EXECUTIVE SUMMARY

• Small capitalization stocks have generally outperformed larger peers over time.

• Volatility of small cap stocks has exceeded large cap over time; however, a diversified portfolio that includes both small and large cap stocks can enhance the risk/return profile of a portfolio.

• Active managers have outperformed the Russell 2000 over a variety of time periods.
Companies with small capitalizations are generally earlier in the life cycle, usually with faster earnings growth and less diversified end markets than their large capitalization peers. While there is no absolute characterization of what constitutes a small capitalization name, one of the most commonly used benchmarks to track the performance of small cap stocks is the Russell 2000. The Russell 2000 is comprised of the smallest 2000 names within the broad-market Russell 3000, with the remainder representing the large-cap Russell 1000. The Russell 3000 is weighted by market cap, and is therefore dominated by the names in the Russell 1000. In fact, the Russell 2000 accounts for only 8% of the weight of the Russell 3000 with two-thirds of the constituents (Figure 1).

As Figure 2 shows, when compared with the Russell 1000, the Russell 2000 has faster earnings growth. This isn’t surprising considering the more mature nature of the larger peers’ business models and end markets. Smaller companies also generally have a lower dividend yield, higher price to earnings ratio, lower return on equity and operating margin, and greater volatility, as measured by beta. Also, given the greater degree of operating risk, small companies carry less financial leverage, as measured by debt-to-capital.

As Figure 3 illustrates, by sector, the Russell 2000 is more exposed to the more economically cyclical and volatile sectors, including Consumer Discretionary, Financials and Industrials, and less exposed to the more mature and capital intensive sectors, including Consumer Staples, Energy and Telecom.

Many of these statistics suggest that the risk and volatility experienced by small capitalization names may be too great to warrant investment in the group, particularly for more risk-averse investors. However, the greater long-term performance and the diversification benefit make small cap investments a valuable part of a balanced investment allocation. Small caps have unique characteristics that may help add to performance, including the fact that they are less followed by Wall Street Analysts (average company in Russell 2000 followed by 5 analysts compared with 21 for Russell Top 200, according to HighMark Capital Management). Also, valuation and price movements are more often driven by company specific factors than broad domestic and foreign macro trends, suggesting opportunity for active managers.

![Figure 1. % Contribution to Russell 3000](image)

![Figure 2. Weighted harmonic average (mutes the impact of outliers)](image)

<table>
<thead>
<tr>
<th></th>
<th>Russell 2000</th>
<th>Russell 1000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Capitalization ($b, Wgt Avg)</td>
<td>1.8</td>
<td>130.0</td>
</tr>
<tr>
<td>Estimated LT EPS Growth (Wgt Harm Avg)</td>
<td>12.0%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Dividend Yield (Wgt Avg)</td>
<td>1.47%</td>
<td>1.98%</td>
</tr>
<tr>
<td>Price to Forward EPS (Wgt Harm Avg)</td>
<td>16.8</td>
<td>15.9</td>
</tr>
<tr>
<td>ROE (Wgt Avg)</td>
<td>11.0%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Operating Margin</td>
<td>11.2%</td>
<td>20.4%</td>
</tr>
<tr>
<td>Projected Beta</td>
<td>1.19%</td>
<td>1.01%</td>
</tr>
</tbody>
</table>

![Figure 3. Sector Weights of Russell 2000 and Russell 1000](image)

As of 08/31/16. Source: FactSet Research Systems Inc.
HISTORICAL PERFORMANCE OF SMALL CAP

While investing in small cap stocks has traditionally delivered higher levels of return, it also has experienced a greater degree of volatility. According to Kenneth French data, dating back to 1927 through August of 2016, small capitalization stocks (as measured by the smallest 30% of companies) returned 15.4% annually, while the middle 40% returned 13.9% and the largest 30% returned 11.0%. Figure 4 illustrates the consistency of that outperformance, with the small cap group outperforming the large cap group in 8 of the past 9 decades, often by a substantial amount. During the current bull market, small caps have outperformed large caps, as shown on Figure 5. This was not, however, the case in 2015, when the S&P 500 returned 1.4% compared with the S&P Small Cap 600, which returned -2.0%.

