Small Capitalizations, Big Opportunities

June 2024

DelMarche

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Abstract

As of March 31st, 2024, the Russell 2000 has underperformed the Russell 1000 on an absolute basis by 10.56%, 6.65%, and 5.10% over the past three-, five-, and ten-year periods. The Russell 2000's failure to keep up with its larger counterpart is a multifaceted story. In this whitepaper we dive into the makeup of the Russell 2000, evaluate the tailwinds Small Caps have had recently, and paint a picture of how to approach the asset class to position your portfolio to take advantage of these opportunities.

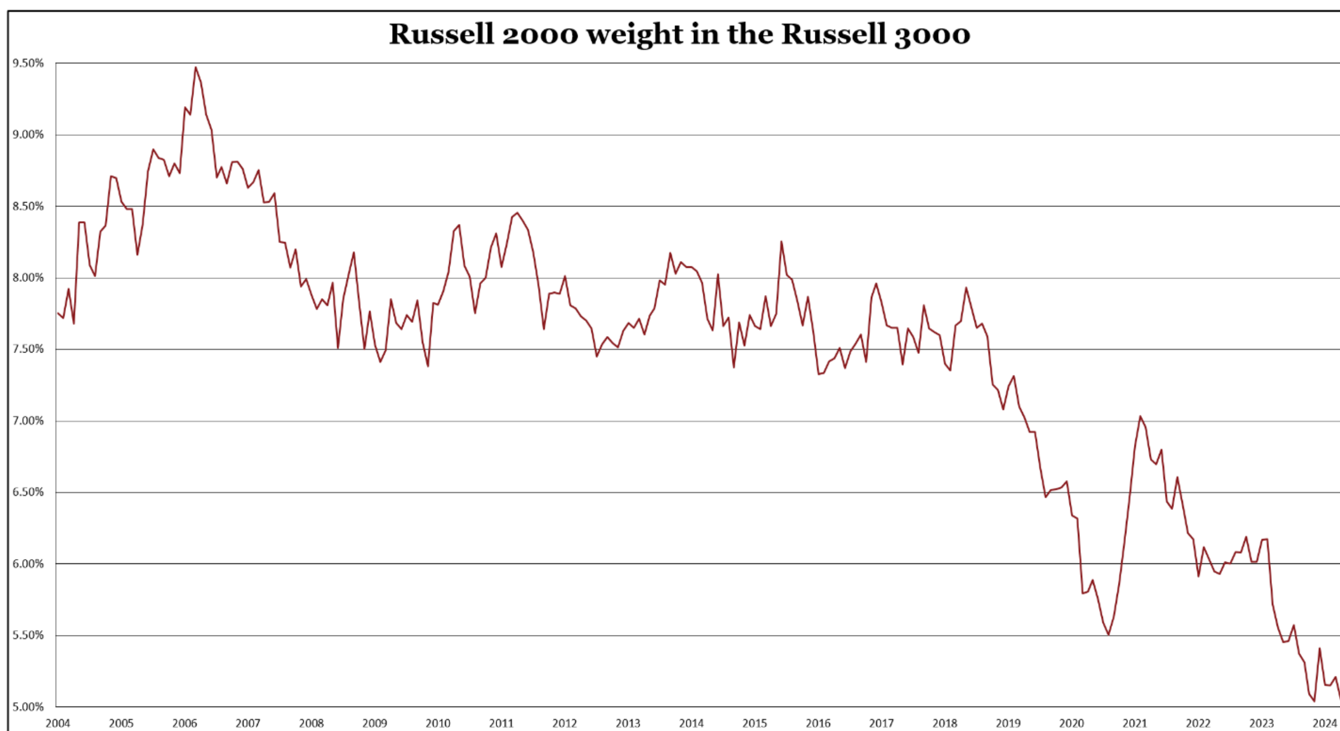
Introduction

On June 28th after the market closes, the Russell indices will finalize their annual rebalancing to help ensure they accurately reflect the market as the companies that make up these indices—and their market caps—expand and contract. As the Russell Indices get their annual makeover, DeMarche sees an opportunity for potential outperformance investing within the smaller part of the market in the next few years. Like any inefficient market, however, an active approach to navigating this space is paramount in today's environment. Even through a near decade of underperformance against other U.S. equity asset classes, we believe the risks in small cap portfolios are worth the diversification benefits, and advocate for higher quality growth and value small cap managers within our clients' portfolios.

