HENNESSY FUNDS

Mid-Cap *White Paper*

The Power of Mid-Caps: Investing in a "Sweet Spot" of the Market

We believe U.S. mid-cap companies offer untapped potential for investors. In this paper, we discuss the merits of allocating to this area of the market. We examine the features unique to many mid-cap stocks, the economic case behind the strong performance of mid-cap stocks, the circumstances that keep them out of the investment limelight, as well as their historical risk and return metrics.

Executive Summary

Investors can select among small, mid and large capitalization companies to meet their U.S. equity allocation goals, and then weight their portfolio appropriately to fit their risk and return preferences. Many investors follow the daily performance of the S&P 500 Index and the Dow Jones Industrial Average and are familiar with many larger companies. At the other end of the spectrum, small companies hold investors' interest because of their long-standing reputation for growth and superior returns. This dual focus can result in investors concentrating on primarily large- and small-cap stocks, neglecting specifically mid-cap stocks altogether.

Wall Street coverage of mid-cap stocks is relatively poor, which presents an opportunity for investors to find, and invest in, well-managed, thriving mid-cap companies whose prices may not yet reflect their value or potential. In addition, mid-cap stocks tend to be under-owned by investors, with assets invested in mid-cap equities significantly smaller than relative market capitalization analysis would suggest.

While small-cap stocks have a reputation for delivering some of the best returns in the stock market, in fact mid-cap stocks have outperformed both small- and large-caps over the long term. And, mid-caps have produced that superior return with less risk than that of small-cap stocks.

At this point in the cycle, with a strong U.S. Dollar and the potential for slower growth following a long expansion, we believe characteristics such as domestic orientation and earnings resilience make mid-cap stocks even more attractive.

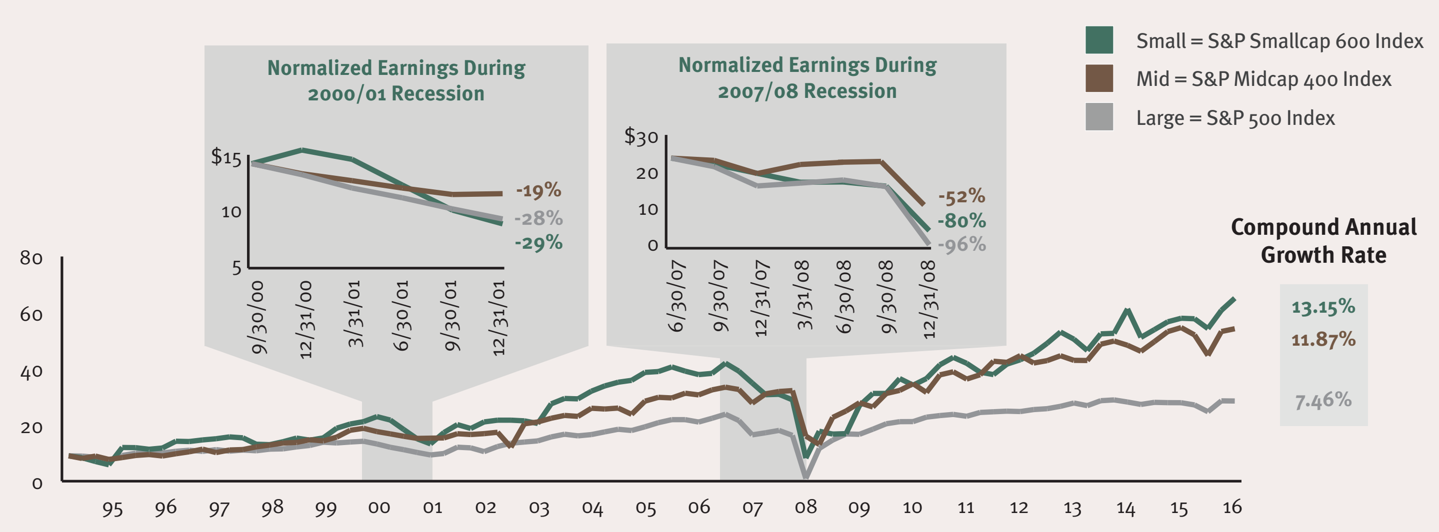
I. The Mid-Cap Market Opportunity

Mid-cap companies, generally defined as those with a market cap of between $2 billion and $10 billion, are sometimes referred to as the "sweet spot" of the U.S. equity market. Mid-cap companies are generally small enough in size to offer higher long-term growth potential akin to a small company. This growth potential is theoretically higher than the growth potential of large companies, which almost by definition tend to operate in more mature industries and have less opportunity to grow by gaining market share.

