Small Cap is Active Management's Rightful Home

Recent trends show a growing willingness among investors to apply indexing's logic farther down the market-cap ladder. But, when it comes to smaller companies, the indexing argument isn't very convincing. Maintaining exposure to the small-cap "category" through an index-based product eliminates the chance to benefit in an area that, we contend, offers active managers with fundamentals-based strategies the most consistent and pronounced opportunity to generate excess return.

Passive influx: funds form the foundation while ETFs keep piling on...

The Vanguard Group introduced the first index fund at the end of 1975 as a low-cost way for investors to gain exposure to the companies of the S&P 500 Index, which account for roughly 80 percent of the stock market's total capitalization. The strategy initially attracted $11 million in assets under management.

According to S&P Dow Jones Indices, more than $7.8 trillion is currently benchmarked to the S&P 500 Index, "with index assets comprising approximately $2.2 trillion of this total." Other estimates put indexing's reach at more than one out of every three shares outstanding among the index's component companies.

The emergence of exchange-traded funds (ETFs), the first of which was launched in 1993 to track the S&P 500 Index, only adds momentum to passive investing's growing presence within the equity market. Since 2008, when the SEC broadened the scope of allowable ETF strategies, the number of ETFs more than doubled to 1,594 through the end of 2015.

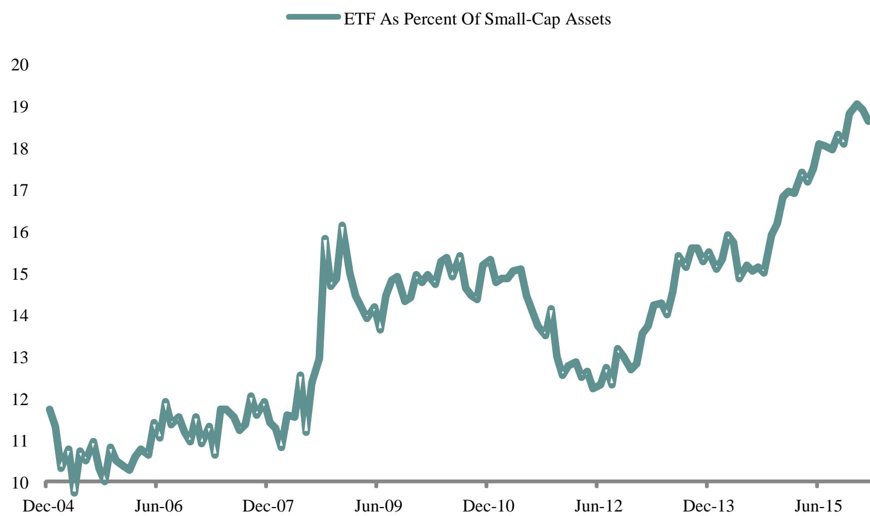
Smaller companies already occupied passive investing space via index mutual funds, but the proliferation of ETFs in recent years helped bring the index-based presence in the small-cap category to new levels. While the typical index fund holder is a retail investor, institutional investors are credited with driving increased ETF demand.

The iShares Russell 2000 ETF, the largest small-cap ETF by assets under management, is the ninth largest among all U.S. equity ETFs and the third most active ETF by average daily volume, according to the ETF Database.

ETFs as a Percentage of Small Cap

The Investment Company Institute's most recent annual fact book showed that small caps accounted for more than 10 percent of the $966 billion dedicated to broad-based domestic equity ETFs at the end of 2015.

Over the past five calendar years, small-cap ETFs attracted $23 billion in inflows while $103 billion fled active small-cap management. As a percentage of total small-cap assets, ETFs now approach 20 percent, data compiled by Jefferies show.



Source: EPFR; Jefferies

Large- and small-cap indexes are different by design...

There's a reason the S&P 500 Index is the inspiration for and the undisputed champion of passive investing strategies. In addition to capturing the vast majority of the market's movements due to the size of the index's components, the index is attractive because a solid, business-specific argument can be made in support of investing in any one of its component companies. That's not the case when it comes to the Russell 2000 Index or its style-focused offspring, the Russell 2000 Growth and Russell 2000 Value Indexes.

After winning consideration via size, the market's biggest companies must pass a series of other hurdles to earn a spot in the S&P 500 Index. From an active manager's point of view, the most important qualification in the group is "financial viability," which is explained in "S&P U.S. Indices Methodology" with this requirement: "The sum of the most recent four consecutive quarters' as-reported earnings should be positive as should be the most recent quarter."

