STATERA

ASSET MANAGEMENT

Commentary: September 2020

DISPROPORTIONATE EXCESS

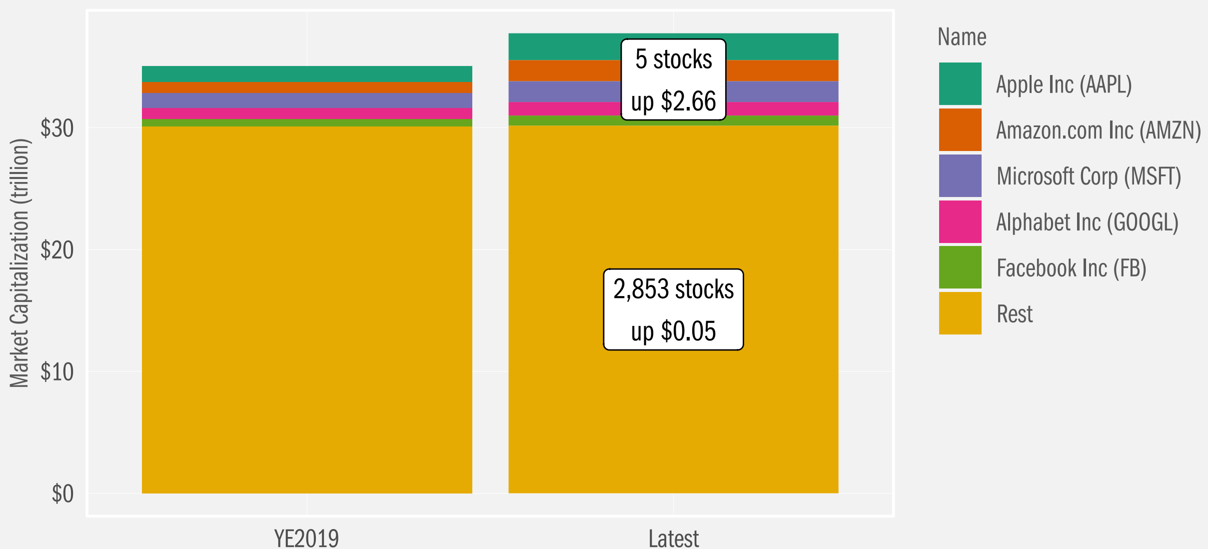
History shows that smaller-capitalization stocks have tended to outperform larger-cap stocks over time. Just not always. And just not for the recent past—this year in particular. It still seems far more reasonable to us to believe that it should be easier for small stocks to get big than it should be for larger stocks to get vastly bigger. Though 2020 so far counters that belief, it by no means dismantles it. We've seen small caps underperform before, and have witnessed their subsequent outperformance. That precedent continues to offer further support for our belief in our approach.

How The Mighty Have Grown

Feeling a bit left behind in the equity rally so far in 2020, we knew already that our preference for smaller-capitalization stocks was among the stronger drivers of relative performance. To confirm that belief, we took a look at the year-to-date performance of a broad swath of the U.S. equity market to see where gains have been had and had not. Turns out that just a few very large "mega-cap" stocks have dominated market returns. We think most readers will find the names of the these stocks quite familiar, with each of them just happening to be notable technology companies. Without these five very large names, the market would still be up, but not by much. Add in Tesla (TSLA) to the largest five, though, and the rest of U.S. stocks are down for 2020.

Figure 1: Year-to-Date Gain in Market Capitalization

The top 5 largest stocks have accounted for most of the gains in the domestic equity market this year



From 12.31.19 through 08.31.20. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Universe includes members as of 12.31.19 of the Bloomberg U.S. 3,000 Index, which is a float market-cap-weighted benchmark of the 3,000 most highly capitalized U.S. companies. Ranking is based on market capitalization as of 08.31.20. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Slicing the Universe

If we rank the universe of U.S. stocks by market capitalization (which is the stock price multiplied by the number of tradeable shares of that stock) and then slice that list into "buckets" of equal numbers of stocks, we have another view of the narrowness of this year's market gains. In Figure 2 we show these data, with the sole group showing an aggregate gain being the largest fifth of stocks in the universe.