However, in contrast to small companies, mid-cap businesses often enjoy greater access to capital and more established, dominant market positions, and they often have management teams with greater experience. In an S&P Dow Jones Indices report, contributing authors Fei Mei Chan and Craig Lazara maintain that mid-sized businesses have "successfully navigated the challenges inherent to small companies," yet the size of the business is "not so large that rapid growth is unattainable."[1]

The favorable combination of fundamentals alluded to by Chan and Lazara may also help to explain why the earnings of mid-cap companies have shown more resilience in the last two economic downturns than the earnings of both large-cap and small-cap companies. In the 2000/01 recession, the earnings of the S&P Midcap 400 Index companies fell just 19% peak to trough, while the earnings of the S&P 600 Smallcap Index companies fell 29% and the earnings of the S&P 500 Index companies fell 28% (see chart below). In the following recession of 2007/08, the chart below shows mid-cap earnings fell 52% peak to trough, while earnings from small-cap and large-cap stocks fell 80% and 96%, respectively.

Earnings for Large-, Mid- and Small-Caps (1995-2016)



Earnings growth is not a measure of the fund's future performance.

Source: Bloomberg as of 12/31/16

1. Chan, Fei Mei and Lazzara, Craig J. "Mid Cap: A Sweet Spot for Performance." S&P Dow Jones Indices, September 2015.

If mid-cap stocks show more earnings stability during recessions, they might be expected to grow more slowly in periods of economic expansion. Indeed, over the past three expansions, spanning 1995-2016, mid-cap earnings growth has lagged small-cap earnings growth. However, the difference in the average annualized growth rates in the expansion years has been relatively small: 17% for mid-cap stocks versus 20% for small-cap stocks. And, both mid-cap and small-cap earnings growth have significantly outpaced that of large-cap stocks. In effect, earnings resilience in downturns and strong growth during recoveries have allowed mid-cap earnings to almost keep pace with small-cap earnings growth over the long term (posting an annual growth rate of 12% compared to 13% for small-cap earnings), while exhibiting less volatility.

II. An Overlooked Area of the Market

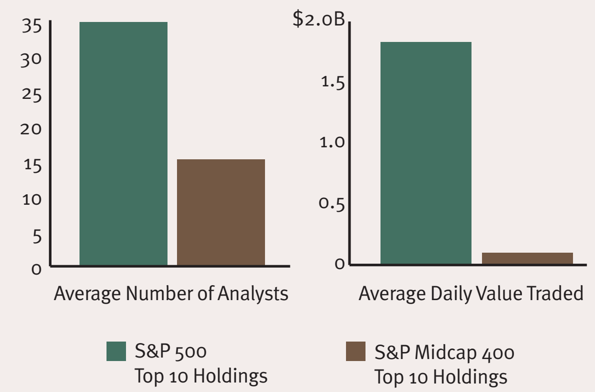
Low Research Analyst Coverage

Research coverage by large brokerage firms has historically elevated investors' awareness of publicly traded companies. Smaller companies, however, are increasingly being ignored by research analysts. Regulatory reforms put in place a decade ago have required the separation of Investment Banking from Research. As a result, research departments at large, integrated Wall Street firms have been forced to scale back on personnel and have struggled to provide coverage for thousands of U.S. publicly traded companies. According to the World Federation of Exchanges, approximately 35% to 40% of all publicly traded equities in the world have no research coverage at all, and it is the smaller, less liquid companies that tend to slip through the cracks.[2] Broker-dealers often have less incentive to cover small and mid sized companies, as larger, more liquid companies generate higher trading commission revenue and are more likely to generate higher investment banking fees.

