

THE SMID SWEET SPOT

EXPANDING HORIZONS FOR INVESTORS

Chantal Brennan, *Managing Director, International Small & Mid Cap Equities*

Camilla Macun, *Vice President, European Small & Mid Cap Equities*

Executive Summary

Small- and mid-cap (SMID) investing represents an increasingly distinct asset class that merits consideration by investors, because it can deliver a combination of high returns and ample liquidity.

In the past 10 years, international small-cap stocks have strongly outperformed their large-cap peers (Exhibit 1). Moreover, small-cap investing has gained wider recognition, becoming a mature asset category that has increasingly entered the mainstream of both institutional and retail investing.

Exhibit 1 - Superior Long-Term Performance

Performance	1yr	3yr	5yr	10yr
EAFE Small	(9.04)	8.97	23.21	7.65
EAFE SMID	(4.83)	11.22	22.79	7.87
EAFE Standard	(0.24)	10.64	18.71	4.74
S&P 500	(5.42)	3.40	9.61	2.40

Source: MSCI Barra and Bloomberg, February 28, 2008

Small-cap investing's solid track record over the past decade has also made the asset class a victim of its own success. Strong small-cap performance has given asset managers a choice between overstretching their capacity (and, in many cases, inhibiting performance) or entering the "SMID" space. To capture alpha for a greater portion of their assets, many investors are selecting the latter course, and this phenomenon is still in its early stages internationally.

Defining SMID

There are approximately 30,000 companies listed globally that make up the small-, mid- and large-cap universe. However, small-, mid- and large-cap stocks are defined differently based

on the type of market. To date, no single definition of SMID has emerged as the universal standard, although the ongoing reclassification of the widely used MSCI Barra Index series is helping to address this issue¹ (Exhibit 2).

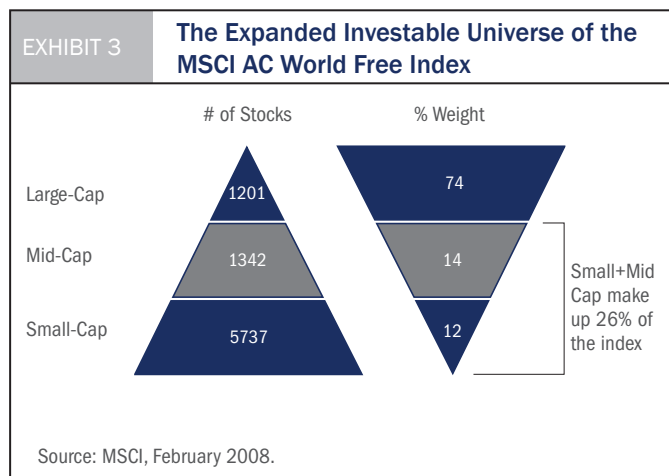
Exhibit 2 - Market Capitalization Bands

	Developed Markets	Emerging Markets
Large-Cap	US\$ > 10 billion	US\$ > 5 billion
Mid-Cap	US\$ 4 billion – 10 billion	US\$ 2 billion – 5 billion
Small-Cap	US\$ < 4 billion	US\$ < 2 billion

Source: MSCI Barra, November 2007

Of the previously mentioned 30,000 listed companies, only about one third meet the minimum liquidity requirements and other criteria defined by MSCI for inclusion in the Enhanced Index series. The Index covers 99% of the resulting free-float-adjusted investable universe – significantly up from the 85% it historically covered.

As seen in Exhibit 3, the MSCI AC World Free definition gives an investor access to three distinct opportunity sets, each with its own advantages.



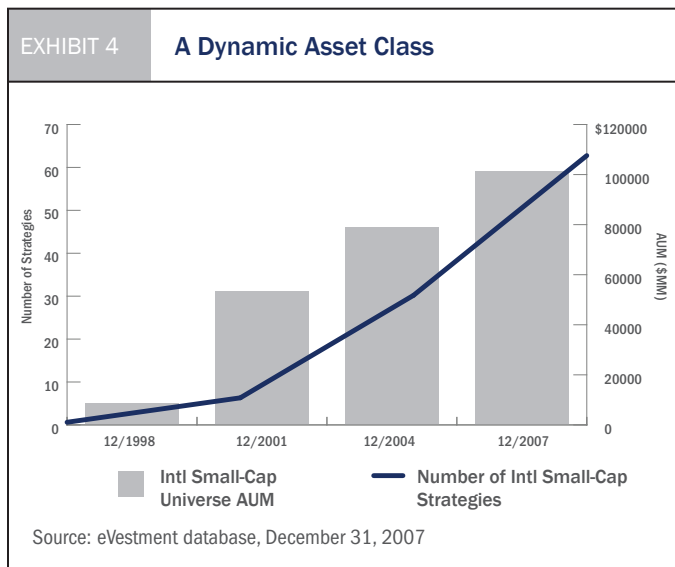
For the first time in MSCI history, investors have been given a conclusive definition of what actually constitutes a small-, mid- or large-cap stock. The resulting index has been constructed in a way that enables investors to apply a standard definition across markets and regions that encompasses 99% of all eligible stocks.

