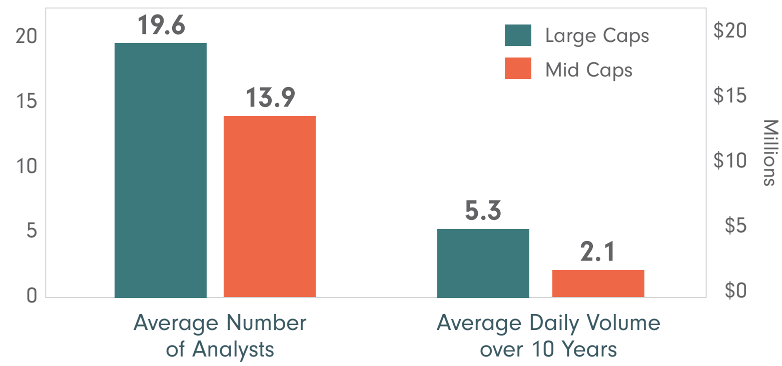
[2]There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio, or that diversification among different asset classes reduces risk.

The Value of Active Management

Data indicate that mid-cap equities constitute an overlooked area of the stock market, creating an opportunity for active managers to add value through fundamental research analysis (Figure 8). Trading activity echoes this notion, as large-cap stocks experienced average daily volume of 5.3 million shares over the past 10 years—more than double that of mid-cap stocks at 2.1 million.

FIGURE 8

LESS RESEARCH COVERAGE & TRADING ACTIVITY IN MID-CAP SEGMENT

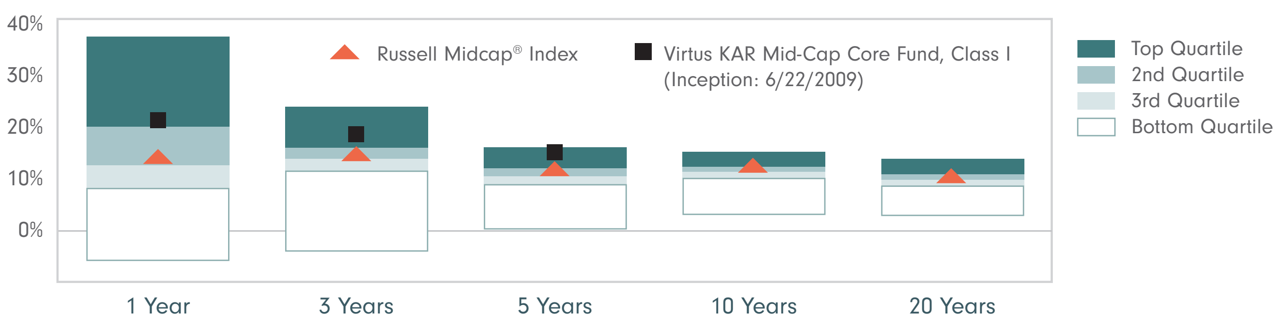


Past performance is not indicative of future results. As of 9/30/18. Source: FactSet.

Further evidence to support active management is offered in Figure 9, which compares passive investing in the mid-cap category, represented by the Russell Midcap® Index, against active investing, represented by the Morningstar mid-cap fund universe, divided into quartiles. The data show that the passive approach falls below the top quartile of its peer group of active managers across all time periods studied.

FIGURE 9

ACTIVE VS. PASSIVE—QUARTILE RANKINGS BASED ON ANNUALIZED RETURN



Past performance is not indicative of future results. As of 9/30/18. Source: Morningstar Direct. Fund (Class I) ranked against a broad universe consisting of the combined Morningstar Mid-Cap Blend, Mid-Cap Growth, and Mid-Cap Value categories. Number of funds ranked: 1,294, 1,137, 1,003, 714, and 207 for the respective 1-, 3-, 5-, 10-, and 20-year periods.