Comparisons of analyst ratings and daily trading volumes between large-cap and mid-cap companies demonstrate this disparity. The largest companies in the S&P 500 Index, on average, attracted nearly twice the number of analysts than the ten largest companies in the S&P Midcap 400 Index. The average daily value traded over the last week in January 2017 for the top ten companies in the S&P 500 Index was $1.83 billion, while the average daily value traded for the top ten companies in the S&P Midcap 400 Index over the same period was just $101.5 million.

With less analyst coverage, perhaps many mid-cap companies with strong business models and successful track records are not being discovered and

Mid-Caps Receive Less Research Coverage and Have a Lower Trading Value



Source: Bloomberg as of 1/31/17

2. Canivet, Justin, "Small Cap Analyst Coverage: An 'Under-the-Radar' Dilemma" World Federation of Exchanges, 2010.

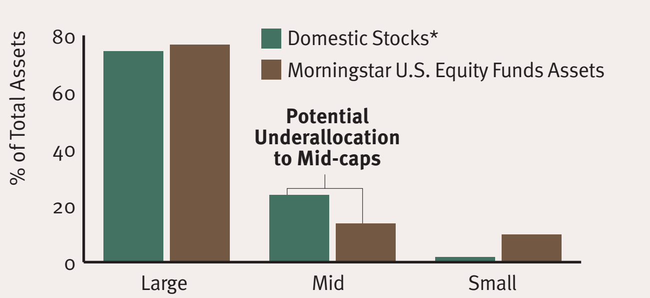
appreciated by the market as they deserve. This failure, in turn, may give those investors who do focus their time and energy on researching mid-cap companies an opportunity to find and invest in undervalued and underappreciated stocks.

Historical Underallocation to Mid-Caps

Investors appear to be chronically underweight mid-cap stocks. Many small- and large-cap funds often extend their reach into the mid-cap space, and investors may believe they have covered the entire market-cap spectrum with their allocation to small- and large-cap funds alone. Some investors may not appreciate the potential benefits of making a specific allocation to mid-cap stocks.

A comparison of market capitalizations against mutual fund assets helps to quantify the extent of this underweight position. Using the S&P Midcap 400 Index market capitalization range, as of December 31, 2016, mid-cap stocks accounted for approximately 20% of the total market capitalization of U.S. companies. Yet, among all mutual funds and exchange-traded funds in Morningstar's U.S. large, mid and small fund categories, less than 14% of assets were invested in the mid-cap fund category.

Investors May Be Underallocated to Mid-Caps



Source: Morningstar as of 12/31/16
**Traded on Major U.S. Exchanges*

III. Mid-Cap Performance

A Note About Benchmarks

A number of indices can be used to track the performance of small-, mid- and large-cap segments of the U.S. equity market, with indices from Russell and S&P Dow Jones arguably among the most commonly used. However, index construction methodology, market capitalization range and number of constituents differ significantly between these two index providers.

Russell annually ranks all eligible securities in the U.S. stock market based on descending order of total market capitalization and selects those ranked from 201 to 1,000 for inclusion in the Russell Midcap Index. As of January 31, 2017, the Russell Midcap Index held approximately 800 stocks with market capitalizations ranging from $84.5 million to as high as $59.3 billion, with a median market cap of $6.8 billion.

Defining Mid-caps: Methodology Differences Between Russell and S&P Indices

	Russell Midcap	S&P Midcap 400
Number of stocks	~800	400
Median market cap	$6.8B	$3.8B
Smallest stock by market cap	$84.5M	$1.1B
Largest stock by market cap	$59.3B	$10.8B

Source: Bloomberg as of 1/31/17

Whereas Russell uses market cap alone to select its constituents, the S&P Dow Jones uses additional criteria, such as liquidity and financial viability, to identify which 400 stocks should be included in their mid-cap index. As of January 31, 2017, the market cap of the smallest stock among the S&P Midcap 400 holdings was $1.08 billion, while that of the largest was $10.8 billion, resulting in a median market cap of $3.8 billion.

