COMMENTARY

November 13, 2020

Dear Clients and Colleagues:

Small-cap stocks are a great source of alpha in comparison to large-cap stocks, because most of them are underfollowed, despite the fact that they often grow fast. Many small caps are high quality and deliver consistent results, but not many people know about them. As a result, they are often underpriced, which creates opportunities for active managers.

Two commonly used small-cap indices are the Russell 2000 and the S&P 600. Both contain a different number of companies and have different criteria to add a name to the list.

Theoretically, the risk/return profile of various indices in the same universe should be similar. For example in large-cap United States (US) equities, the S&P 500 and Russell 1000 have had similar risk/return profiles (9.92% versus 9.93% per year, respectively, since December 31, 1993).

However, in the small-cap universe, the returns of the Russell 2000 and the S&P 600 have been notably different. Since year-end 1993, the S&P 600 has returned 9.82% per year, while the Russell 2000 has returned 8.58%.


SPX ↑3602.34 +92.90 3601.29/3603.81
At 14:55 d O 3583.04 H 3645.99 L 3583.04 Prev 3509.44
SPX Index Settings Comparative Returns
Range 12/31/1993 - 11/06/2020 Period Daily No. of Period 9807 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPX Index	USD	652.37%	1170.75%	-.89%	9.92%
2)	RIY Index	USD	684.32%	1171.64%	--	9.93%
3)	SML Index	USD	825.22%	1139.32%	-32.31%	9.82%
4)	RTY Index	USD	533.98%	796.62%	-375.02%	8.51%
5)						
6)						

Source: Bloomberg

Why does S&P 600 have superior risk adjusted return?

The criteria used to add a company to S&P 600 is one of the major drivers for the higher risk adjusted return. Let us walk through some of the key differentials between the construction of the Russell 2000 and S&P 600 indices.

The Russell 2000 index is reconstituted annually at the end of June, when securities are ranked according to their total market capitalization as of the last trading day of May. No constituent additions occur after the June reconstitution. During the course of the year, mergers and other corporate actions often reduce the number of Russell 2000 constituents. Constituent deletions may also occur due to bankruptcy, mergers, acquisitions, significant restructuring, or substantial violations of one or more of the eligibility rules.

Conversely, to be eligible for inclusion in the S&P 600, companies must meet various criteria, including market capitalization, liquidity, public float, sector representation, and profitability measures. Since S&P 600 does not follow a scheduled automatic approach, additions and deletions are less predictable. Historically, both indices have similar weighted average market capitalization. However, given the annual reconstitution in Russell 2000, the largest constituents are significantly larger than the average member, and in most instances could be considered mid-cap or large-cap stocks.

The S&P 600 companies are required to have positive earnings according to the generally accepted accounting principles (GAAP) for the most recent four consecutive quarters and the most recent single quarter. The index also requires that at least 50% of shares be publicly floated, while the criteria for Russell 2000 is only 5%.

Empirical evidence has proven that small-cap securities that are profitable and investable have earned higher risk-adjusted returns than those that are not. This is why the S&P 600 has a quality bias and delivered higher historical returns than the Russell 2000.

What changed in 2020?

In 2020, we saw a major trend reversal as the Russell 2000 outperformed the S&P 600 by a huge margin. In other words, quality names have trailed and so have fundamental managers with a quality bias.

Source: Bloomberg

This result does not come as a major surprise when we look at the difference between the sector weightings of the two indices. The Russell 2000 has 21% exposure to the healthcare sector, including a larger exposure to biotech, versus 12% weight in the S&P 600.

Five of the top ten names in the Russell 2000 are healthcare in comparison to just two in the S&P 600. The largest name in the S&P 600 index has a market cap of $4.3 billion versus over $12 billion in the Russell 2000.

What is the takeaway?

The SP 600 has exposure to the “real economy” versus a speculative bias in the Russell 2000. As the real economy recovers from the impact of COVID-19, it’s just a matter of time before quality begins outperforming once again.

Our ability to be highly selective and nimble in our portfolio holdings leaves us well positioned to enter a period of great opportunity for fundamental stock pickers. Our focus on high-quality companies with defensible business models and strong balance sheets should help outperform our small-cap benchmark. As we reflect on the state of markets and the fundamentals of our target companies, we are excited about the current environment and future growth opportunities.

Have a great weekend.

The Global Alpha team