Understanding the Universe

As a reminder, the Russell 3000 Index measures the performance of the largest 3,000 U.S. companies, representing approximately 96% of the investable U.S. equity market. The largest 1,000 stocks indexed in the Russell 3000 make up the Russell 1000, while the Russell 2000 is made up of the smallest 2,000 companies of the Russell 3000. As of March 31st, 2024, the Russell 2000 accounts for 5.2% of the Russell 3000's total market cap, the lowest it has been in more than 20 years.

Figure 1



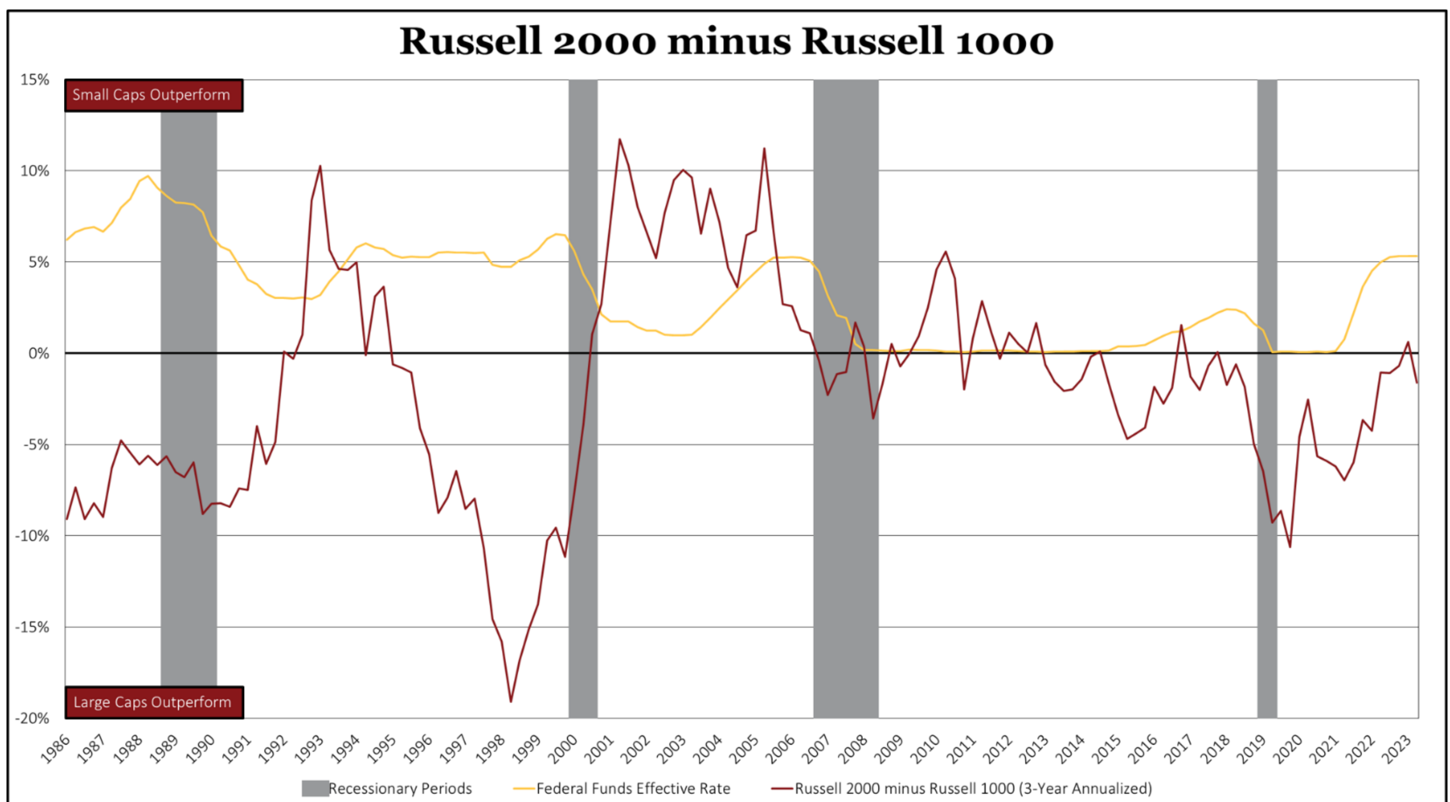
Source: Morningstar

When examining the historical trailing P/E ratios for indices versus their current valuations, the Russell 2000 is three points below its 10-year historical average (14.37 vs. 17.85), while the Russell 1000 is more than two points above its 10-year historical average (22.93 vs. 20.53). Valuations, however, can be deceiving depending on how stocks in all categories are performing relative to each other.