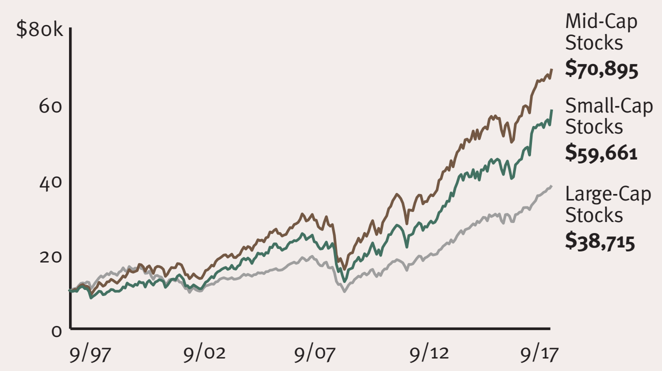
While the Russell Midcap Index tends to be more commonly used as a benchmark for mid-cap mutual funds, it includes a number of companies that would traditionally be considered large-cap. For the purposes of comparing performance within this White Paper, we believe it is most appropriate to use the S&P Midcap 400 Index, which is limited to companies with market caps more commonly defined as purely mid-cap, along with the associated S&P 500 (large-cap) and S&P Smallcap 600 Indices.

HIGHER TOTAL RETURN

It is a widely held perception that small stocks have outperformed their large counterparts over longer periods of time. And this is, by and large, true. Over the last 20 years, small-cap stocks have outperformed large-cap stocks by quite a large margin. As shown in the chart, a hypothetical $10,000 investment in small-cap stocks would have been worth nearly $60,000 20 years later, 54% more than the same investment in large-cap stocks, which would have been worth nearly $39,000 at the end of the 20-year period ended September 30, 2017.

However, in what may come as a surprise to many investors, that same $10,000 invested in mid-cap stocks would have yielded the highest return of all over the 20-year period—worth nearly $71,000. Mid-cap stocks have produced the highest returns over the 20-year period, 19% higher than the returns of small-caps and almost twice the return of large-caps.

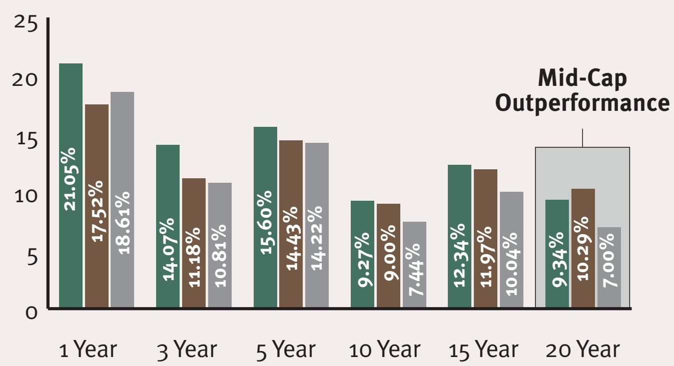
MID-CAPS DOMINATE PERFORMANCE
(HYPOTHETICAL GROWTH OF $10,000 – 9/30/97-9/30/17)



Source: Morningstar

This chart illustrates the performance of a hypothetical $10,000 investment and does not imply future performance. One cannot invest directly in an index.

MARKET CAP AVERAGE ANNUAL TOTAL RETURNS
(AS OF 9/30/17)



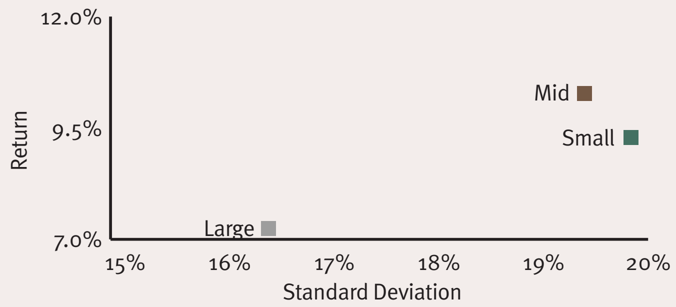
Source: Morningstar

Past performance does not guarantee future results.

