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Mid Cap Stocks:
Opportunities in the Heart of the Market

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David J. Gullen, CFA, CAIA, Product Specialist; and Steven L. Pollack, CFA, Portfolio Manager

Executive Summary

A common approach to diversifying a U.S. equity allocation is to supplement a core of large-capitalization equity investments with an allocation to small-capitalization stocks. While simple to execute and intuitively attractive, such an approach overlooks the significant opportunities available in U.S. mid cap stocks.

U.S. mid cap companies — for purposes of this paper, companies with market capitalizations between $1 billion and $18 billion — offer several advantages to investors, among them:

- Robust long-term performance potential results
- Historical outperformance in both up and down markets
- A potentially inefficient market where managers can add value through individual stock selection
- Higher return per unit of risk or risk-adjusted return
- A compelling combination of high earnings growth and reasonable valuations
- The ability to benefit from merger and acquisition activity
- A high representation of companies at the optimal point in their growth cycle

> U.S. mid caps are clearly "the heart of the market," **providing the largest investable universe and highest number of potential opportunities.**

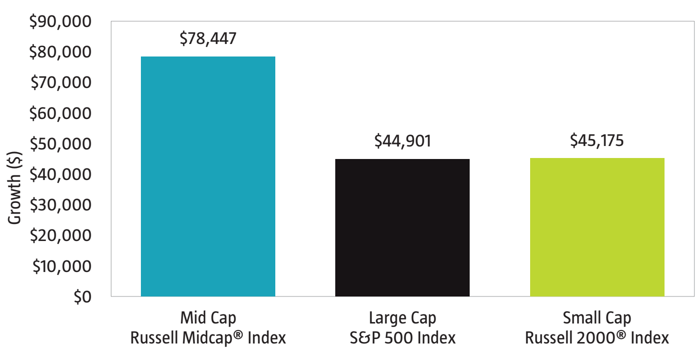
Outperformance through the Full Market Cycle

U.S. mid cap stocks, while not part of most traditional asset allocation models, have outperformed both large and small caps by a comfortable margin over time. While investors are often told that small caps historically deliver the best performance, the Russell Midcap® Index outpaced both the large cap S&P 500 Index and the small cap Russell 2000® Index in the three-, seven-, ten- and twenty-year periods ending on June 30, 2013.

U.S. mid cap stocks also have a considerable performance advantage in the 32-year period beginning in 1979. Notably, this interval incorporates a wide range of market cycles, including three major bear market declines (1987, 2000–2002 and 2008) as well as four significant bull market rallies (1982–1987, the 1990s, 2003–2007 and 2009–2011). In short, U.S. mid cap stocks have been an all-weather investment for more than three decades.

Large sweet spot for adding value, with less risk

Growth of $1,000 and annualized returns (January 1979–June 2013)
U.S. mid caps have historically outperformed large and small cap stocks by a substantial margin.



Source: FactSet Research Systems.
Data as of June 30, 2013.
Please refer to the Performance Disclosures on the last page for important disclosures.

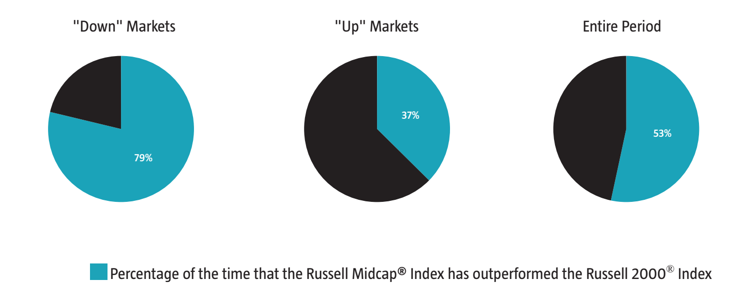
The performance of the U.S. mid cap asset class is not simply a blend of small and large cap performance (i.e., it is not possible to create synthetic exposure to mid caps through a 50/50 allocation to these two categories). If this were the case, mid caps' returns would fall in between the returns of their large and small cap counterparts. Instead, mid caps have outperformed both groups over the long run — indicating that the mid cap segment should be considered a separate asset class unto itself.

Consistent Performance Versus Small Caps

While in many cases an asset class that delivers meaningful long-term outperformance can be expected to lag during bear markets, this has not been the case with mid caps. Since 1979, mid caps outperformed small caps in 79% of the months in which the small cap Russell 2000® Index had a negative return. In the months in which small-cap returns were positive, mid caps outperformed nearly 40% of the time. Overall, mid caps outpaced small caps 53% of the time. This demonstrates that a key element of mid caps' strong historical relative performance has been their tendency to preserve capital in down markets.