The Small-Cap Dilemma

The evolution of the SMID asset class has occurred due to small-cap investors' desire to examine markets with high alpha potential, in exchange for lower risk and greater liquidity. Superior risk-reward profiles, the ability to move beyond limited market coverage, and diversification of sector and region risk are just a few of the inherent advantages of small- and mid-cap stocks².

Initially, small-cap investing was the preserve of local investment teams with analysts on the ground. However, this knowledge base was increasingly exploited by investors eager to take advantage of the attractive opportunities in this space.

Success inevitably brought capacity issues, as the market responded to small-cap opportunities by launching an increasing number of dedicated products (Exhibit 4). In fact, demand for small-cap products has outstripped that for large-cap by a ratio of more than four to one³.



It can even be claimed that the small-cap asset class has become a victim of its own success. Many of the best-performing products are now closed to investors, because of capacity constraints and other issues (Exhibits 5 and 6.)

Exhibit 5 – Reasons Cited by Money Managers for Closing Small-Cap Products

International Small-Cap Equities	
Liquidity constraints or trading difficulty	84%
Higher transaction costs above a certain asset level	19%
Difficulty servicing clients above a certain asset level	19%

Source: Intersec Research, November 2005 and February 2006

Exhibit 6 – Large Percentage of International Assets are in Closed Strategies

	% AUM	# of Strategies
Open	60%	46
Closed	40%	17

Source: eVestment database, December 31, 2007

Additionally, one-year performance rankings for international small-cap strategies appear to dip into the 3rd and 4th Quartiles the year after AUM reaches the range US \$1.8 billion to US \$4.4 billion.⁴

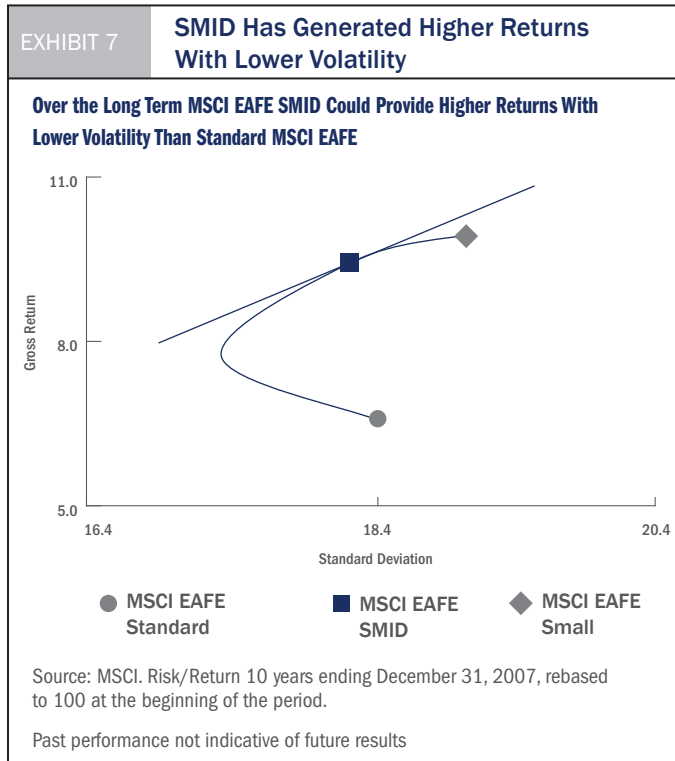
The SMID “Sweet Spot”

The ability to access a sound alternative strategy to purely small-cap stocks become of paramount importance due to the nature of smaller companies and their expected growth life cycle. Because of their size, availability and trading requirements, small-cap equities continue to be a capacity-constrained asset class. Many small-cap stocks are illiquid, have low free float, historically involve a high level of family ownership, and do not tend to warrant analyst coverage.

Before the emergence of SMID, if a company classified as “small” grew too large to remain in a strictly small-cap portfolio, the stock would be cast into a vacuum in terms of analyst coverage. Without any dedicated asset class, these disenfranchised stocks would be grouped together with other equities categorized as too big to be deemed “small,” yet too lacking in capitalization to be considered “large.”

This resulted in a wider range of worthwhile under-the-radar opportunities, although they were hard to find and even more difficult to evaluate. Thanks to the capacity issues identified above, this “no man’s land” will continue to be a fertile area

for finding alpha in the coming years. In fact, as the chart (Exhibit 7) shows, SMID offers attractive risk/reward opportunities.



This phenomenon is further supported by recent aforementioned AC World Free Index series changes made by MSCI Barra that take a broader view of the opportunity set, by deliberately taking a more inclusive stance reporting smaller companies.

Given the prominence of the index provider, this reclassification of the index will have a meaningful and imminent effect on the way investors allocate their assets. More precisely, an additional 14% of the global market capitalization is now being included that was previously excluded from the investable universe.

Over the last 12 months, MSCI Barra has been gradually changing the composition of its indices to incorporate its new methodology; these changes will have been finalized by May 2008. At that point, MSCI Barra clients who have yet to adopt this new structure will be obliged to migrate to this new, more small-cap and SMID-aware product.