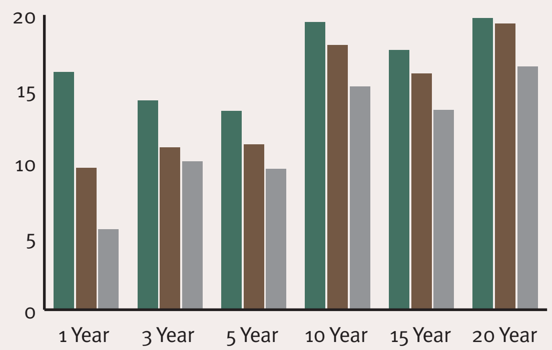
Key to Charts

- Small = S&P Smallcap 600 Index
- Mid = S&P Midcap 400 Index
- Large = S&P 500 Index

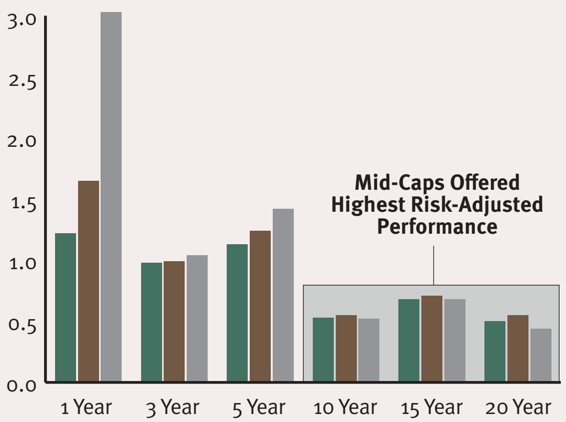
Risk/Return Over 20 Years (as of 9/30/17)



Standard Deviation (as of 9/30/17)



Sharpe Ratios (as of 9/30/17)



Source: Morningstar

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Lower Volatility, Better Risk-Adjusted Performance

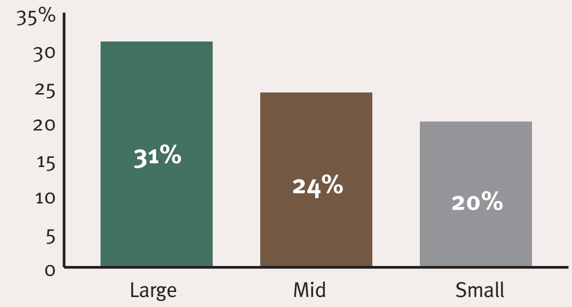
Not only have mid-cap stocks generated higher absolute returns than the much feted small-cap stocks, mid-caps have also provided these superior returns with less associated risk. Using standard deviation as a statistical measure of historical volatility, investors in mid-cap stocks have consistently been rewarded with lower risk relative to small-cap investors over the 1, 3, 5, 10, 15 and 20 years ended September 30, 2017. While mid-caps have historically exhibited higher standard deviation than large-caps, investors were compensated for this higher volatility with higher returns for the 5, 10, 15 and 20 year periods.

The balance between the risk and reward offered by an investment vehicle is encapsulated in a statistical measure called the Sharpe ratio. Measuring how much return an investor has received for the level of risk taken, the Sharpe ratio is a risk-adjusted measure of return used to evaluate the historical performance of an index or fund. Mid-cap stocks have generated higher Sharpe ratios than either large-cap or small-cap stocks for the 10, 15 and 20 year periods ended September 30, 2017.

IV. Stronger U.S. Dollar Trend Favors Mid-Caps

Periods of U.S. Dollar strength, such as the period between June 2014 and December 2016, can cause challenges for multi-national companies with global sales. Foreign earnings when translated back into U.S. Dollars are smaller than they otherwise would be, and exporters must adjust their prices downward or risk being priced out of their markets. These difficulties are especially acute for large companies that tend to have higher export ratios than smaller companies. On average, large companies in the S&P 500 Index generate 31% of revenues from foreign sources, compared with just 24% for the mid-cap companies in the S&P Midcap 400 Index. And for small companies in the S&P Smallcap 600 Index, the ratio is 20%. As a result, mid-cap companies should find their profits relatively well insulated from negative foreign exchange effects, should the U.S. Dollar continue to strengthen.