U.S. Mid caps outperformed small caps, especially in falling markets

Russell Midcap® Index versus the Russell 2000® Index
U.S. mid caps have preserved capital and compounded returns for favorable performance since January 1979.



Source: Robeco Investment Management.
Data as of June 30, 2013.
Please refer to the Performance Disclosures on the last page for important disclosures.

Favorable Upside Capture Relative to Large Caps

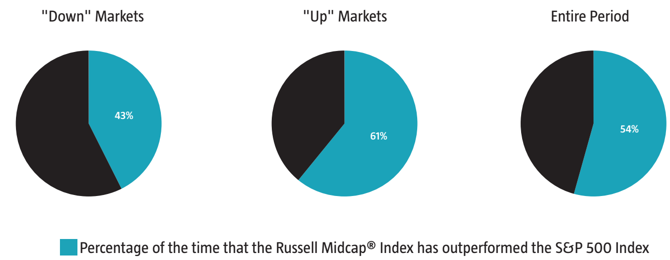
U.S. mid caps have also displayed a favorable return profile compared to large caps. In the months since January 1979 when the large cap S&P 500 Index produced a positive return, mid caps outperformed 61% of the time. In down months, mid caps outperformed 43% of the time. In total, mid caps outperformed large caps in 54% of the months measured. We can see that an important element of mid caps' historical performance advantage over large caps has been their tendency to outperform in rising markets.

In summary, mid caps have performed better than large caps in rising markets and have been less volatile than small caps when stock prices are falling. In this way, U.S. mid caps provide both upside capture and downside protection relative to other segments of the market. These performance profiles make the case for the asset class as a source of diversification in portfolios that are invested primarily in large and small cap stocks.

Mid caps outperformed large caps, especially in rising markets

Russell Midcap® Index versus the S&P 500 Index

U.S. mid caps have preserved capital and compounded returns for favorable performance since January 1979.



Source: Robeco Investment Management.
Data as of June 30, 2013.
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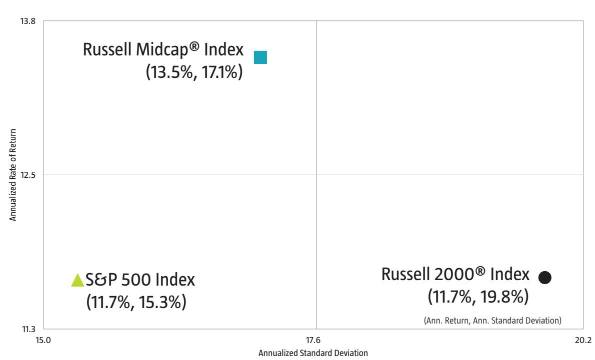
Deliver Returns with Lower Risk than Small Caps

U.S. mid caps have delivered better returns than small and large caps over time, and they have done so without an inordinate amount of volatility. In fact, mid caps have experienced slightly higher volatility than large caps and less volatility than small caps. As a result, mid caps have not just outperformed, but they have done so with a lower level of risk than the rest of the market.

Another way to look at the relationship between risk and return is the Sharpe ratio, a measure of risk-adjusted performance.[1] On this front, mid caps have displayed a superior risk-return profile than that of both small and large companies when measured over multiple time periods.

U.S. mid cap stocks have an attractive combination of risk and reward

January 1979 through June 2013



Source: Robeco Investment Management.
Data as of June 30, 2013.
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An Overlooked Asset Class

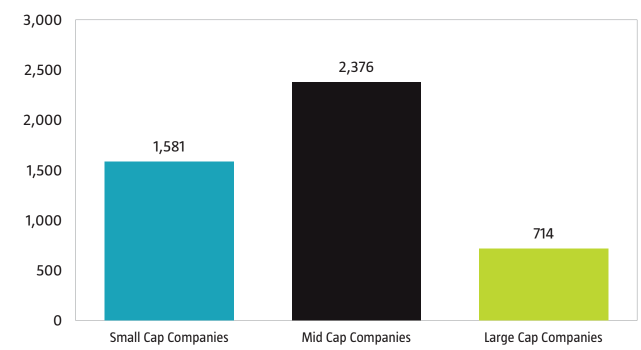
One of the most compelling features of mid caps is the low level of investor participation in relation to the size of the asset class. This suggests that there is greater opportunity for active managers to exploit inefficiencies within the mid cap segment compared to both large and small company stocks. The U.S. market has over 4,100 companies with market capitalizations of at least $200 million. Many investors may be surprised to learn that for all of the attention given to large and small cap stocks in allocation models, more than half of the securities in this investable universe fall within the mid cap range.

