

Plan Benefits of Passive Choices Beyond Large-Cap

Whether your plan lineup is offered as a core group or through various investment tiers, extending its options to include passive choices in the small- and mid-cap asset classes can add value. As illustrated in *S&P Indices Versus Active (SPIVA) Scorecard: Year-End 2010* and in the table below, for the five-year period ending December 31, 2010, only 21.81% of active mid-cap funds outperformed the S&P MidCap 400®, and similarly, only 36.98 of active small-cap funds outperformed the S&P SmallCap 600®.¹

Active managers who outperform benchmarks rarely do so in consecutive periods.

Percentage of U.S. Equity Funds Outperformed by Benchmarks

Fund Category	Benchmark	3-Year (%)	5-Year (%)
All Mid-Cap Funds	S&P MidCap 400	83.90	78.19
All Small-Cap Funds	S&P SmallCap 600	70.11	63.02

Source: S&P Indices, CRSP. Data as of December 31, 2010. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Furthermore, those active managers who do outperform benchmarks in one period rarely do so in subsequent periods according to historical research available in the latest edition of the *S&P Persistence Scorecard*.² As shown in the table below, relatively few top quartile active funds maintain their outperformance over time. Additionally, over a typical period of several years, a significant number of small- and mid-cap funds may merge, liquidate, or change style, sometimes altering the asset class lineup of plans which offer them. In contrast, passive choices remove the risk of top-performing managers failing to repeat their performance from one period to the next. They also offer pure asset class exposure without style slippage, preserving a plan's asset allocation offering through time.

Three-Year Transition Matrix (March 2008-March 2011): Performance over Two Non-Overlapping Three-Year Periods

	1 st Quartile (%)	2 nd Quartile (%)	3 rd Quartile (%)	4 th Quartile (%)	Merged/Liquidated (%)	Style Changed (%)
Mid-Cap Funds						
1 st Quartile	12.50	13.75	15.00	16.25	12.50	30.00
2 nd Quartile	18.75	16.25	13.75	13.75	12.50	25.00
3 rd Quartile	16.25	11.25	17.50	11.25	11.25	32.50
4 th Quartile	6.25	13.75	7.50	12.50	30.00	30.00
Small-Cap Funds						
1 st Quartile	25.93	25.00	20.37	19.44	0.93	8.33
2 nd Quartile	21.30	19.44	27.78	16.67	12.96	1.85
3 rd Quartile	19.63	22.43	21.50	20.56	14.02	1.87
4 th Quartile	14.81	15.74	12.04	25.00	29.63	2.78

Source: S&P Indices. Data from March 31, 2008 through March 31, 2011. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

¹ Source: *SPIVA Scorecard: Year-End 2010*. Available at www.spiva.standardandpoors.com.

² Source: *S&P Persistence Scorecard: May 2011*. Available at www.spiva.standardandpoors.com.

Active management fees also tend to be high for small- and mid-cap products, as shown in the table below. Reducing this expense burden is another way fiduciaries can contribute to better plan outcomes.

Funds in Lipper Categories (All Share Classes)

	Mid-Cap (%)	Small-Cap (%)
Avg Expense Ratio	1.84	1.72
Median Expense Ratio	1.41	1.53
Asset-Weighted Avg	0.87	0.92

Source: Factset, Lipper. Data available as of December 31, 2010. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Over the last fifteen years, mid-caps have carved a path of their own.

In Volatile Markets, Does Active Management Pay?

One of the most enduring investment myths is the belief that active management has a distinct advantage in bear markets due to the ability to shift rapidly into cash or defensive securities. In the year-end 2008 edition of the *SPIVA Scorecard*, we examined bear market returns, and found strong evidence to dispel this idea (see chart below).³

Percentage of Active Funds Outperformed by Benchmarks in Bear Markets

	2008 (%)	2000-2002 (%)
All Mid-Cap Funds	74.70	77.30
All Small-Cap Funds	83.80	71.60