The opportunity for small caps to revert does not stop at valuation, though. Since its inception, the Russell 2000 has had positive annualized three-year returns in 19 out of 21 quarters following three-year periods with an annualized return of less than 2%, averaging 16.6% during this time. As the three-year annualized return for the Russell 2000 as of the first quarter of 2024 has been less than 2% three of the past four quarters, the odds of a major turnaround look favorable.

Regardless of the historical trends, the market environment can also play a huge factor in small cap performance. The past six recessions have resulted in the Russell 2000 beating their larger counterpart by approximately 5.5% on an annualized basis during the 12 months after a recession started. Regardless of whether we enter a recessionary period, changes in interest rates are another attributable factor that affect small cap names more than large cap. The past three years have been difficult for small cap companies because of rising interest rates. Inflated interest rates more adversely impact small cap companies, which are frequently required to take on more short-term financing and floating rate debt compared to the larger companies in the U.S. equity market. Since the indices were founded in 1984, the Russell 2000 has outperformed the Russell 1000 by a total of 18.9% in the 22 quarters after the Federal Funds Effective Rate dropped by 50 basis points or more. Despite the “higher for longer” sentiment we have seen recently, even a small drop in interest rates could benefit the health of balance sheets for many small cap companies.

Figure 2



Source: Federal Reserve Bank of St. Louis

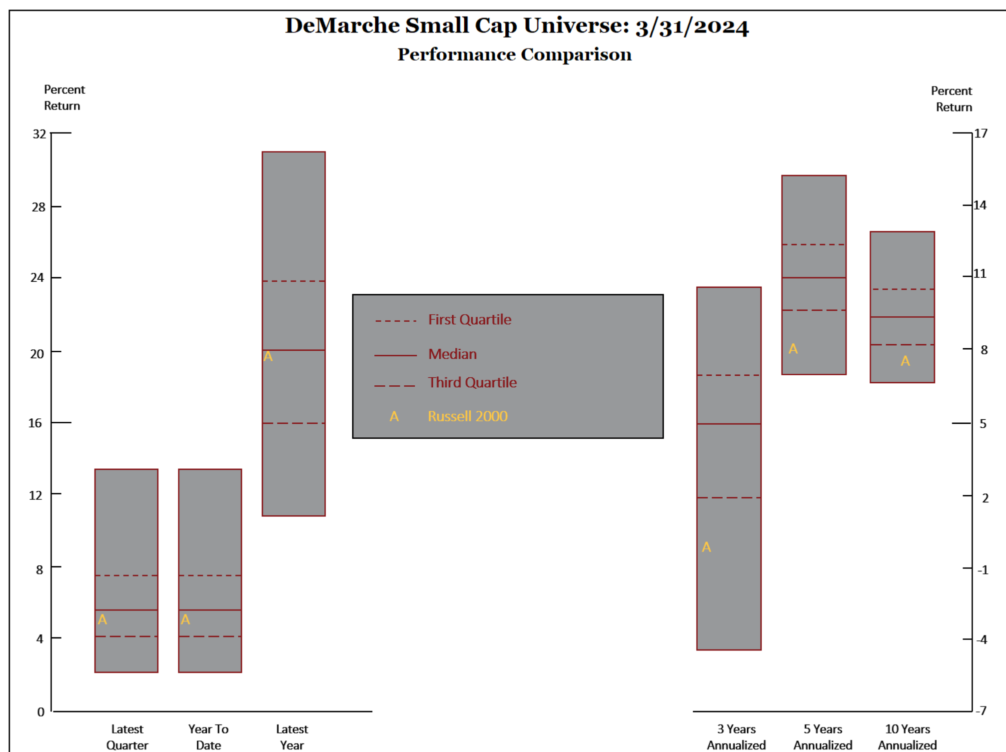
A Misconstrued Market

As noted in the DeMarche Capital Markets Review for the first quarter of 2024, passive investment products held more assets than their actively managed counterparts for the first time ever. The total on hand for ETFs and passively managed mutual funds totaled $13.3 trillion while actively managed funds totaled $13.2 trillion. If the market continues down its passive path, there are concerns that the efficient markets hypothesis that passive funds rely upon will no longer be applicable. For example, more than 42% of the companies in the Russell 2000 were not profitable at the end of 2023. Even the U.S. Small Cap S&P 600 Index—which is deemed "higher quality" by many—has more than 20% of companies in its index with negative earnings! Those taking a passive approach to investing in the U.S. Small Cap Universe are putting their money into both profitable companies with strong balance sheets and economically challenged companies alike. Though there may be some solid turnaround stories within the pool of unprofitable companies, we would argue that many are not worth investing in altogether, and their impact in the index is dragging down total returns for passive investors.

On top of the lack of profitable names, only 29% of companies in the Russell 2000 have an average daily trading volume greater than $15 million per day over the past six months. At $15 million average daily volume traded, it would take a manager approximately 33 trading days to build a $50 million position when trading 10% of the total volume every day. With the average assets under management of $2 billion for all managers in DeMarche's small cap universes, it would take this manager approximately a month and a half to build a 2.5% position. Volatility is a much bigger concern for small cap companies than their larger counterparts. Therefore, it is key for an investment manager to remain nimble from a trading perspective in the small cap space, and assets under management is many times an overlooked, yet an important factor that affects a manager's ability to be nimble.