[1] Sharpe ratio analytics are detailed on page 5.

Looked at another way, the mid cap asset class has nearly five times as many investable companies as large caps, and over 30% more than small caps. U.S. mid caps are clearly "the heart of the market," providing the largest investable universe and highest number of potential opportunities.

Despite this, mid cap companies are not nearly as widely followed by sell-side research analysts as their large cap counterparts. The median coverage for each large cap stock is 18 analysts, yet for mid cap stocks the number is only 10. Fewer analysts, in turn, equates to greater latitude for managers to exploit inefficiencies through stock selection.

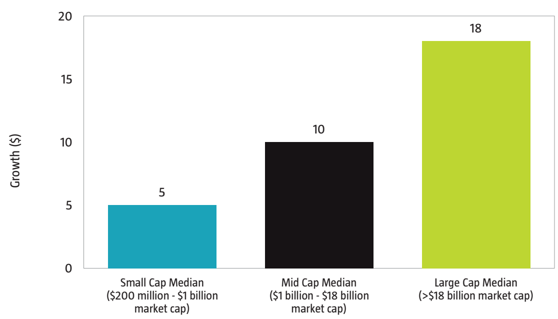
Investing in the heart of the market



Source: Factset Research Systems. Data as of June 30, 2013.
Vision Universe: >$200 million market capitalization.
Please refer to the Performance Disclosures on the last page for important disclosures.

Mid cap stocks are not widely followed

Median analyst coverage per stock



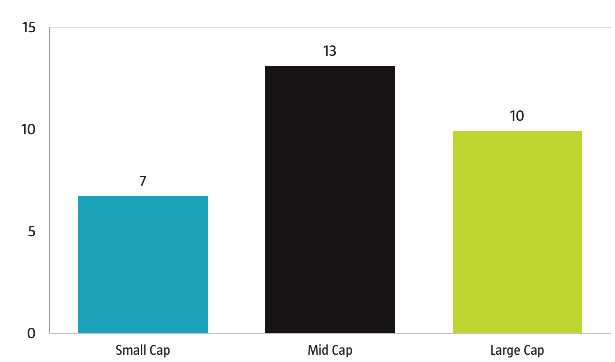
Source: Factset Research Systems and Robeco Investment Management. Data as of June 30, 2013.
This is a hypothetical illustration and not indicative of any investment.
Vision Universe: >$200 million market capitalization, excluding financials and REITs.

Interestingly, mid caps are not receiving their proportional share of investor assets. The chart above looks at the amount of market cap available per dollar invested in the large, mid and small cap tiers. U.S. mid caps have the most "real estate" available given the money flowing into the asset class — 30% more than large caps and nearly double that of small caps. This indicates that the mid-cap market is less crowded than the other segments of the market. In other words, there is a smaller amount of money flowing into a larger number of stocks.

In summary, U.S. mid caps provide active managers with more latitude to add value than either large or small caps. What's more, if the disparity between market cap and asset allocation in the mid cap space comes into balance over time, the resulting inflow of cash into the asset class would provide additional support for its long-term performance.

Mid cap is uncrowded

Amount of market cap available per dollars invested



Source: Morningstar and Robeco Investment Management.
Data as of June 30, 2013.
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The Risk of Underweighting Mid Caps

Investors' tendency to underweight mid caps may be a result of the assumption that buying a large cap fund and a small cap fund provides appropriate exposure to the mid cap space.

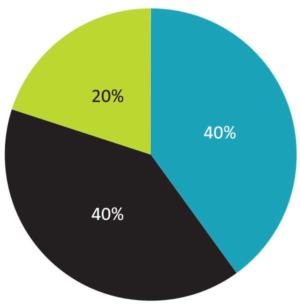
In reality, this is not the case. Based on mutual fund allocations, the average investor is significantly underweight in mid caps.

For an asset class with superior absolute and risk-adjusted returns, a weighting at least equal to that of the market — if not an outright overweight — seems to be a more appropriate position. Investors may therefore want to consider the risk of not holding sufficient mid-cap exposure in their portfolios.

The potential risk of being underweight in mid cap stocks is evident from the following tables. An investor who opted for a market weight, or ideally an overweight, in mid cap stocks would have enjoyed substantially higher returns over all trailing time periods, without a substantial increase in portfolio risk.