What the Future Holds

As an asset class, SMID has reached a meaningful level of recognition in the U.S. institutional marketplace. SMID has grown at over five times the rate of small caps over the last three years (Exhibit 8). We expect this to be replicated in other developed and developing equity markets over time.

Exhibit 8 - Total U.S. SMID Versus U.S. Small-Cap Asset Growth

	AUM, US\$ (in Millions)	Growth
US SMID	118,226	78%
US Small	59,701	14%

Source: eVestment database, December 31, 2007

Additionally, we believe the SMID phenomenon will gain traction, as investment funds seek to gain better control of their asset allocation and redefine the efficient frontier. The structural changes to the MSCI Barra Index series will ensure this is not a temporary manifestation.

SMID has emerged as an “asset class of choice” for the best of reasons: the preservation of product integrity; desire to manage capacity in a dynamic, yet inefficient segment of the market; and a more inclusive index structure.

We argue that the SMID “sweet spot” is not a unique occurrence, but stems from large-cap investors’ need to move further down the market-cap range to generate alpha and small-cap investors’ need to buy bigger stocks in order to alleviate capacity issues.

SMID investing is clearly a product of its time, and one that is here to stay.

References

- 1 “Global Investable Market Indices Methodology,” MSCI Barra, November, 2007
- 2 “International Small Caps: EAFE’s Promise Fulfilled,” AIG Investments, 2004
- 3 “Small Cap Spillover: New Approaches Address Capacity Issues,” Casey, Quirk & Associates, March, 2006
- 4 Source: eVestment as of December 31, 2007. Peer rankings based on the eVestment International Small Cap Equity Universe. Strategies used in this analysis are small-cap and do not include all-cap or small-mid cap strategies.

Chantal Brennan joined AIG Investments in 1996 and is the Head of the European Smaller Companies Team based in London, Deputy Head of European Equities, and Product Head of International Small Cap. Prior to joining AIG Investments, she served as a Research Analyst with Standard Life Assurance Company in Scotland. Ms. Brennan received Bachelor's and Master's degrees in Economics from University College Dublin and a Masters of Science in Investment and Treasury from Dublin City University. She is a member of the UK Society of Investment Professionals and the CFA Institute.

Camilla Macun joined AIG Investments in 2004 and is a Senior Portfolio Manager with the European Smaller Companies team. Prior to joining AIG Investments, Ms. Macun worked at Morley Fund Management, where she was responsible for managing their European smaller companies' assets. Previously, Ms. Macun worked at Lombard Odier Asset Management and Investec Asset Management managing a variety of different smaller company mandates. Ms. Macun received a degree in History from Bristol University in 1991. She is a member of the UK Society of Investment Professionals and the CFA Institute.

ACKNOWLEDGEMENTS

The authors would like to thank AIG Investments colleagues Tess Amodeo-Vickery and Christine McQuillan for their valuable assistance and contributions.

Past performance not indicative of future results

AIG Investments is a group of international companies that provide investment advice and market asset management products and services to clients around the world.

AIG Investments is a service mark of American International Group, Inc. (AIG). Services and products are provided by one or more affiliates of AIG.

Readership: This document is intended solely for the addressee(s). Its content may be legally privileged and/or confidential. This document is being provided for informational purposes only.

This white paper is the work product of AIG Investments and should not be reproduced or distributed in any manner without the express written permission of AIG Investments.

Opinions/Information: Any opinions expressed or information provided in this document may be subject to change without notice and AIG Investments has no obligation to update such opinion or information. We are not soliciting or recommending any action based on this material.

Any industry outlook, conclusions or forward looking observations provided herein are for informational purposes only and should not be relied upon.

Unless otherwise noted, all information contained herein is sourced with AIG and/or AIG Investments internal data.

The content included herein has been shared with various in-house departments within the member companies of AIG Investments and/or AIG Private Bank Ltd., in the ordinary course of completion. All AIG Investments member companies comply with the confidentiality requirements of their respective jurisdictions.

Parts of this presentation may be based on information received from sources we consider reliable. We do not represent that all of this information is accurate or complete, however, and it may not be relied upon as such.

AIG Global Investment Corp. (Switzerland) Ltd. is a wholly owned subsidiary of AIG Private Bank Ltd.

AIG Investments Europe Limited is authorised and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by AIG Investments Europe Limited.

AIG Global Real Estate Investment (Europe) Ltd. is an Appointed Representative of AIG Global Investment Corp. (Europe) Ltd.

Approved by AIG Investments Ireland Limited and AIG Investments Fund Management Limited, both regulated by the Financial Regulator in Ireland.

In Australia, this document is intended for a limited number of wholesale clients as such term is defined in chapter 7 of the Corporations Act 2001 (CTH). The entity receiving this document represents that if it is in Australia, it is a wholesale client and it will not distribute this document to any other person whether in or outside of Australia.

AIG Global Investment Corp. (Middle East) Limited is regulated by the Dubai Financial Services Authority. In Dubai this document is intended for wholesale customers only and not Retail Customers and the financial products and services to which this material relates will only be made available to wholesale customers who meet the regulatory criteria to be treated as a client of AIG Global Investment Corp. (Middle East) Limited."

Published March 2008