What have you done with my small-cap premium?

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Summary:

Evidence for the small-cap premium has been around for 30 years. Many investors take it as given that small-cap stocks outperform medium- and large-caps. However, an analysis of long term returns of US stocks tells a different story.

Abstract

Academic research has demonstrated the existence of what is known as the “size” or “small-cap” premium beginning over 30 years ago. Today many investors take it as given that small stocks will outperform large stocks based on this foundational principle of finance. It is a rational expectation, since small stocks are demonstrably more risky than larger stocks, so they should provide investors with additional compensation for bearing this risk in the form of extra return.

With over four decades of return history for the Russell US Indexes we can produce a long-term analysis of the relative performance of large and small US companies using the Russell 1000 large cap index and the Russell 2000 small cap index. Over the last 40 years, large stocks have actually edged out small stocks by a slight margin through the end of 2018.

Source: FTSE Russell. Data from December 31, 1978 - December 31, 2018. Past performance is not guarantee of future results. Please see the end for important legal disclosures.

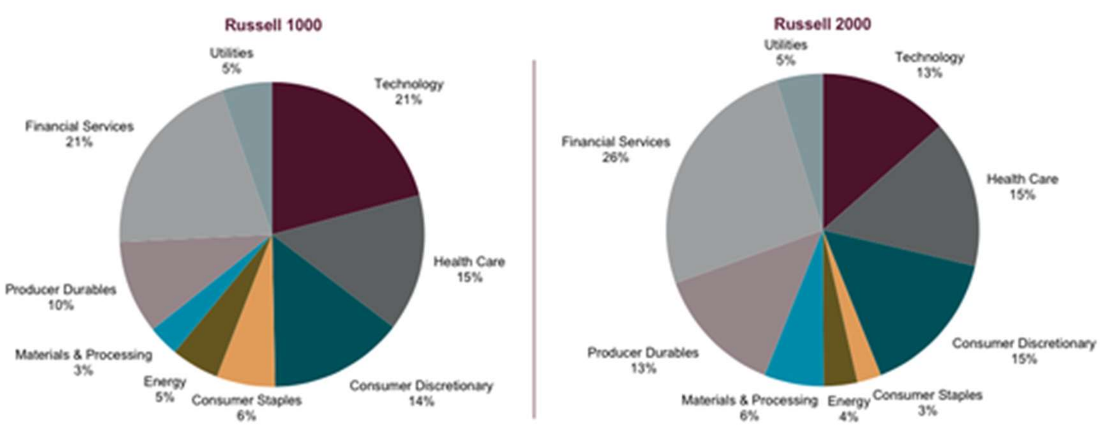
Note that any performance analysis such as this is subject to time period dependency; the results can be unique to the specific time period under consideration, and different conclusions may be reached depending on the time period chosen for the analysis. Digging deeper into the last 40 years demonstrates how different time periods may have produced different outcomes with respect to the performance of large stocks versus small stocks.

Annualized returns			
Time Period (ending 12/31/2018)	**Russell 1000**	**Russell 2000**	**Difference**
40 years	11.5	11.1	0.4
First 10 years (1979-1988)	16.1	16.9	-0.9
Second 10 years (1989-1998)	19.0	12.9	6.1
Third 10 years (1999-2008)	-1.1	3.0	-4.1
Last 10 years (2009-2018)	13.3	12.0	1.3

Source: FTSE Russell. Data from December 31, 1978 - December 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