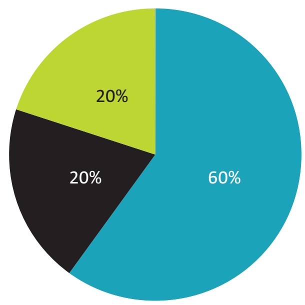
Comparison of return and risk for mid cap allocation scenarios

Portfolio 1



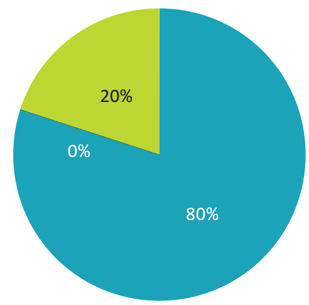
40% S&P 500 Index
40% Russell Midcap® Index
20% Russell 2000® Index

Portfolio 2



60% S&P 500 Index
20% Russell Midcap® Index
20% Russell 2000® Index

Portfolio 3



80% S&P 500 Index
0% Russell Midcap® Index
20% Russell 2000® Index

	5 Year			10 Year			20 Year			30 Year		
	Return (%)	Standard Deviation	Sharpe Ratio	Return (%)	Standard Deviation	Sharpe Ratio	Return (%)	Standard Deviation	Sharpe Ratio	Return (%)	Standard Deviation	Sharpe Ratio
Portfolio 1	7.94	20.87	0.46	9.15	16.59	0.51	9.62	16.16	0.47	10.77	16.29	0.45
Portfolio 2	7.70	20.09	0.46	8.48	15.96	0.49	9.23	15.77	0.45	10.55	15.92	0.45
Portfolio 3	7.39	19.36	0.46	7.78	15.38	0.46	8.78	15.46	0.43	10.28	15.62	0.44
S&P 500 Index	7.01	18.42	0.45	7.30	14.58	0.44	8.66	15.15	0.43	10.54	15.30	0.46
Russell Midcap® Index	8.28	22.31	0.46	10.65	17.67	0.57	10.70	16.89	0.51	11.72	16.96	0.49
Russell 2000® Index	8.77	24.07	0.46	9.53	19.74	0.48	8.88	19.61	0.38	8.83	19.52	0.32

Source: Bloomberg. Data as of June 30, 2013. Data assumes annual rebalancing.
Please refer to the Performance Disclosures on the last page for important disclosures.

Additional Reasons to Ensure Adequate U.S. Mid Cap Stock Exposure

U.S. mid caps offer more than just a strong track record of risk and return. The asset class also features superior earnings growth, compelling valuations, the potential to benefit from an environment of slow economic growth and a high representation of companies at a dynamic point in their life cycle.

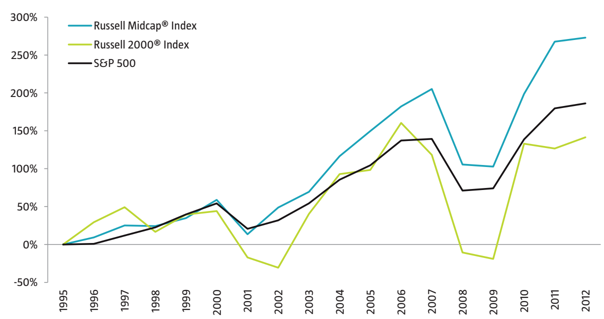
Consistent Growth Profile

U.S. mid cap stocks, as a group, offer a better earnings growth profile than investors can find in other segments of the market. Not only has the asset class produced higher cumulative growth in the 15-year period ended in December 2011 …

… but it has also featured a higher trailing 10-year growth rate for seven years running.

Small, mid, and large cap growth

Earnings growth rates favor mid caps: 1996 through June 2013



Source: Bloomberg.
Data as of December 31, 2012.
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Slow Economic Growth May Spur Acquisitions

Slower growth is typically a negative for the stock market, but a prolonged period of economic doldrums can actually be a positive for mid caps because it often spurs an increase in merger and acquisition activity. Large caps, which have record levels of cash on their balance sheets, can essentially "buy growth" by purchasing companies with faster growth rates. U.S. mid caps are a fertile hunting ground for larger, cash-rich companies, thanks to their compelling combination of superior earnings growth and attractive valuations.