Over the past 20 years, the Index gained 10.31%, lagging the 10.71% return of the top quartile of active funds in the peer group, and higher than the peer group's median performance of 9.63%. This analysis suggests there is room for active management to add value to the investment process. To illustrate this point, Figure 9 also considers the performance of the Virtus KAR Mid-Cap Core Fund (I: VIMCX), actively managed by Kayne Anderson Rudnick (KAR), for all relevant periods since the fund's 2009 inception. For the 5-year period, the Fund gained 14.81%, landing it in the 3rd percentile of the peer group and outpacing both the Index's 11.65% and the peer group median of 10.34%.[3]

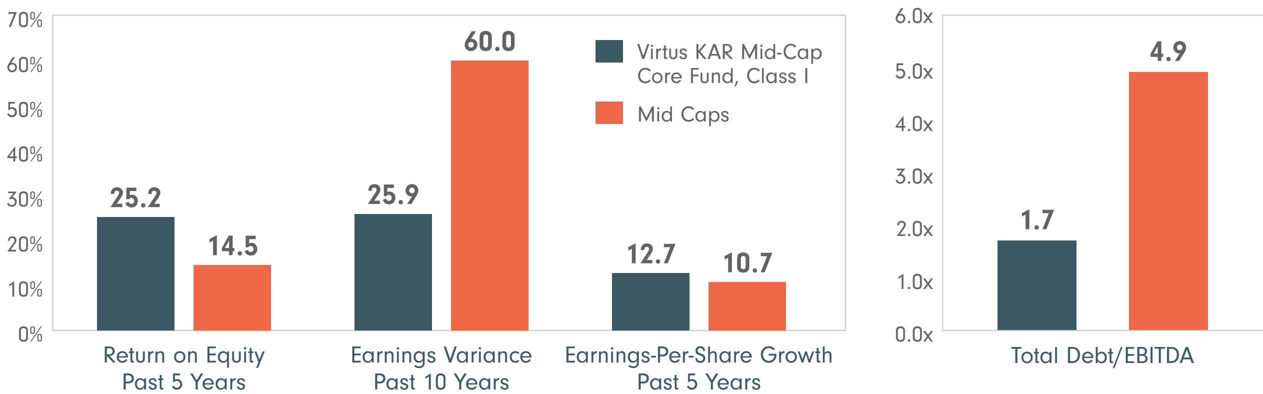
[3]View detailed Fund performance information on page 7.

KAR—An Active Mid-Cap Manager with a Quality Approach

Kayne Anderson Rudnick believes that owning quality businesses produces a portfolio with solid fundamental characteristics—return on equity, earnings variance, earnings-per-share growth, low total debt to profitability—capable of achieving strong relative performance in both good and bad markets. Since inception, the Virtus KAR Mid-Cap Core Fund has pursued greater risk-adjusted returns by adhering to a disciplined research process and strict guidelines for selecting well-run mid-cap businesses that dominate their markets and offer a competitive advantage.

FIGURE 10

FUNDAMENTAL CHARACTERISTICS



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Conclusion

Investors may be well served by including an allocation to mid-cap stocks as part of a diversified portfolio. The data show that mid caps have historically outperformed large caps and small caps over the last 20 years, driven by their more favorable fundamental characteristics in comparison. When mid-cap stocks are added to a portfolio of small-cap and large-cap stocks, the risk-return profile of the portfolio shows significant improvement. Based on this data, the conclusion is not whether to add mid caps, but how best to achieve mid-cap exposure. Data supports the potential value of an actively managed mid-cap strategy over a passive, index-driven approach. The time-tested Virtus KAR Mid-Cap Core Fund is one such active strategy that investors may wish to consider.

Average Annual Total Returns (%) as of 9/30/18

Virtus KAR Mid-Cap Core Fund (VIMCX)

	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEPTION 6/22/2009
NAV	5.81	11.20	20.93	18.21	14.81	n/a	15.92
Russell Midcap® Index	5.00	7.46	13.98	14.52	11.65	n/a	16.61

Performance data quoted represents past results. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so your shares, when redeemed, may be worth more or less than their original cost. Please visit Virtus.com for performance data current to the most recent month-end.

