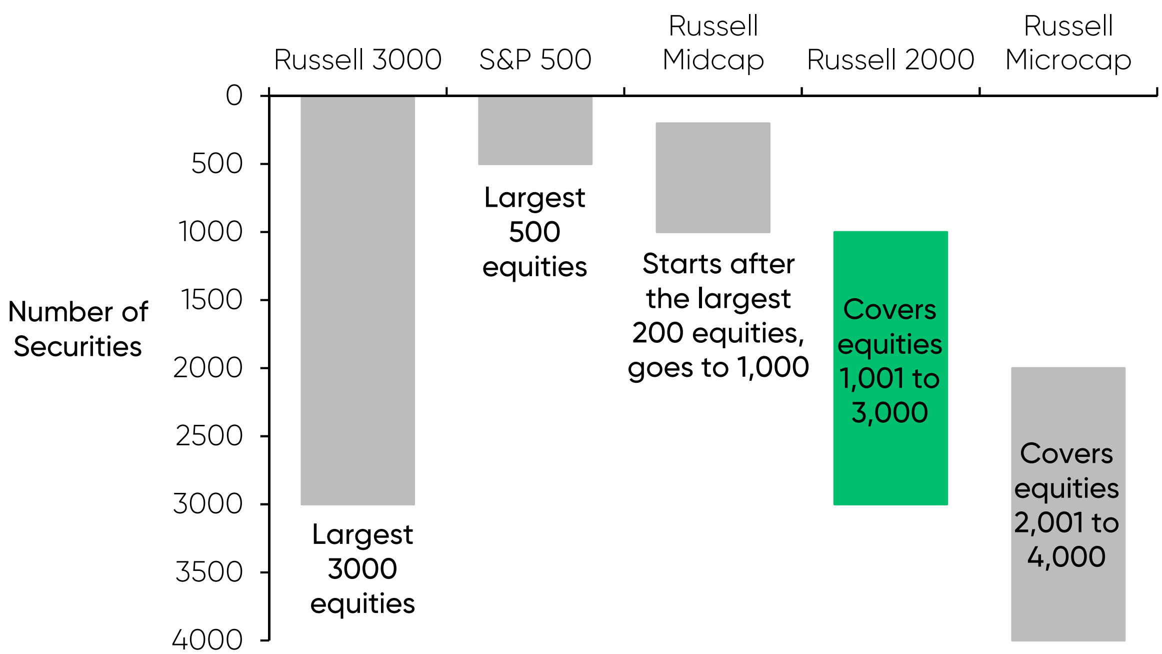
WHY US SMALL CAP?

Most global equity investors agree proper diversification entails having exposure to different countries, geographic areas, sectors, and styles. Yet, many institutional investors do not diversify within these categories. An active mandate devoted to US small cap equities—a category which offers diversification benefits, direct exposure to the US market and consistent returns, can improve long term performance.

DIVERSIFICATION

A US small cap allocation gives access to a large investible universe by equity count and covers equities otherwise missed in larger cap indices. The Russell 2000, which is a common benchmark for US small cap equities, covers the bottom 2000 companies of the Russell 3000, a much larger range than the S&P 500 and Russell Midcap. (Exhibit 1)

Exhibit 1: US Investible Market by Index



Source: FactSet as of 31/05/2020.

The Russell 2000 also exhibits relatively lower correlation to the major equity indices (especially European and Emerging Markets equities) and provides exposure to rotating leadership between large and small cap equities.