The "Sweet Spot"

The mid cap segment offers a different type of company than investors find within the large and small cap "bookends" of the market. The mid cap asset class is characterized by companies that are more successful and mature than those in the small cap arena, which makes mid caps generally less risky than small caps. At the same time, mid cap firms start from a lower baseline in terms of business volume and are generally more nimble than those in the large cap space, which creates more upside potential. U.S. mid caps also present investors with the opportunity to select companies that have "graduated" from small cap status, indicating that their businesses are moving in the right direction.

Performance

Russell Midcap® Index delivered the fastest growth in seven of the eight years

	10 Year Trailing Earnings Growth (%)							
	2012	2011	2010	2009	2008	2007	2006	2005
S&P 500 Index	8.05	8.77	4.47	2.24	3.39	7.90	8.93	7.41
Russell Midcap® Index	9.63	12.48	6.52	4.16	5.16	9.34	9.94	9.58
Russell 2000® Index	13.27	10.59	4.93	-5.29	-2.62	3.59	7.26	7.09

Source: Bloomberg.
Data as of December 31, 2012.

Conclusion: Now is the Time to Look at U.S. Mid Cap Strategies for Your Clients

Over time, U.S. mid caps have provided investors with both strong absolute returns and a favorable risk/reward profile compared to other segments of the U.S. stock market. Typically, a rational investor could be expected to hold a market weight, if not an overweight, in an asset class with these favorable characteristics. Instead, mid caps are frequently under-represented in investor portfolios. We hope the preceding information will help investors move forward to rectify that.

About Robeco Investment Management, Inc.

Robeco Investment Management, Inc. is an SEC-registered Investment Adviser consisting of two investment divisions: Robeco Boston Partners and Robeco Weiss, Peck & Greer. Robeco Investment Management is a wholly-owned subsidiary of Robeco Group. Robeco is majority owned by ORIX Corporation, a financial services company based in Japan. Robeco Investment Management offers investment products and services to institutional and private investors worldwide. Robeco Boston Partners is the subadviser to John Hancock Disciplined Value and Disciplined Value Mid Cap Funds.

About the Authors

David J. Gullen, CFA, CAIA

Mr. Gullen is a managing director at Robeco Investment Management and has extensive experience with all of the firm's Value Equity disciplines as a product specialist. He joined the firm from Decision Analytics, a registered investment adviser consulting institutions on investing balance sheet cash. Prior to this, he had been a risk management consultant for Wells Fargo Bank. Mr. Gullen holds a B.A. degree in history from Georgetown University, where he also received a master's degree in public policy. He holds the Chartered Financial Analyst and the Chartered Alternative Investment Analyst designations as well as FINRA licenses 7 and 63. He is in his twelfth year with the firm and has fifteen years of industry experience.

Steven L. Pollack, CFA

Mr. Pollack is the portfolio manager for Robeco Boston Partners Mid Cap Value Equity product. Steve joined the firm from Hughes Investments where he spent twelve years as an equity portfolio manager, managing value equity across the market capitalization spectrum. Prior to Hughes Investments, Steve was with Remington, Inc., and Arthur Anderson & Co. Mr. Pollack is a graduate from Georgia Institute of Technology and holds an M.B.A. from The Anderson School of Management at the University of California at Los Angeles. He holds the Chartered Financial Analyst designation. Steve is in his thirteenth year with the firm and has twenty-nine years of investment experience.

Robeco Investment Management Disclosure

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Sharpe ratio measures risk-adjusted performance. The Sharpe ratio is calculated by subtracting the risk-free rate — such as that of the 10-year U.S. Treasury bond — from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

Standard deviation is a measure of the dispersion of a set of data from its mean.

The Russell Midcap® Index is a market-capitalization-weighted index representing the smallest 800 companies in the Russell 1000® Index. The average Russell Midcap® Index member has a market cap of $8 billion to $10 billion, with a median value of $4 billion to $5 billion. The Russell 2000® Index is an index measuring the performance of the 2,000 smallest companies in the Russell 3000® Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000® Index serves as a benchmark for small-cap stocks in the United States. The S&P 500 Index is a free-float capitalization-weighted index, published since 1957, of the prices of 500 large-cap common stocks actively traded in the United States.

Past performance is no indication of future performance of an index. It is not possible to invest directly in an index.

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Robeco Boston Partners | One Beacon Street, Boston, MA 02108 tel: 617-832-8200 fax: 617-832-8135

Robeco Weiss, Peck & Greer | 909 Third Avenue, New York, New York 10022 tel: 212-908-9500 fax: 212-908-9672 **www.robecoinvest.com**