THE S&P MIDCAP 400® AND ITS ROLE IN INDEXED INSURANCE PRODUCTS

S&P Indices licenses insurance carriers to use the S&P 500® and the S&P MidCap 400 within insurance products. Carriers who offer index-linked insurance products utilize the underlying index as the basis for their crediting rates, which play a primary role in the overall performance of the product.

Mid-caps constitute a distinct asset class with a distinct performance profile.

S&P Indices plays an even larger role in indexed life insurance, with 100% of the top ten selling indexed life products offering an S&P index *(Source: Lifespecs.com)*. As of January 1, 2011, over US$ 200 billion has been placed within index-linked annuities, and over US$ 3.4 billion of target life premium has been paid on index-linked life policies (*Source: Lifespecs.com*).

Recent reports show that:

- Over 92% of the top 25 fixed indexed annuities offer the S&P 500 as a crediting method (*Source: Cerulli & Associates*).
- Over 60 indexed life products also offer the S&P MidCap 400 as a crediting method (*Source: Lifespecs.com*).

What Makes A Mid-Cap Stock?

The definition of a mid-cap stock is somewhat arbitrary, and different index providers draw the requisite lines in different places. Candidates for inclusion in the S&P MidCap 400, for example, are generally required to have market capitalizations between US$ 1 billion and US$ 4.4 billion. In contrast, constituents of the S&P 500 typically exceed US$ 4.0 billion in market capitalization.[1] As of year-end 2010, *total* capitalization of the S&P MidCap 400 amounted to approximately US$ 1.1 trillion, and accounted for approximately 8% of the total U.S. stock market. In contrast, the total capitalization of the S&P 500 was US$ 11.4 trillion, approximately ten times larger than that of the S&P MidCap 400.

As with any S&P equity index, candidates for inclusion in the S&P MidCap 400 must meet several pre-defined criteria. In addition to market capitalization guidelines, additional criteria include:

- **U.S. domicile:** The S&P MidCap 400 is intended to be a benchmark of the *U.S.* mid-cap market. Therefore, all constituent companies must be domiciled in the United States. American Depositary Receipts (ADRs) are not eligible for index membership.
- **Liquidity:** All stocks in the S&P MidCap 400 are traded on the New York Stock Exchange or on the Nasdaq. The public float – i.e., the proportion of the company's capitalization available for purchase by investors – must be at least 50% of the total shares outstanding. This prevents closely held companies from entering the index.

[1] These guidelines are effective as of March 2011. The S&P U.S. Index Committee occasionally revises them upward or downward as overall stock market values fluctuate.

- **Profitability**: All index entrants must have achieved at least four consecutive quarters of positive earnings.

It is important to note that the S&P MidCap 400 is distinct from the larger-cap S&P 500 and (for that matter) the S&P SmallCap 600®. There is no overlap of stocks within these three indices.[2]

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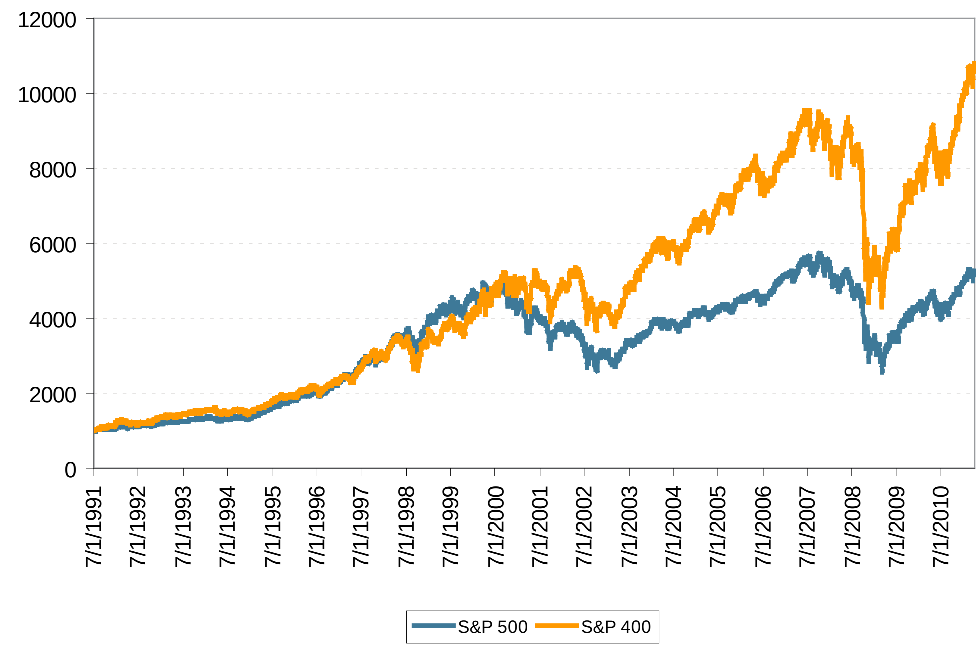
A Historical Perspective