If you were to narrow down the list of 1,930 companies in the Russell 2000 to only include profitable companies with more than $15 million per day in average daily volume, you are left with just 384 names. When comparing performance to the 100+ small cap strategies in DeMarche's small cap peer universe, the Russell 2000 sits in the bottom quartile amongst all managers on an absolute basis for the past three-, five-, and ten-year periods. This suggests an active approach with a recommended manager in the small cap space has been important, no matter where we are in the market cycle.

Figure 3



Source: DeMarche

Analyzing Active Managers

With an understanding of the immense opportunity and inefficient nature of the U.S. small cap market, the next question is how can you take advantage of it? Three characteristics to be cognizant of when choosing an active manager to navigate the U.S. small cap space include assets under management, number of holdings, and turnover—all of which work in tandem due to the constraints found in the Russell 2000's investable universe.

When evaluating managers, DeMarche makes it a point of emphasis to ask and continuously monitor the amount a manager has in assets under management, the number of holdings a strategy has, and how turnover has been versus its historical averages. It is also important to understand how the decision to close or restrict investment in the strategy is made. We understand there are many different approaches to generating alpha in an inefficient market, but have been surprised how much a strategy's style can change when management firms put the growth of their bottom line over the goodwill of their clients by growing their assets under management above a reasonable level.

Neither assets under management, number of holdings, nor turnover have hard and fast thresholds that make them uninvestable. Rather, a manager who has historically high turnover (say 100% or more) and a low number of holdings (say 50 names) would not feasibly be able to manage a portfolio that is greater than $3 billion in today's market without skewing toward the larger names in the small cap universe. These leading indicators, among the others included in our past white paper "Do Leading Indicators Actually Indicate?" can give you a better glimpse into how DeMarche regularly evaluates manager characteristics to help foresee future outperformance for our clients. If all this feels overwhelming to monitor, don't hesitate to reach out to a DeMarche consultant who can assist you further with these determinants and guide how your small cap exposure should fit within your asset allocation policy.

Conclusion

Despite a disappointing past decade, history has proved to reward those with the patience to stay invested during periods of undesirable performance in the small cap space. Amongst the tailwinds noted, we emphasize the discrepancies between companies in the smaller half of the U.S. public markets and describe factors to be cognizant of when choosing a manager to invest in this market on your behalf. Opportunities like we are seeing in the small cap universe also emphasize the importance of rebalancing your portfolio consistently to meet Investment Policy Statement targets.

Put Research to Work

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Sources Utilized:

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