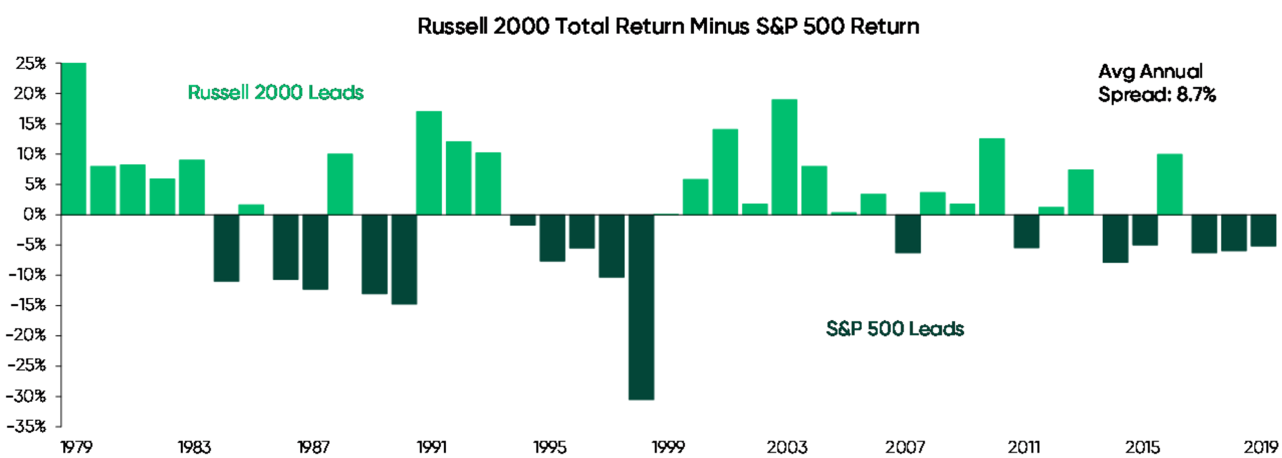
Exhibit 2: Correlation between indices (1979 – May 2020)

	Russell 2000	S&P 500	MSCI World	MSCI EM	MSCI Europe
Russell 2000	1.00	0.83	0.76	0.65	0.65
S&P 500	0.83	1.00	0.89	0.66	0.74
MSCI World	0.76	0.89	1.00	0.73	0.89
MSCI EM	0.65	0.66	0.73	1.00	0.68
MSCI Europe	0.65	0.74	0.89	0.73	1.00

Source: FactSet as of 31/05/2020. Correlations are based on monthly price returns in USD since 1979; correlations to MSCI EM since 1988.

Over the past 41 years, the Russell 2000 has led the S&P 500 24 times on a calendar year basis. On average, the annual spread between the two benchmarks is 8.7%, allowing investors to benefit from rotating leadership. As shown in Exhibit 3, the S&P 500 and Russell 2000 have exchanged leads 15 times since 1979.

