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 primarily on large- and small-cap stocks and neglecting mid-cap stocks altogether.

Mid-cap stocks offer investors the opportunity to invest in established businesses run by seasoned management teams, which are growing earnings at some of the fastest rates in the market.

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 the potential for slower growth following a long expansion, characteristics such as earnings resilience make mid-cap stocks even more attractive.

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 in descending order by market capitalization and selects those ranked from 201 to 1,000 for inclusion in the Russell Midcap Index. As of January 31, 2018, the Russell Midcap Index held approximately 780 stocks with market capitalizations ranging from $821 million to $37.6 billion, with a median and average market cap of $8.3 billion and $15.6 billion respectively.

Whereas Russell uses market-cap alone to select constituents for its indices, S&P uses additional criteria such as liquidity and financial stability, as well as market-cap to select the 400 stocks to be included in their mid-cap index. As of January 31, 2018, the market cap of the smallest stock among the S&P Midcap 400 Index holdings was $860 million, while that of the largest was $12.6 billion, (excluding one outlier with a market cap of $25.6 billion), resulting in a median and average market cap of $4.1 billion and $4.6 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 large-cap companies. For the purposes of comparing performance within this White Paper, we believe it is more 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.

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

	Russell Midcap	S&P Midcap 400
Number of stocks	780	400
Median market cap	$8.3B	$4.1B
Smallest stock by market cap	$821.0M	$860.0M
Largest stock by market cap	$37.6B	$12.6B

**Excludes one outlier with a market cap of $25.6 billion*
Source: Bloomberg as of 1/31/18

I. The Mid-Cap Market Opportunity

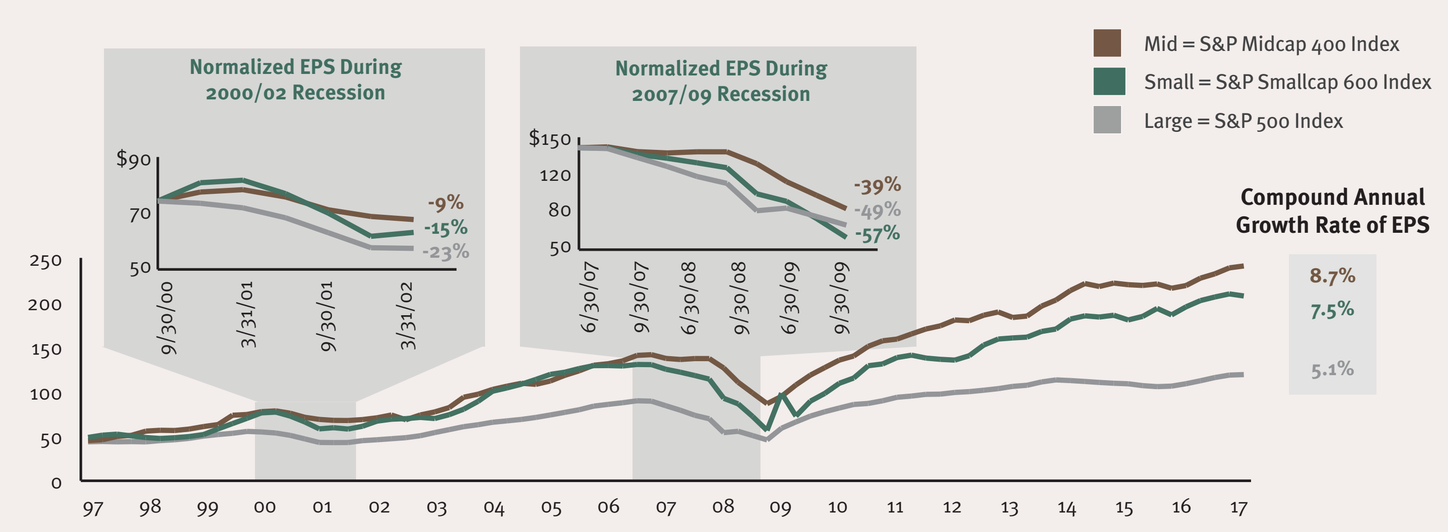
Mid-cap companies, generally defined as those with a market cap of between $2 billion and $10 billion, are sometimes referred to as the "sweet spot" of the U.S. equity market. Mid-cap companies are generally small enough in size to offer higher long-term growth potential akin to a small company. This growth potential is theoretically higher than the growth potential of many large companies, which 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 have established more dominant market positions. They also tend to have management teams with more 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 2000/02 recession, the earnings per share (EPS) of the S&P Midcap 400 Index companies fell just 9% peak to trough, while the EPS of the S&P Smallcap 600 Index fell 15% and the EPS of the S&P 500 Index fell 23% (see left chart below). In the following recession of 2007/09, (see right chart below), mid-cap EPS fell 39% peak to trough, while EPS from small-cap and large-cap stocks fell 57% and 49%, respectively.