Average Revenue from Foreign Sources



Source: Bloomberg as of 12/31/16

Final Thoughts

Sitting in the "sweet spot" of the market, mid-caps present a compelling investment case, and we believe they deserve to play a more significant role in investors' portfolios. Their position in the stable growth phase of a businesses' life cycle along with their historical outperformance and favorable risk attributes provide strong evidence that mid-cap stocks merit a permanent position in any U.S. equity portfolio.

Moreover, at this point in the cycle when profit growth for large companies is being crimped by the strong U.S. Dollar, and a period of slower growth may be approaching following the long economic expansion, the cyclical case for earnings-resilient, domestic-oriented mid-cap stocks appears strong.

Investors looking to add greater alpha to the mid-cap allocation of their portfolios, may want to consider a concentrated strategy. With a focused strategy of selecting among the best of the mid-caps, we believe investors have the opportunity to outperform the overall mid-cap category. A portfolio does not have the opportunity to outperform the benchmark if its composition mirrors the benchmark. Furthermore, research has shown that the extent to which a fund's holdings differ from those of its benchmark—its active share—can have a significant correlation with its ability to outperform its index.[3]

3. Cremers, Martijn and Petajisto, Antti. "How Active Is Your Fund Manager? A New Measure That Predicts Performance," The Review of Financial Studies, V. 22 n9 2009, pp 3329 - 3365 , which cites data from the period 1990-2003.

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About Hennessy Funds

Founded in 1989, Hennessy Funds has a longstanding track record of performance and offers a broad range of mutual funds, with strategies that can play a role in nearly every investor's portfolio allocation. Our line-up includes domestic equity, sector and specialty as well as multi-asset products. Each of the Hennessy Funds employ a consistent and repeatable investment process, combining time-tested stock selection strategies with a highly disciplined, team-managed approach. Our goal is to provide products that investors can have confidence in, knowing their money is invested as promised, with their best interest in mind.

Hennessy Funds offers two complementary mid-cap portfolios. The **Hennessy Focus Fund (HFCSX/HFCIX)** is a high conviction, "best ideas" portfolio of 20-30 stocks that embraces a patient, long-term perspective and invests in companies that, we believe, represent future growth engines. The **Hennessy Cornerstone Mid Cap 30 Fund (HFMDX/HIMDX)** is a concentrated portfolio of 30 proven domestic mid-cap companies that have exhibited growth in both earnings and stock price and that, we believe, are trading at a discount.

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Important Disclosure

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. This and other important information can be found in the Fund's statutory and summary prospectuses. To obtain a free prospectus, please call 800-966-4354 or visit hennessyfunds.com. Please read the prospectus carefully before investing.

Mutual fund investing involves risk; Principal loss is possible. Small and medium-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies. The Cornerstone Mid Cap 30 Fund's formula-based strategy may cause the Fund to buy or sell securities at times when it may not be advantageous. The Focus Fund is a non-diversified fund, meaning that it may concentrate its assets in fewer holdings than a diversified fund and be more exposed to individual stock volatility than a diversified fund. Investments in foreign securities may involve greater volatility and political, economic and currency risk and differences in accounting methods.

The S&P 500 Index is an unmanaged index commonly used to measure the performance of large-cap U.S. stocks. The S&P Midcap 400 Index is an unmanaged index used to measure the performance of mid-cap U.S. stocks. The S&P Smallcap 600 Index is an unmanaged index used as a measure the performance of small-cap U.S. stocks. The Russell Midcap Index is an unmanaged index commonly used to measure the performance of U.S. mid-cap stocks. One cannot invest directly in an index. The Dow Jones Industrial Average is an unmanaged index commonly used to measure the performance of U.S. stocks. The compound annual growth rate is the mean annual growth rate of an investment over a specified period of time longer than one year. Median market cap is the midpoint of market capitalization (market price multiplied by the number of shares outstanding) of the stocks in a portfolio. Half the stocks in the portfolio will have higher market capitalizations; half will have lower. Standard deviation is a statistical measure of the historical volatility of a mutual fund or portfolio. Sharpe ratio is a risk-adjusted measure of return that is often used to evaluate the performance of a portfolio.

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