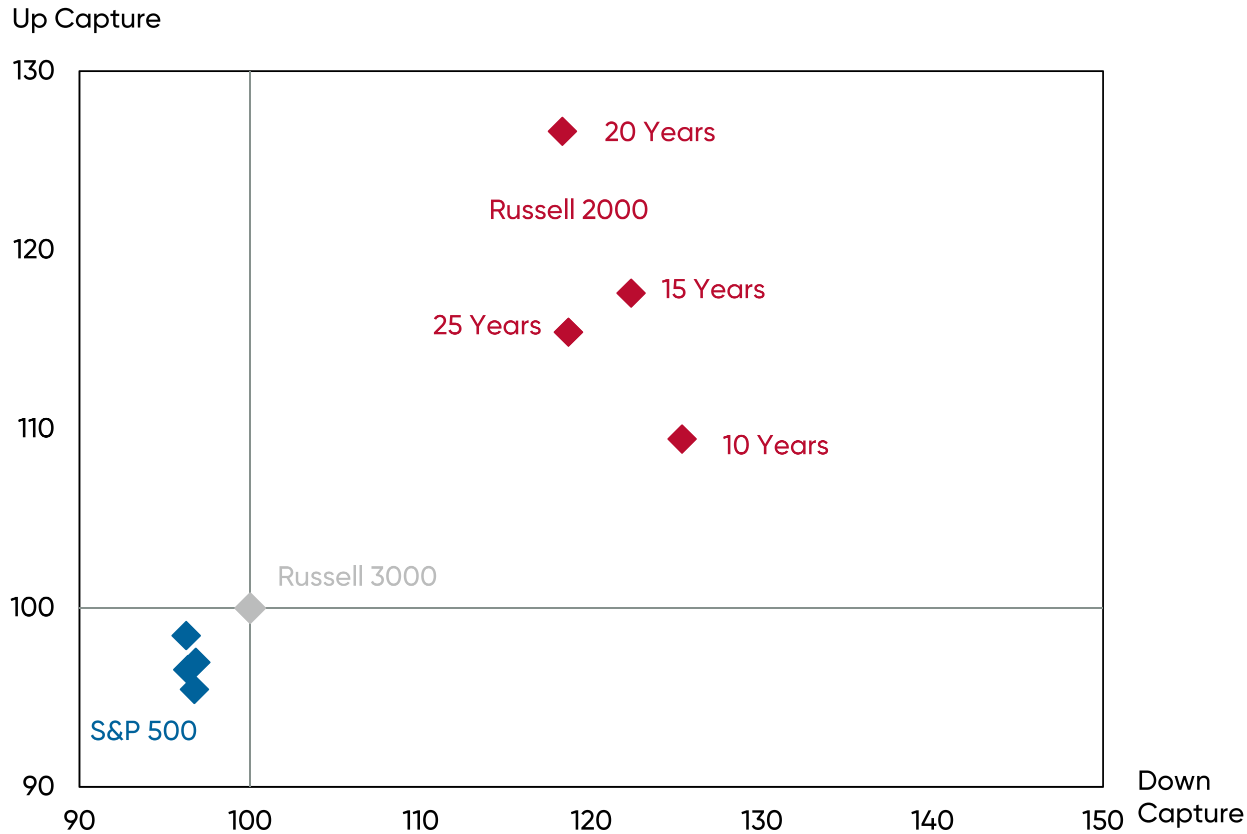
Exhibit 3: Annual Relative Return of Russell 2000 and S&P 500



Source: FactSet as of 31/12/2019. Total returns in USD since 1979.

Compared to the Russell 3000 and the S&P 500, the Russell 2000 has historically performed significantly better during "up" markets (periods of positive absolute returns), while performing worse during "down" markets (periods of negative absolute returns). This characteristic makes an allocation to US small cap not only a good diversifier, which can lead to better risk-adjusted returns, but also means that US small cap securities generally do well in bull markets.