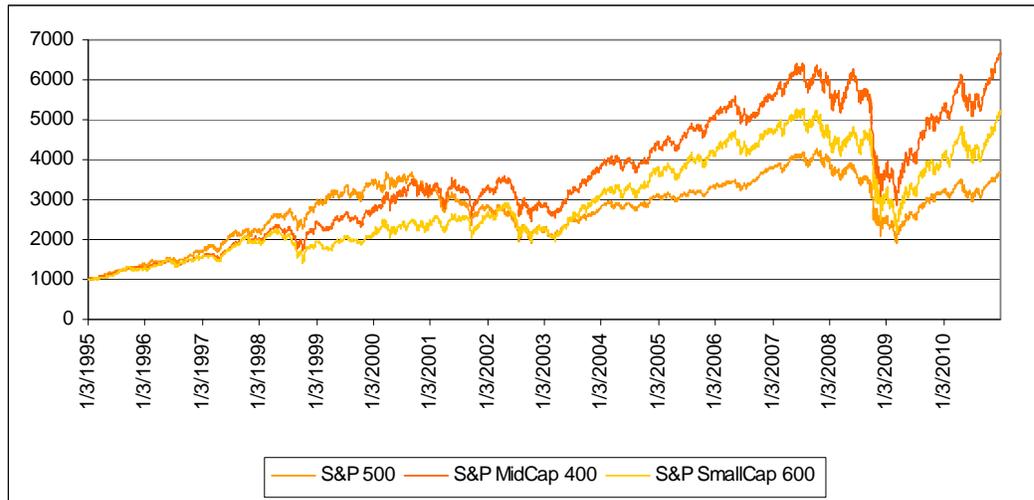
Source: S&P Indices, CRSP. Data as of December 31, 2008. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Solutions to Improve Participant Outcomes

Although sometimes overlooked, mid-caps form a unique asset class whose performance is distinct from that of both large- and small-cap equities. Exposure to this market segment offers investments in companies which, as a group, may undergo rapid growth as businesses reach scale. As shown in the graph on the following page, mid-cap stocks have carved a path which is distinct from those of large- and small-caps over the last fifteen years.

³Source: *SPIVA Scorecard: Year-End 2008*. Available at www.spiva.standardandpoors.com.

Performance of the S&P 500®, S&P MidCap 400 and S&P SmallCap 600

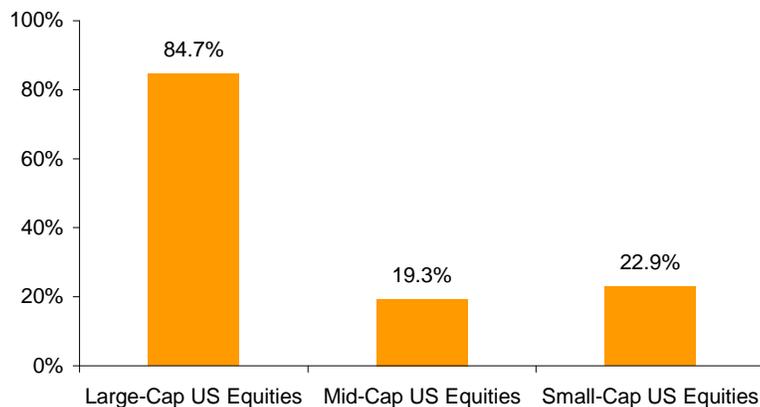


Source: S&P Indices. Daily data from January 3, 1995 through December 31, 2010. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Passive choices can help to alleviate active risk and may lower overall plan costs.

While many defined contribution plans use active funds to offer mid- and small-cap exposure, passive choices can help to alleviate active risk and may lower overall plan costs. In research conducted by S&P Indices, a mere 16% of plans offered passive mid-cap investments, and only 20% offered passive small-cap investments.⁴ Nevertheless, the *SPIVA Scorecard* shows that only a minority of active small- and mid-cap fund managers tend to beat the market in any given period.

Percentage of Plans with Index Funds



Source: Sample of 150 DC plans in the Money Market Database (MMD). Data as of April 2011. Graphs are provided for illustrative purposes. Past performance is not a guarantee of future results.

The S&P MidCap 400 and S&P SmallCap 600 are transparent, investable measures of the mid- and small-cap market segments. By offering investment products replicating these two leading benchmarks in their DC plans, sponsors may be able to enhance participant outcomes while typically lowering overall plan costs.

For additional information about passive investing beyond large-caps, visit www.equityindices.standardandpoors.com.

Related Research

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Tickers

	Price Return	Total Return
S&P MidCap 400		
Bloomberg SM	MID	SPTRMDCP
Reuters	.MID	.TR4GSPC
S&P SmallCap 600		
Bloomberg	SML	SPTRSMCP
Reuters	.SML	

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Contact us:

1-877-SPCLIENT

thoughtleadership@standardandpoors.com

www.equityindices.standardandpoors.com

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