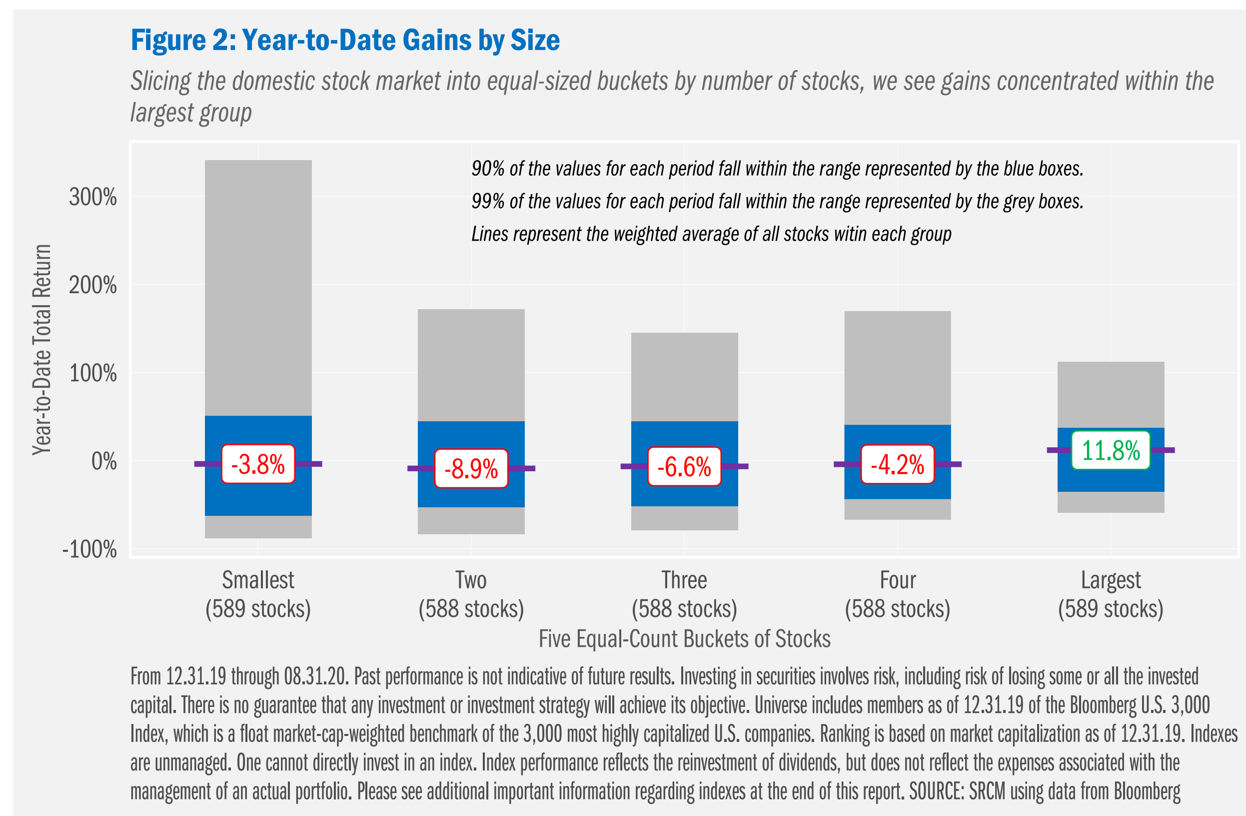


Figure 2: Year-to-Date Gains by Size

Slicing the domestic stock market into equal-sized buckets by number of stocks, we see gains concentrated within the largest group

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Weighty Matters

To understand how the broader market can be up while so many stocks are down, it helps to know that most equity indexes[1] are capitalization weighted. This means that the larger the stock, the greater the portion of the index it represents and larger an effect its performance has on that of the broader index. Said differently, the index measures the "weighted average" performance of stocks, with the larger weights by market capitalization having a large influence. That the largest names have added a substantial amount in terms of market cap is not on its own surprising, given the fact that even small gains for big stocks lead to large gains in total dollars of market capitalization (which we showed in Figure 1). Because the percentage gains among the largest stocks are so grand, though, their advances well overshadow mostly negative returns among the remainder of stocks that compose the market.