Exhibit 4: Up and Down Market Capture in the last 10, 15, 20, and 25 Years

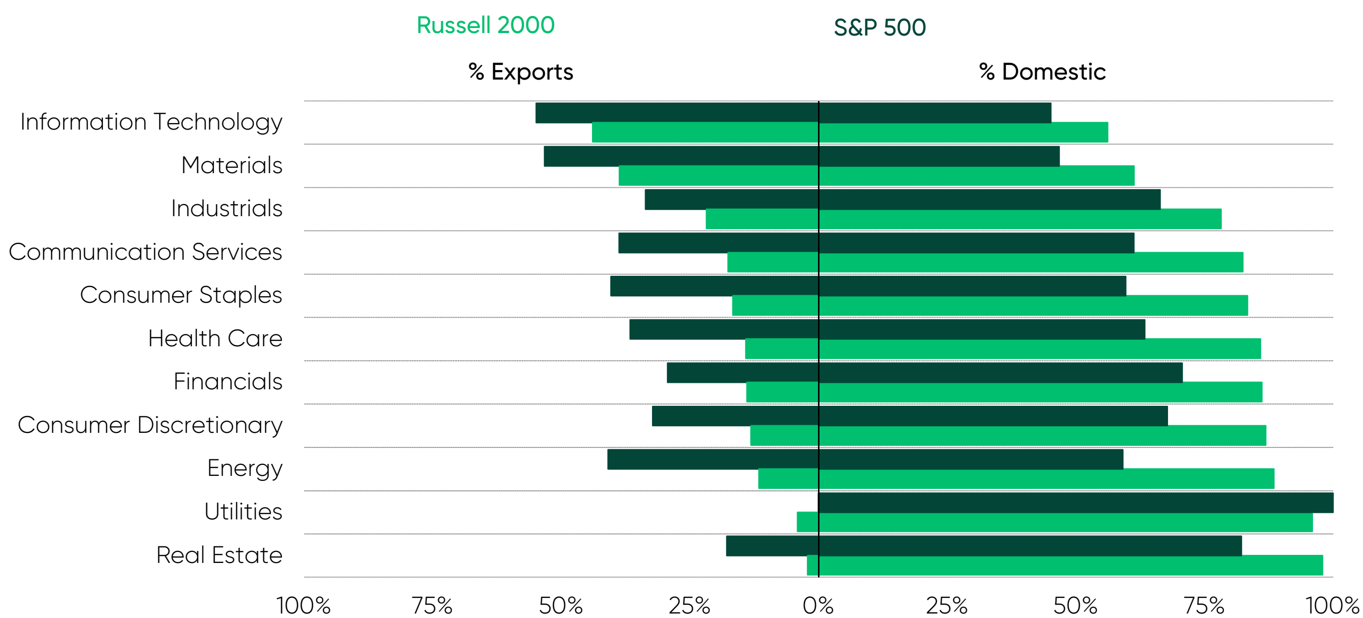


Source: eVestment as of 31/05/2020. Based on monthly data points in USD.

DIRECT EXPOSURE TO THE US ECONOMY

US small cap equities offer more direct exposure to the US economy, as a greater portion of their revenues are derived domestically relative to more globalised, larger peers as shown in exhibits 5 and 6. For example, in the Energy sector, Russell 2000 companies derive 88% of their income domestically, compared to 59% for S&P 500 Energy companies.

Exhibits 5 and 6: Revenue Derived Domestically and Abroad



Source: FactSet GeoRev as of 31/05/2020.

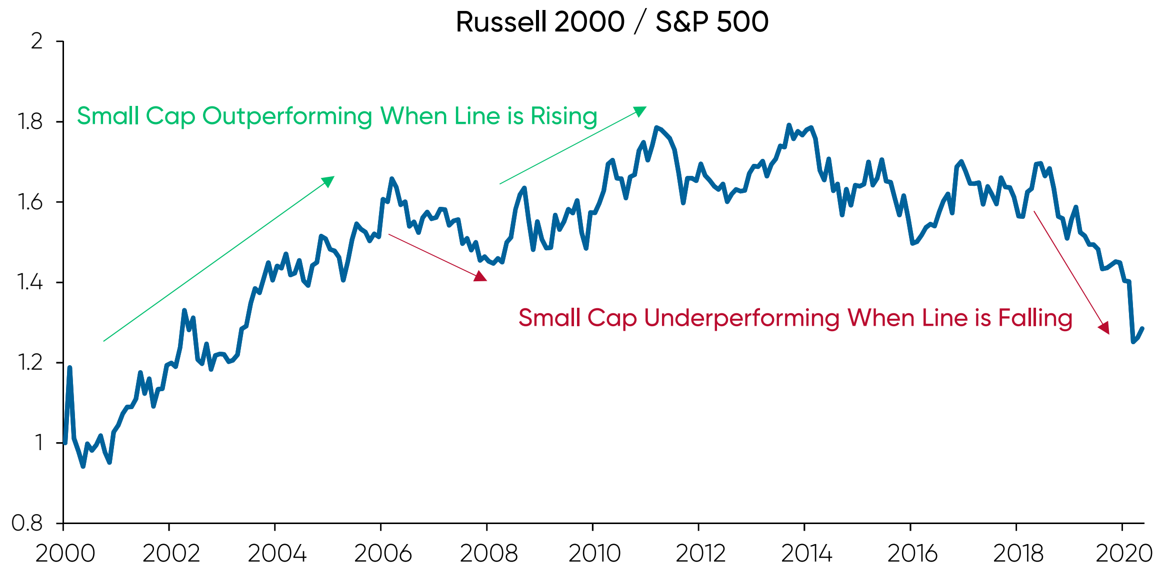
Sector	% Revenue Derived Domestically		
	Russell 2000	S&P 500	Difference
Energy	88%	59%	29%
Consumer Staples	83%	60%	24%
Health Care	86%	63%	22%
Communication Services	82%	61%	21%
Consumer Discretionary	87%	68%	19%
Real Estate	98%	82%	16%
Financials	86%	71%	15%
Materials	61%	47%	15%
Industrials	78%	66%	12%
Information Technology	56%	45%	11%
Utilities	96%	100%	-4%

