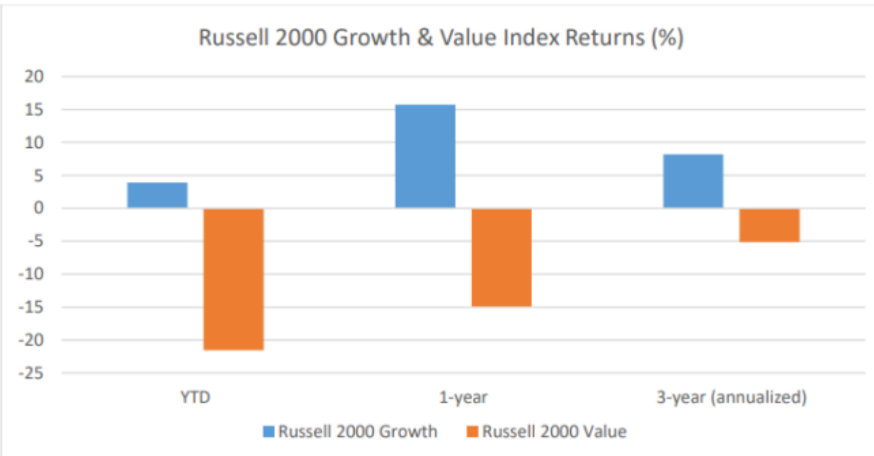
Getting to the core of small cap investing

By: Mike McLean, CFA | & J. Griffith Noble, CFA | October 5, 2020

Boston - Many investors are familiar with the massive outperformance of large cap growth over the last few years, and since the March equity market bottom in particular. It has been easy to attribute this to the success of a small group of dominant growth companies, like Apple, Microsoft and Amazon. These stocks have driven the performance of not only the growth benchmarks, but also the entire market.

What some investors may not realize, however, is that the same dynamic has also held in the far more diversified small-cap market. As of September 30, the Russell 2000 Growth Index has outperformed the Russell 2000 Value Index by more than 25 percentage points year to date, and by more than 13 percentage points annualized over the past three years.

Outperformance of growth over value extends to small caps



Source: FactSet, FTSE Russell, Eaton Vance equity research as of September 30, 2020.

While the five largest holdings account for more than 22% of the S&P 500 Index, and can help explain the outperformance of growth, the five largest holdings in the Russell 2000 Index make up just 2.2% of the Index.

Sectors help to explain growth outperformance

So what explains the outperformance of growth across capitalizations in today's equity markets? Rather than focusing on style, we believe this trend can best be viewed through a sector lens. Two sectors, health care and information technology, account for 55% of the Russell 2000 Growth Index, but only 13% of the Russell 2000 Value Index. On the other side, financials and real estate account for 37% of Russell 2000 Value, but only 8% of Russell 2000 Growth.

Year to date through September 30, some of growth's outperformance makes sense. Many technology firms have been thriving in an environment where an increasing amount of activity is occurring online, and biotech has received a lift from potential COVID-19 vaccines and therapies.

It's a different picture for those prominent value sectors. Just as real estate is struggling with less retail traffic and fewer office workers, banks face headwinds from historically low interest rates and credit concerns related to the economic shutdown.

Going forward, we think the question of growth versus value will come down to the following factors: the path of interest rates, overall economic growth and whether growth companies can live up to the elevated expectations over time. All of these are difficult to predict with any precision.

Bottom line: This uncertainty highlights the opportunity for core managers. We believe a core strategy in small caps can offer better diversification, balance and flexibility than a growth or value strategy dominated by just two sectors. A flexible core strategy may benefit as the extreme growth/value performance gap narrows or as growth further extends its leadership.

Russell 2000 Index is an unmanaged index of 2,000 US small-cap stocks.

Russell 2000 Growth Index is an unmanaged index of US small-cap growth stocks.

Russell 2000 Value Index is an unmanaged index of US small-cap value stocks.

S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.

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