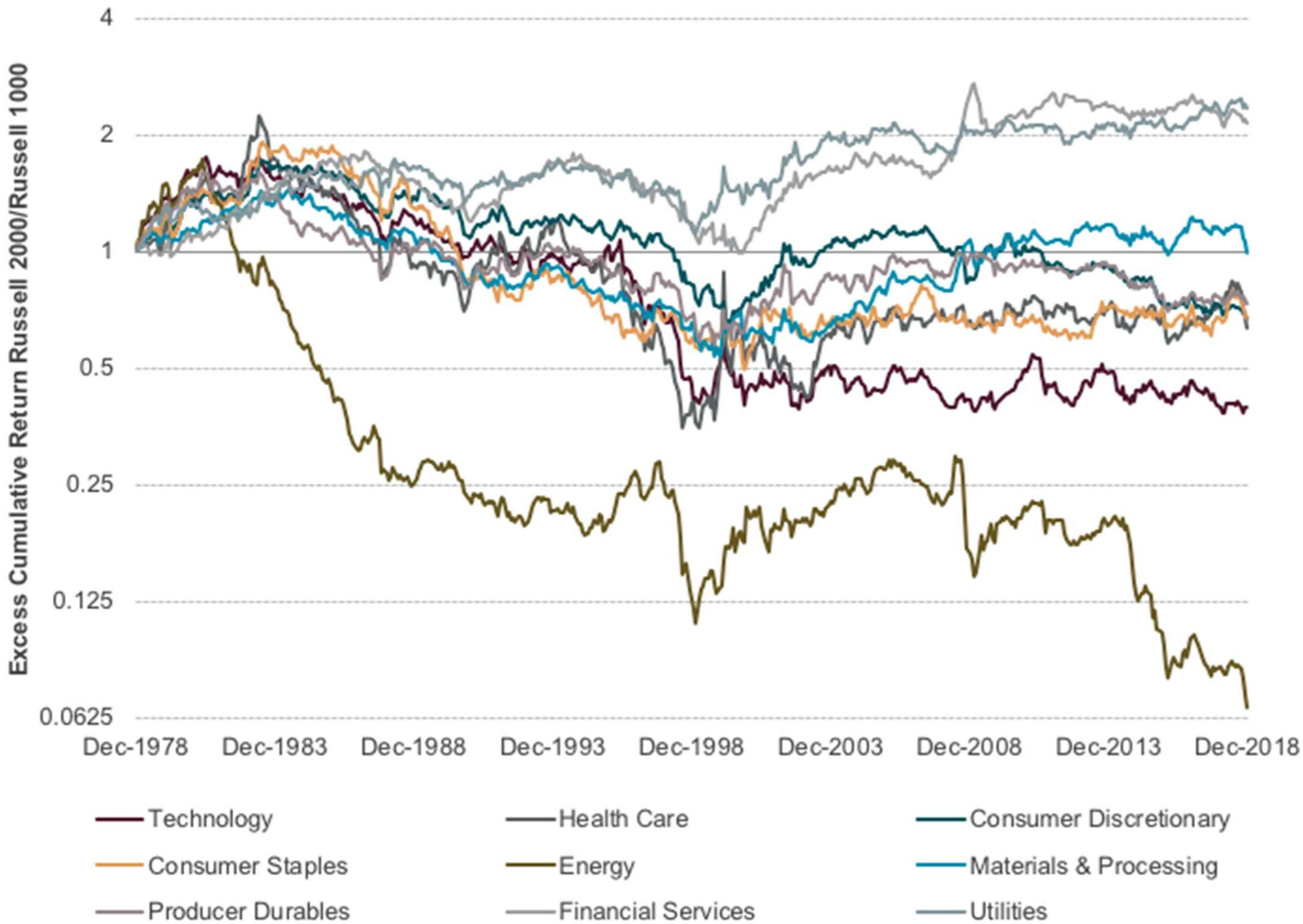
For the entire 40 year period ending December 31, 2018 the Russell 1000 Index would have outperformed the Russell 2000 Index by about 0.4% (40 basis points) on average. However, if we look at each of the successive decades within the longer period we see that this relationship is not always the same. The Russell 2000 would have outperformed the Russell 1000 in the first and third 10-year periods, and underperformed the Russell 1000 in the second and fourth 10-year period. Does this contradict the academic evidence for the small cap premium? Not necessarily, but it does highlight that the small cap premium is not guaranteed over any specific time period. This is why academics require very long time series' for research; the more observations they have, the higher their confidence in the conclusions that they may reach.

Perhaps a more tangible reason for performance differences is the underlying economic sector composition for the Russell 1000 and Russell 2000 Indexes.



Source: FTSE Russell. Data as of December 31, 2018, using the Russell Global Classification System (RGS).

The Russell 1000 is heavily weighted in Technology, while the Russell 2000 is more heavily weighted to Financial Services. The relative performance of these sectors can drive performance differences between large and small stocks, but an even bigger driver of differences is the fact that performance for the same sector can be very different between the indexes.



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Over the last 40 years, Russell 1000 Energy stocks have substantially outperformed their Russell 2000 counterparts by a multiple of over 15 to 1. This is largely driven by the fact that Russell 2000 Energy companies tend to be specialized in industries like Crude Oil Production or Oil Well Services, which have suffered with the decline of oil prices globally, whereas the Russell 1000 Energy sector is dominated by global, Integrated Oil companies, which have more diversified business models. Similarly, large Technology sector companies within the Russell 1000 have grown dramatically relative to their Russell 2000 counterparts, and given the large weight to Technology stocks in both indexes this can frequently be a large contributor to the excess performance of the Russell 1000.

Understanding the economic underpinnings of the Russell 1000 and Russell 2000 Indexes helps investors understand what has driven the relative performance between the two indexes and is a useful analysis for assessing whether to expect a “small cap premium” in the future.

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