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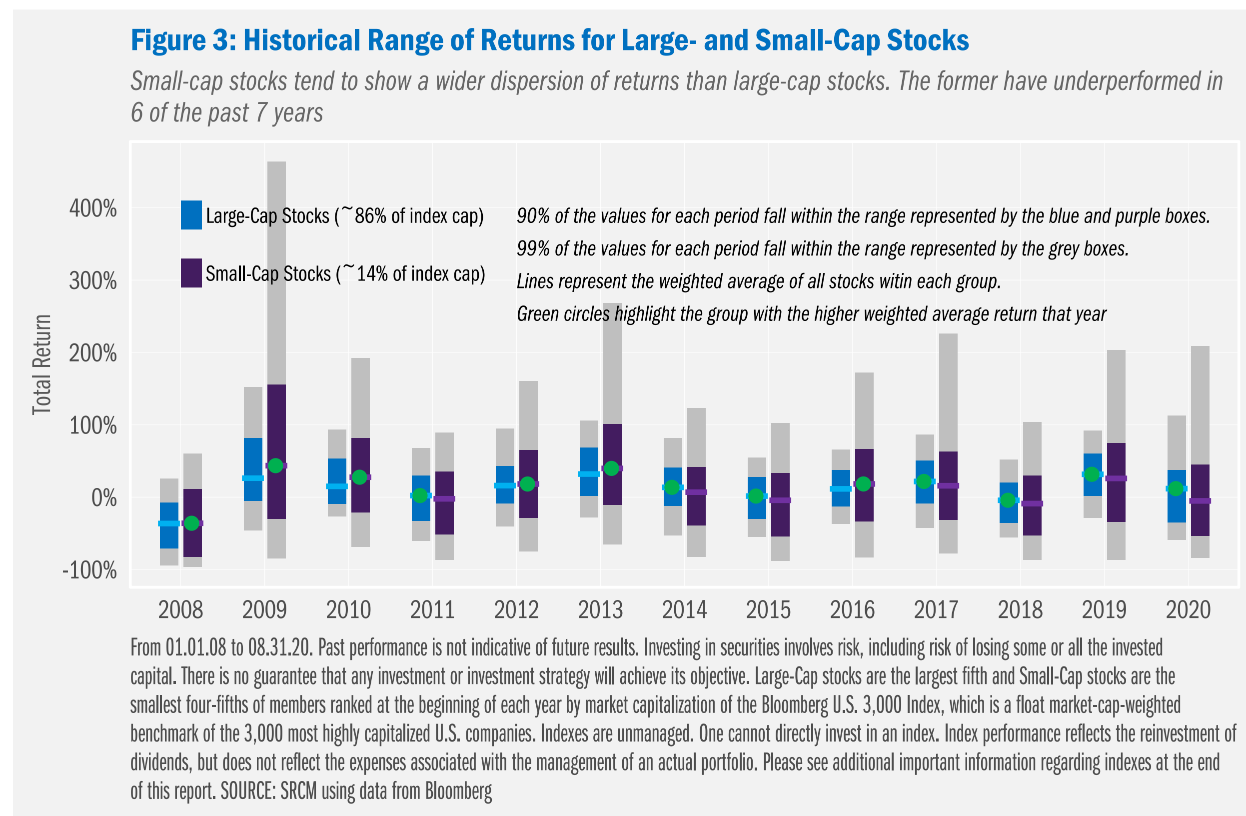
[1] As a reminder, we use indexes to present details regarding "market" performance. The term market may mean different groups at different times, so we generally add a bit of color to define the market we are reviewing. We normally include the descriptor "broad" to mean all stocks (or most stocks within the universe, as we did in this case). But, we can have an index that represents only large-cap stocks (e.g., the S&P 500 Index) or only a portion of large-cap stocks (e.g., the S&P 500 Value Index).

It's Been a Bit

This year's underperformance for smaller stocks builds upon relatively weaker performance that we've experienced over the latter portion of the past decade. Taking an analysis similar to that we did for Figure 2, but collapsing the smaller four buckets into one, we see that the largest fifth of stocks have outperformed in 6 of the past 7 years, including year-to-date 2020. The prior 5 years showed the opposite, however, with smaller-cap stocks generally having outperformed coming out of the Great Recession.