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 last complete expansion, 2002-2007, annualized EPS growth from mid-cap companies averaged 15.7%, in line with, but just below annualized EPS growth from both small- and large-cap companies of 17.6% and 15.9% respectively. However, in the current expansion, which began in 2009, mid-cap companies have been outperforming both large- and small-cap companies in terms of EPS growth. Mid-cap companies lead the field with annualized EPS growth of 14.3% over the last seven years vs. 11.2% and 10.6% for small- and large-cap companies respectively. In effect, over the latest 20-year period, earnings resilience in downturns and strong growth during recoveries have allowed mid-cap earnings to exhibit the fastest growth of all the three major market-cap sectors, posting annualized EPS growth of 8.7% from 1997-2017, compared with 7.5% from small-caps and 5.1% from large-caps.

EARNINGS PER SHARE FOR LARGE-, MID- AND SMALL-CAPS (1997-2017)



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

Source: Bloomberg as of 12/31/17

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

II. An Overlooked Area of the Market

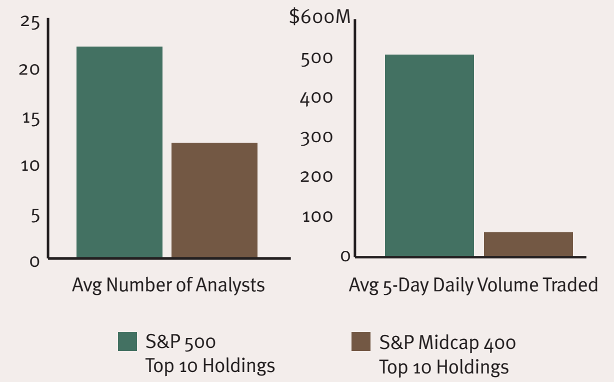
Low Research Analyst Coverage

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 more than 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. As of January 31, 2018, the ten largest companies in the S&P 500 Index, on average, received analyst coverage from 22 broker-dealers and generated an average of nearly $511 million of average 5-day daily trading volume per company. By comparison, the top ten largest companies in the S&P Midcap 400 Index, on average, attracted coverage from 12 brokers and generated just $63 million of average 5-day daily trading volume per company.

With less analyst coverage, perhaps many mid-cap companies with strong business models and successful track records are not being discovered and appreciated by the market as much 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.

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



Source: Bloomberg as of 1/31/18

Historical Underallocation to Mid-Caps

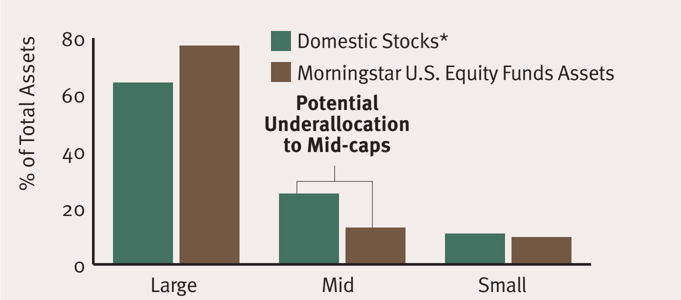
Investors appear to be chronically underweight mid-cap stocks. Many small- and large-cap funds often extend their reach into the mid-cap space, and investors may believe they have covered the entire market-cap spectrum with their allocation to small- and large-cap funds alone. Some investors may not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

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

underweight position. Using the S&P Midcap 400 Index market capitalization range (as of December 2017) mid-cap stocks accounted for 25% 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, only 13% of assets were invested in the mid-cap fund category.

INVESTORS MAY BE UNDERALLOCATED TO MID-CAPS



Source: Morningstar as of 12/31/17
**Traded on Major U.S. Exchanges*

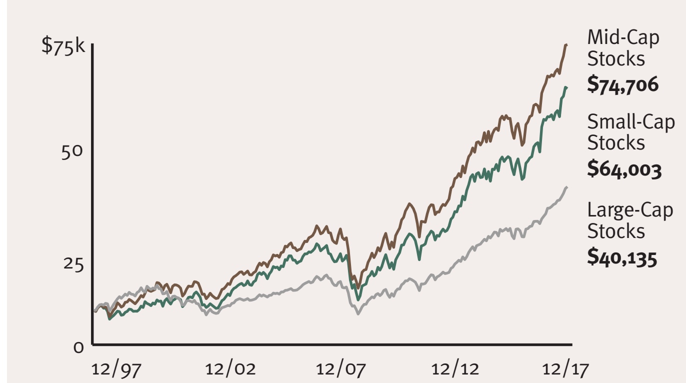
III. MID-CAP PERFORMANCE

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 just over $64,000 20 years later, 60% more than the same investment in large-cap stocks, which would have been worth approximately $40,000 at the end of the 20-year period ended December 31, 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 $75,000. Mid-cap stocks have produced the highest returns over the 20-year period, 17% higher than the returns of small-caps and 86% higher than the returns of large-caps.