The fund class gross expense ratio is 1.23%. The net expense ratio is 0.96%, which reflects a contractual expense reimbursement in effect through 1/31/2019. This ratio reflects the direct and indirect expenses paid by the Fund.

The net expense ratio minus the indirect expenses incurred by the underlying funds in which the Fund invests is 0.95%.

Average annual total return is the annual compound return for the indicated period and reflects the change in share price and the reinvestment of all dividends and capital gains. Returns for periods of one year or less are cumulative returns. Class I shares have no sales charges or distribution or service fees, therefore their returns do not reflect these expenses. Fees and expenses vary, and other share classes are subject to sales charges and fees. Class I shares are offered primarily to eligible institutional investors who purchase the minimum amounts required as described in the prospectus and may not be available to all investors. For fund performance on other share classes, please visit www.virtus.com.

Definitions

Capital Generation—{ROE x (1-Payout)} indicates how quickly a firm can grow without changing its financing and dividend policies. The retention ratio is calculated as one minus the dividend payout ratio. Capital generation illustrates the importance of profitability (return on equity) and a firm's dividend policy on a company's growth.

Dividend-per-Share Growth measures the trailing dividends/share growth of a portfolio's holdings.

Earnings Variance measures the volatility of the annual earnings per share. On a portfolio level, a high earnings variance means the portfolio is heavily invested in companies with volatile earnings. Unlike earnings growth, this statistic looks at the companies' earnings patterns. Newer companies and smaller companies tend to have highly variable earnings.

Earnings-per-Share (EPS) Growth indicates the earnings available to each common share. Earnings-per-share growth is the growth rate of these earnings per share. On a portfolio level, this statistic measures the trailing earnings per share growth of a portfolio's holdings.

Market Capitalization is calculated by multiplying a company's outstanding shares by its stock price. As generally defined, the market cap range for small caps is $300 million to $2 billion, $2 billion to $10 billion for mid caps, and $10 billion to $200 billion for large caps.

Return on Equity (ROE) relates how well a company is using the money invested in it so that it can bring a return to its investors. A high portfolio ROE indicates that the portfolio is invested in historically profitable companies.

Standard Deviation measures variability of returns around the average return for an investment portfolio. Higher standard deviation suggests greater risk.

Total Debt/EBITDA is calculated by dividing total debt by earnings before interest, taxes, depreciation, and amortization. It is a measure of a company's ability to pay off its incurred debt.

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.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

Virtus KAR Mid-Cap Core Fund Investment Team

Jon K. Christensen, CFA
Portfolio Manager and Senior Research Analyst
Industry start date: 1995
Start date with Fund: 2009

Craig Stone
Portfolio Manager and Senior Research Analyst
Industry start date: 1989
Start date with Fund: 2009

About Kayne Anderson Rudnick

High quality at a reasonable price is the guiding principle at Kayne Anderson Rudnick (KAR). The firm manages investment solutions for individuals and institutions, with a focus on companies across market caps that are characterized by market dominance, excellent management, financial strength, and consistent growth. Founded in 1984, and affiliated with Virtus Investment Partners since 2001, Los Angeles-based KAR has $26.8 billion in assets under management, as of September 30, 2018.

About Virtus Investment Partners

Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

VIRTUS
MUTUAL FUNDS

To learn more about the Virtus KAR Mid-Cap Core Fund, or other strategies managed by KAR, please visit virtus.com or call 1-800-243-4361.

IMPORTANT RISK CONSIDERATIONS
Equity Securities: The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk. **Limited Number of Investments:** Because the fund has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a less concentrated fund. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund. **Prospectus:** For additional information on risks, please see the fund's prospectus.

Please carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For this and other information about any Virtus mutual fund, contact your financial representative, call 1-800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.

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