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Small and Mid Cap Allocations to Drive Near- and Long-Term Excess Returns

Patrick Quinn, CFA
Principal

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Small cap stocks have outperformed their large cap counterparts in the US by 200 basis points (bps) per year since 1926. We will discuss the potential advantages of adding a strategic allocation of mid cap equities to the well-documented case for small cap stocks. From a more tactical standpoint, we will put the current environment in context as it relates to the prospects of small and mid cap relative returns. Finally, we'll discuss why we believe it is prudent to utilize active management to maximize the return potential of the inefficient small and mid cap asset class.

The widely accepted total US equity benchmark, the Russell 3000 Index, can be divided into three discrete size segments. First, the Russell Top 200 Index (roughly 200 large cap stocks, 67% of total US market cap), then the Russell Midcap Index (roughly 800 mid cap stocks, 25% of total US market cap), and finally the Russell 2000 Index (roughly 2000 small cap stocks, 8% of total US market cap). The widely accepted small-mid cap benchmark, the Russell 2500 Index, is comprised of the Russell 2000 Index plus the 500 smallest stocks of the 800 in the Russell Midcap Index.

Since the inception of the Russell indices in 1979, the Russell 2500 Index has outpaced the Russell Top 200 Index by 163 bps per year. The risk-adjusted returns have been superior for small-mid caps too, with a Sharpe ratio since inception of 0.35 versus 0.32 for the large cap index. We believe the small-mid cap advantage in benchmark returns (even before considering the return premium of active management) is primarily a function of higher earnings and cash flow growth – the true long-run driver of stock prices.

While many institutional investors utilize a separate allocation for small caps, we believe most do not have the proper exposure to mid caps. This is because many investors incorporate their mid cap exposure within their large cap mandate, often benchmarked to the Russell 1000 (which includes both the Russell Top 200 and Russell Midcap indices). But because 73% of the Russell 1000 is comprised of the largest 200 stocks, large cap managers focus their research time, and portfolio weight, on this relatively efficient segment of the market. According to the eVestment Alliance database, US large cap portfolios are 6% underweight the smaller end of the Russell 1000. Therefore, utilizing a large cap mandate to gain exposure to the mid cap asset class typically results in a strategic underweight to mid caps - a suboptimal solution, since a strong case can be made for a strategic overweight due to mid caps' higher absolute and risk-adjusted returns. And this doesn't even consider the potential opportunity cost of lost alpha due to using managers not focused on the small and mid cap area.

Moving from a strategic discussion to a more tactical one, let's discuss smaller cap equities in the current environment. To gauge investor risk appetite for size during and after recessions, we analyzed relative performance around the last 12 recessions. Small caps consistently underperformed large caps (-11.6% versus -7.4%) during the first half of recessions and outperformed during the second half (18.8% versus 15.0%). Even more importantly, given where we are in the current economic cycle, the small cap outperformance persisted in the year following the end of recessions. Only once in the last 12 recessions has this not been the case. The data also suggest that in year two following the end of a recession, there has been virtually no return differential, on average, among the size segments. Rather, at that point in the cycle, relative performance comes down to fundamentals and valuation.

Some talk about the direction of the US dollar, the interest rate environment, and market direction as drivers of smaller cap relative performance, but an analysis of past cycles suggests there is little correlation to these factors. Instead, the data suggest that small versus large cap performance cycles have been driven by extremes in fear and risk aversion or extremes in relative valuation. The former would favor smaller cap equities currently. From a valuation standpoint, current relative valuations are in line with long-term averages, giving no advantage to any size segment. Therefore, we believe fundamentals are most likely to dictate small-mid cap relative performance beyond year one post this recession.

From a fundamental perspective, we believe small and mid cap companies have better growth profiles than large companies and are less dependent on overall economic growth to fuel earnings. They are essentially the "market share gainers" who are less dependent on overall end market growth that large companies require. The risk to small and mid cap stock prices (as opposed to company fundamentals) is a resurgence of broad-based fear and liquidity concerns. However, we believe the US has passed the economic "Armageddon" scenario. Even if the US is due for a period of subdued economic growth, small and mid cap stocks could perform quite well. Take two of the more lackluster periods of economic growth over the last several decades, July 1973 to December 1975 and January 1979 to March 1983. The cumulative real GDP growth during the first period was 0.9% and small caps outperformed large caps 34.3% versus 17.6% per year. In the second period, cumulative GDP growth over the four years was 2.2% and small caps outperformed large 6.6% versus -1.6% per year.

We also believe the opportunities for small-mid cap active managers are substantial. The fact that small and mid cap equities have less Wall Street coverage, greater earnings forecast dispersion, and higher average earnings surprises is well documented. Lower trading volumes in small and mid caps create volatility, on which we believe well-resourced active managers can capitalize on their deep company knowledge and valuation analysis. Also, active managers can potentially reduce the overall volatility seen in benchmark returns by avoiding the most risky businesses and focusing on those that are less economically dependent and those that have open-ended growth opportunities within the vast universe of small and mid cap companies. From a quantitative standpoint, there has been much research documenting the alpha potential in the small cap space. In particular, a 2005 article in the Journal of Portfolio Management by Gregory Allen of Callan Associates asserts that the average alpha over the past 20 years is over 500 bps annually. There is limited survivorship bias in his data, but Allen admits there is perhaps 100 bps of instant history bias. Even after compensating for this, the data suggest significant opportunity for active managers to add value in smaller cap equities.

In summary, small and mid cap stocks have produced superior returns over long periods of time. We believe this is likely to continue as we exit this recession, but also longer term given superior fundamental characteristics and relative valuations that today are in line with long-term averages. Finally, with a strong case for both a strategic and tactical allocation to small and mid cap equities, we believe utilizing active management within the asset class is the most effective way to maximize its return potential.

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