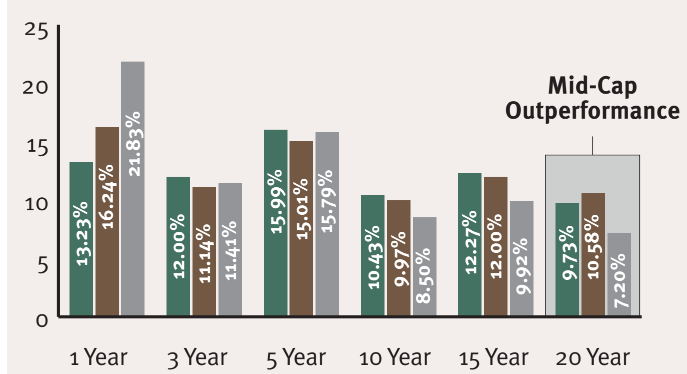
MID-CAPS DOMINATE PERFORMANCE
(HYPOTHETICAL GROWTH OF $10,000 – 12/31/97-12/31/17)



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 12/31/17)



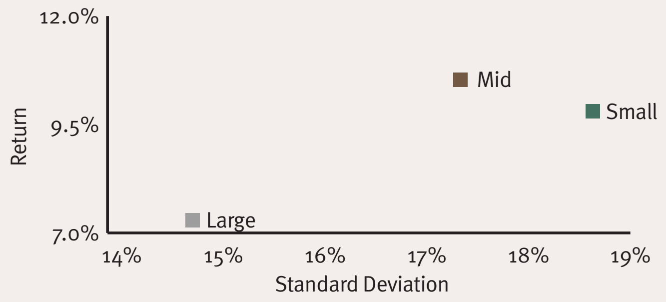
Source: Morningstar

Key to Charts

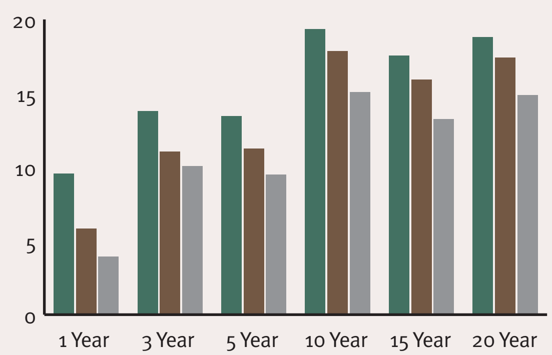
- Mid = S&P Midcap 400 Index
- Small = S&P Smallcap 600 Index
- Large = S&P 500 Index

Past performance does not guarantee future results.

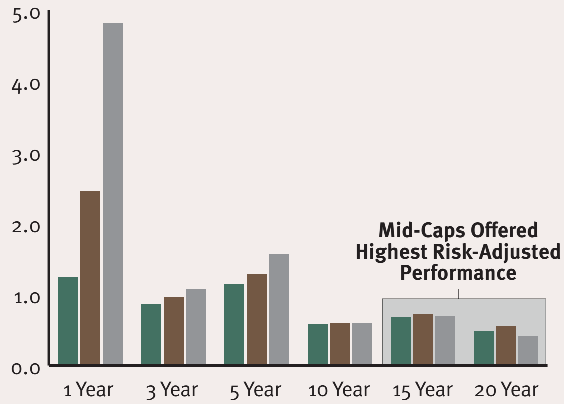
Risk/Return Over 20 Years (as of 12/31/17)



Standard Deviation (as of 12/31/17)



Sharpe Ratios (as of 12/31/17)



Source: Morningstar

Past performance does not guarantee future results.

Key to Charts

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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 December 31, 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.

As shown in the chart to the left, mid-cap stocks have generated higher Sharpe ratios than either large-cap or small-cap stocks for the 15- and 20-year periods ending December 31, 2017.

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 a period of slower growth may be approaching following the long economic expansion, the cyclical case for earnings-resilient, mid-cap stocks appears convincing.

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]

HENNESSY'S MID-CAP OFFERINGS

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.

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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HENNESSY FUNDS

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.

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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.

Index performance is not indicative of fund performance. To obtain fund performance call 800-966-4354 or visit our website at hennessyfunds.com.

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