The first capitalization-weighted index of the U.S. equity market (a predecessor of the S&P 500) dates back to 1923, and the familiar 500-stock formulation was introduced in 1957.[3] It was not until the early 1990s that index providers began to offer distinct indices which intentionally excluded the largest stocks and emphasized smaller capitalization names. Today, some investors commonly think of "large-cap" and "small-cap" indices as they determine portfolio allocations. However, mid-cap indices are often an afterthought.

This oversight is unfortunate, since mid-caps constitute a distinct asset class with a unique performance profile. Exposure to this segment of the market offers investments in companies which, as a group, may undergo rapid growth as their businesses reach scale. As shown in Chart 1, the S&P MidCap 400 outperformed the large-cap S&P 500 for much of the last 20 years.

Chart 1: Large- and Mid-Cap Comparative Performance



Source: Standard & Poor's. Data as of March 31, 2011. Inception date for the S&P 400 was July 1, 1991. Graphs are provided for illustrative purposes. Past performance is not a guarantee of future results.

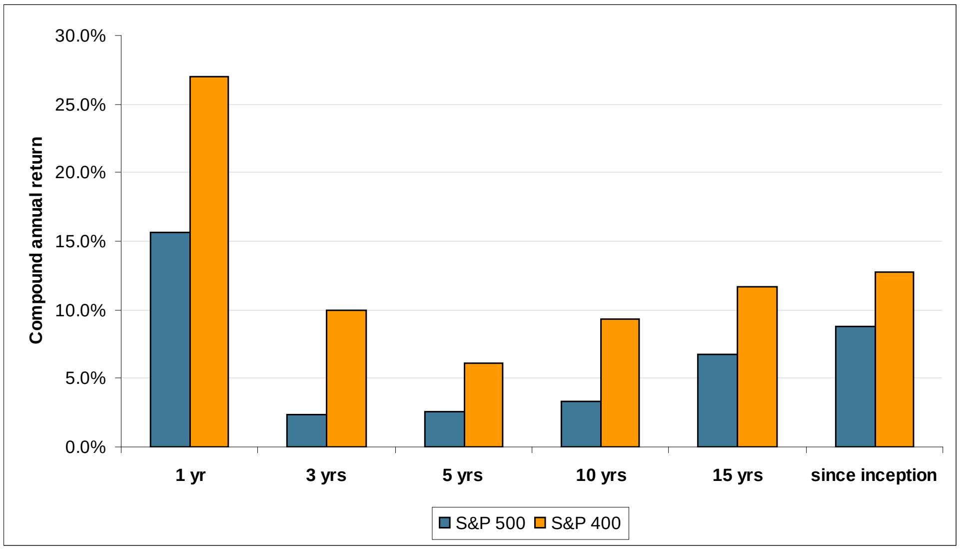
[2] Not all mid-cap indices are so defined. For some index providers, the mid-cap index is a subset of a better-known large- or mid-cap composite.

[3] In a capitalization-weighted index, each stock's importance is proportional to the total value of its outstanding shares. Such indices are better representatives of the equity market than their even more venerable price-weighted cousins. In comparison, in a price-weighted index, each stock's weight is largely influenced by its share price, regardless of the number of shares outstanding. Such indices were a practical necessity in the days before mechanical (let alone electronic) calculating technology. Now, despite the continuing prominence of one of them, they are more a historical curiosity than a realistic gauge of the market.