FTSE Russell, the company responsible for Russell U.S. equity indexes, populates its benchmarks through a process that typically begins in late May, when it ranks the thousands of securities that comprise the U.S. equity market by market cap to create the Russell 3000E Index. Then, on the last Friday in June, FTSE Russell initiates what it calls reconstitution, when it unveils results from subdividing the Russell 3000E Index into smaller indexes by market cap and style.

The Russell 3000 Index is the most encompassing of the group, consisting of the 3,000 largest companies and capturing 98 percent of the total market's capitalization. The Russell 2000 Index is assigned companies that rank in size from #1,001 to #3,000 or, said another way, the 2,000 smallest companies from the Russell 3000 Index. The problem is, quality deteriorates as you descend the market-cap ladder.

One out of every four is, as Donald Trump might say, a loser...

If you lend any credence to the idea that an informed investor can pick stocks based on their individual merits, then you must appreciate the role that earnings play as an influence on stock prices. Public corporations are in the money-making business, so their performance is ultimately measured by the profits they generate for shareholders. It's the reason market strategists share their expectations for aggregate earnings performance before they reveal their forecasts as to where they believe the S&P 500 Index and other market barometers will be from one year to the next.

Earnings drive stock prices, so under what circumstances does it make sense for an investor to build a small-cap portfolio in which one out of every four holdings is losing money? Using the Russell 2000 Index's composition as of May 2016, 26.5 percent of the companies in the index for which there was comparable data reported a loss for calendar year 2015. That might be understandable were the economy gripped in the throes of recession, but GDP grew 2.4 percent last year.

The indexing counterpoint is that indexes are market-cap weighted, so prevalence doesn't necessarily make the trend a material performance force. But statistics compiled by Jefferies show that money-losing companies wield considerable heft.

Companies comprising 21.9 percent of the Russell 2000 Index's total market cap fell into the "non-earner" category, meaning consensus earnings estimates forecast these companies for losses in the year ahead, as of April 29, 2016.

In fact, from the first data point Jefferies collected on the topic in January 1985 through April, non-earners represented 19.6 percent of the Russell 2000 Index's market cap on average. By comparison, companies representing just 2.5 percent of the S&P 500 Index's total capitalization are expected to report losses for 2016.

So Much More to Lose in the Small-Cap Space

	% Component Cos w/2015 Losses	Forecast Non-Earners as %age of Mkt Cap
S&P 500 Index	**2.8%**	**2.5%**
Russell 2000 Index	**26.5%**	**21.9%**

Source: FactSet Research Systems, Jefferies

Ripe for stock picking…

Through trading volume and investment banking fees, large companies are the lifeblood of Wall Street. As a result, they attract the lion's share of the investment community's attention. Two dozen analysts dedicate themselves to covering the typical large-cap company. That can be crowded space for active management, which is most effective in conditions that offer an opportunity to build an edge by outworking the next investor.

Smaller companies are fortunate to build a group of professional followers one-third as large as a big company. That means the small-company message is broadcast unevenly at a lower volume, providing investors the opportunity to identify potential differences between reality and investment community expectations.

Less Coverage = More Opportunity

	Average # of Analysts Per Index Company
S&P 500 Index	**22.7**
Russell 2000 Index	**6.5**

Source: Bloomberg

Data compiled by Bank of America Merrill Lynch show that earnings estimates in the small-cap space tend toward variety more than large-cap estimates, which are more tightly grouped. Over the past 10 calendar years, dispersion among analyst earnings estimates for the forward 12 months was 50 percent greater, on average, in the small-cap category compared with the large-cap category.

Adding access fosters prime conditions for bottom-up stock pickers. Smaller-company management teams tend to be more eager to share their stories with prospective investors. With a fleet of analysts positing their company line, large-company executives don't have to be as accessible. In fact, a number of well-known large-cap companies such as AT&T, Coca-Cola, Ford and Alphabet don't provide the investment community with quarterly earnings guidance.

Stay active…

Every market-cap category offers opportunities to outperform through active management, but the small-cap space can be an especially fruitful hunting ground thanks to its scale and variety. It's a place that offers discerning investors the clearest signals to distinguish between promise and potential trouble. Identifying a winner at this level means isolating a company that could be in the early stages of a long-term growth trajectory. Buying any and all small companies through an index-based vehicle is volunteering to own a portfolio with material exposure to fundamentally flawed companies.

The small-cap category is active management's rightful home. Nowhere is more welcoming to fundamentals-based, bottom-up stock picking. Nowhere is the potential to identify actionable investment intelligence through research legwork greater. The small-cap category offers active managers the chance to do what they do best, making active management the best choice for small-cap investors who want a chance to do better than what an index happens to offer.

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