The absolute level of volatility overstates the risk when viewed in a portfolio context, considering the diversification benefit. As Figure 6 illustrates, when all publicly traded U.S. stocks are separated into quintiles based on market capitalization, the largest quintile and the smallest quintile are only 72% correlated with each other, substantially lower than any other pairing of quintiles. Therefore, while the absolute level of volatility for smaller cap names is higher than large cap, when combined into a portfolio, the low correlation creates a diversification benefit.

Figure 5. Performance of small vs. large during current bull market

Figure 6. Correlation of Monthly Returns by Market Capitalization Quintile (11/1963 - 08/2016)

<table>
<thead>
<tr>
<th>Smallest Quintile</th>
<th>Quintile 2</th>
<th>Quintile 3</th>
<th>Quintile 4</th>
<th>Largest Quintile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smallest Quintile</td>
<td>100%</td>
<td>92%</td>
<td>87%</td>
<td>82%</td>
</tr>
<tr>
<td>Quintile 2</td>
<td>100%</td>
<td>98%</td>
<td>94%</td>
<td>87%</td>
</tr>
<tr>
<td>Quintile 3</td>
<td>100%</td>
<td>98%</td>
<td>92%</td>
<td></td>
</tr>
<tr>
<td>Quintile 4</td>
<td>100%</td>
<td>96%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Largest Quintile</td>
<td></td>
<td>100%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Kenneth French, CRSP

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
HISTORICAL PERFORMANCE OF SMALL CAP

When analyzing risk, it is important to understand how small cap stocks perform in periods of stress. In this regard, small caps have historically been less volatile than suggested by analyzing volatility of return. Figure 7 shows how the Russell 2000 performed during the bear market periods since 2000 (defined as a 20% decline without a 20% rally). During the periods shown, the Russell 2000 averaged a decline of 34%, only slightly worse than the 33% decline of the Russell 1000. In bull markets, however, the outperformance of the Russell 2000 is dramatic, averaging 135% return versus only 114% for the Russell 1000 as described in Figure 8.

We believe active management has added value over time in the small capitalization space. The combination of the large universe of stocks, the lower level of attention from Wall Street analysts, and the undiversified business models has resulted in a less efficient market, which has allowed outperformance of active managers versus the Russell 2000. As Figure 9 illustrates, more than 50% of managers outperformed the index over a 5, 10 and 20-year horizon, with nearly two-thirds outperforming over the past three years.

Figure 7. Performance vs. Bear Markets since 2000
20% correction without a 20% rally

![Figure 7](image)

Source: FactSet Research Systems, Inc.

Figure 8. Performance vs. Bull Markets since 2000
20% rally without a 20% correction

![Figure 8](image)

Source: FactSet Research Systems, Inc.; Morningstar

* Current bull market is still in place since 12/31/14.

Source: FactSet Research Systems, Inc.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
CONCLUSION

Small capitalization stocks have consistently outperformed large caps over the long term, but in 2014 that trend reversed. Given the severity of the performance gap, investors may be underweighted small caps relative to their optimal allocation. Investors should talk to their advisors about their allocation to small caps. There are near term trends that support a recovery in small caps, including the move in the dollar and trends in the M&A market.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Important Disclosures

This material is not a recommendation to buy, sell, hold, or rollover any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

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Principal Risks

Investing in mutual funds involves risk, including the possible loss of principal. Investors' shares, when redeemed, may be worth more or less than their original cost.

Investing in small cap stocks are subject to the risks of investing in equity securities (including small companies). Funds that concentrate on specific sectors or smaller capitalization ranges may be subject to greater volatility than that of other mutual funds.

Index Definitions

Russell 1000® Index: An unmanaged index that measures the performance of the large-cap segment of the U.S. equity universe.

Russell 2000® Index: An unmanaged index that measures the performance of the small-capitalization segment of the U.S. equity universe.

Russell 3000® Index: An unmanaged index that measures the performance of the 3,000 largest U.S. companies in the investable U.S. equity universe.

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