More on Performance….

What is particularly interesting about mid-cap performance is that it isn't simply a higher-beta version of the large-cap segment of the market.[4] This point is illustrated in Chart 2 below, which shows performance over a number of lookback periods, ending at year-end 2010. When the large-cap S&P 500 did well – e.g., in the most recent 12 months – mid-caps performed substantially better. What's remarkable is that during periods of poor or indifferent large-cap performance – e.g., over the past three or five years – mid-caps also outperformed.

Chart 2: Comparative Performance



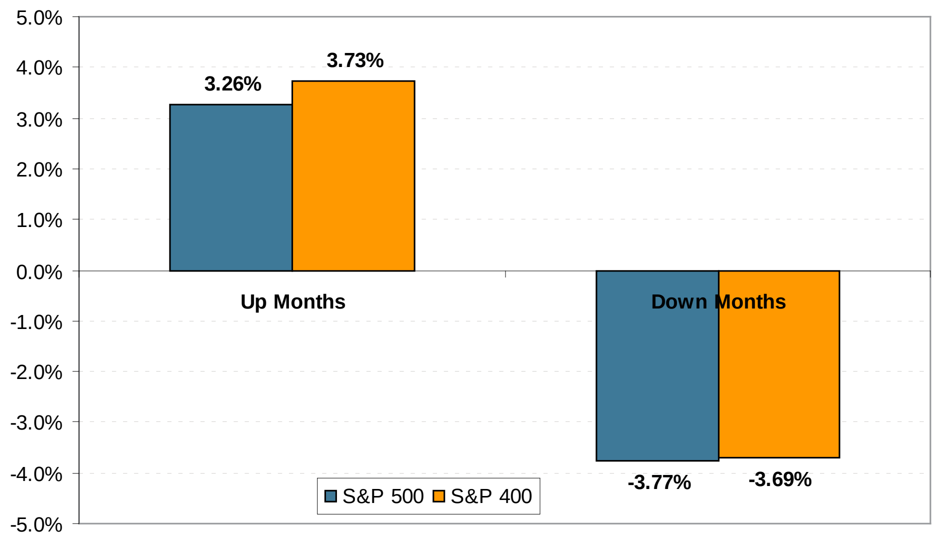
Source: Standard & Poor's. Data as of September 30, 2011. Charts and tables are provided for illustrative purposes. This chart reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

One way to understand these data better is to break them down into individual months. There are 236 months in the data sample (August 1991 through March 2011). Of these, there were 153 "up months" – i.e., months in which the S&P 500 recorded a positive total return. As shown in Chart 3 on the following page, the average return for the S&P 500 during these months was +3.26%. During those same months, the average return for the S&P MidCap 400 was +3.73% – a performance increment of nearly *50 basis points a month,* on average. In the 83 down months, the average performance of the S&P 500 (-3.77%) and the S&P MidCap 400 (-3.69%) was nearly identical, indicating that the outperformance in good times was not given back in bad times.

Of course, past performance is no guarantee of future results – but the historical record of the S&P MidCap 400 makes it an intriguing candidate for investors' consideration.

[4] "Beta" refers to the tendency of a stock or portfolio to magnify or diminish the movements of a market index. Using a crude regression model, the beta of the S&P MidCap 400 with respect to the S&P 500 is 1.03. This means that the upward or downward movements of the S&P 500 tend to be magnified in the S&P MidCap 400 by a factor of 1.03 (which is to say, hardly at all).

Chart 3: Average Monthly Performance (August 1991 – March 2011)



Source: Standard & Poor's. Data as of March 31, 2011. Graphs are provided for illustrative purposes. Past performance is not a guarantee of future results.

Tickers

ETF	Ticker
iShares S&P MidCap 400 Index Fund	IJH
SPDR S&P MidCap 400 ETF	MDY
Vanguard S&P Mid-Cap 400 ETF	IVOO

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