Figure 3: Historical Range of Returns for Large- and Small-Cap Stocks

Small-cap stocks tend to show a wider dispersion of returns than large-cap stocks. The former have underperformed in 6 of the past 7 years



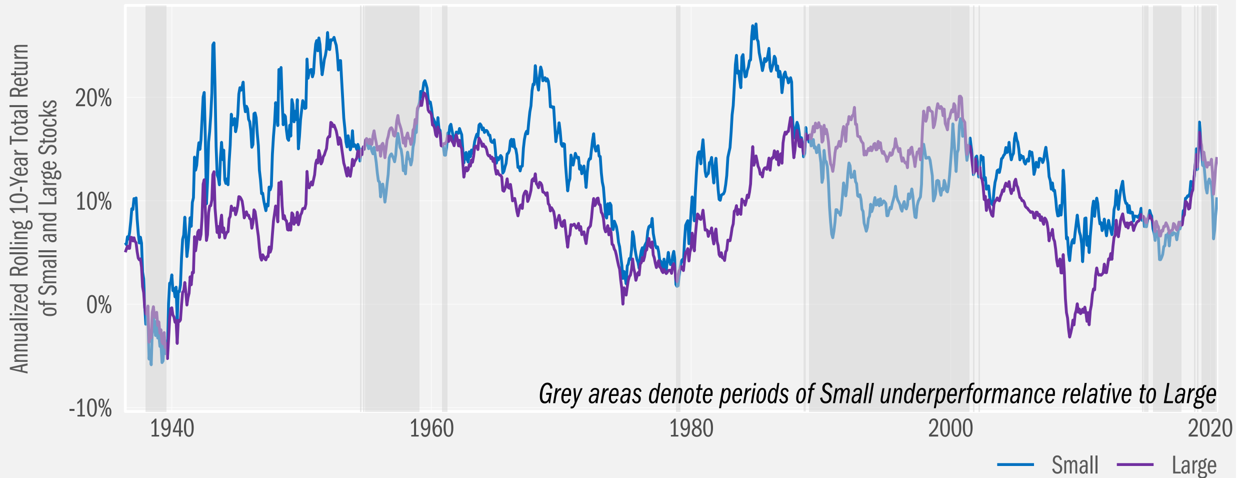
From 01.01.08 to 08.31.20. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Large-Cap stocks are the largest fifth and Small-Cap stocks are the smallest four-fifths of members ranked at the beginning of each year by market capitalization of the Bloomberg U.S. 3,000 Index, which is a float market-cap-weighted benchmark of the 3,000 most highly capitalized U.S. companies. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Déjà Vu Part Deux

We see these periodic episodes of outperformance and underperformance through time. In Figure 4 we show rolling 10-year returns for small-cap and large-cap stocks through the end of June 2020. The grey areas show points during which small-cap stocks had underperformed large-cap stocks over the prior 10-year period. All the other trailing periods are those over which small caps outperformed. These periods of outperformance include a long stretch between the Technology Bubble of 2000-01 and the Great Recession of 2008-09. This historical frame of reference provides some comfort to us in that it reflects the tendency both for small stocks to go through out-of-favor periods and for them to subsequently shine as investors take a stronger liking to the group.

Figure 4: Rolling 10-Year Performance: Small, Versus Large

Historically speaking, Small has outperformed Large over most rolling 10-year periods. Recent underperformance confirms Small outperformance is not guaranteed.



As of 06.30.20. Small stocks are represented by the Fama/French U.S. Small Research Index. Large stocks are represented by the Fama/French U.S. Large Research Index. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from the Data Library of the Web site of Professor Kenneth R. French

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Fama/French U.S. Size Research Indexes: Provided by Professors Eugene Fama and Kenneth French. Index constituents are formed at the end of each June using June market equity and NYSE breakpoints. The reconstitution considers for July of year t to June of t+1 include all NYSE, AMEX, and NASDAQ stocks for which are available market equity data for June of t. The Fama/French U.S. Small Research Index includes the lower 30% in market capitalization. The Fama/French U.S. Large Research Index includes the higher 30% in market capitalization.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

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