Source: FactSet GeoRev as of 31/05/2020.

LONG-TERM CONSISTENT RETURNS

Since 2000, there have been several periods of rotating leadership between US small cap and US large cap securities, making a US small cap allocation and important part of a diversified portfolio. (Exhibit 7)

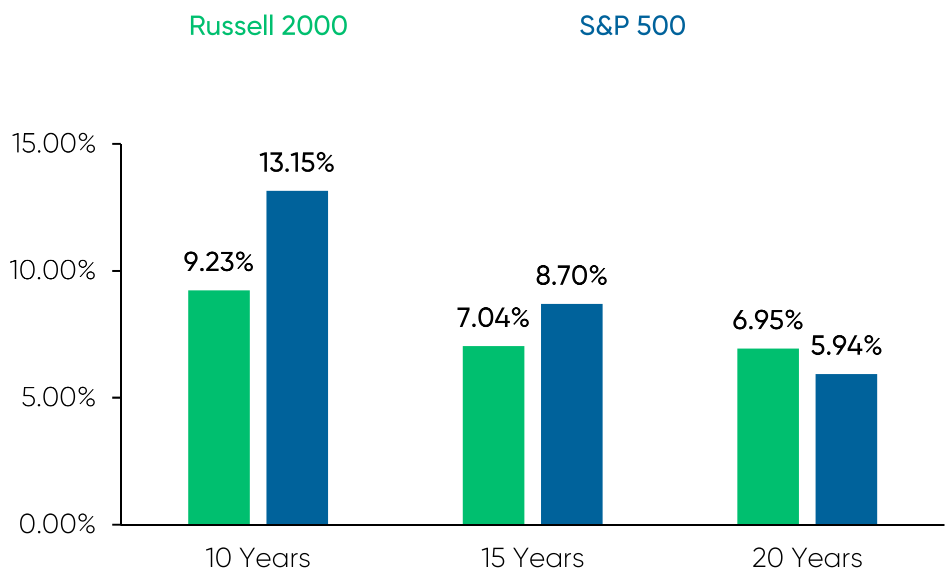
Exhibit 7: Historical Performance and Leadership Rotation



Source: FactSet as of 31/05/2020. Price returns indexed to 1 at 01/01/2000.

While US small cap have underperformed in the last 10 years and, to a lesser extent, the last 15 years, they have held up well in longer time periods, such as the trailing 20 years – making it ideally suited for a strategic long-term allocation. (Exhibit 8)

Exhibit 8: Trailing Return Comparison



Source: FactSet as of 31/05/2020.

ACTIVE MANAGEMENT HAS FARED WELL IN US SMALL CAP

Over the last 20 years, active managers have done an excellent job in generating excess returns in the asset class. Further, despite some potential survivorship bias when looking at performance over long time frames, both asset classes show more managers outperforming their benchmarks (and by a larger margin) over longer time periods. (Exhibits 9 and 10)

Exhibit 9: Share of Managers outperforming in US Small Cap and Large Cap

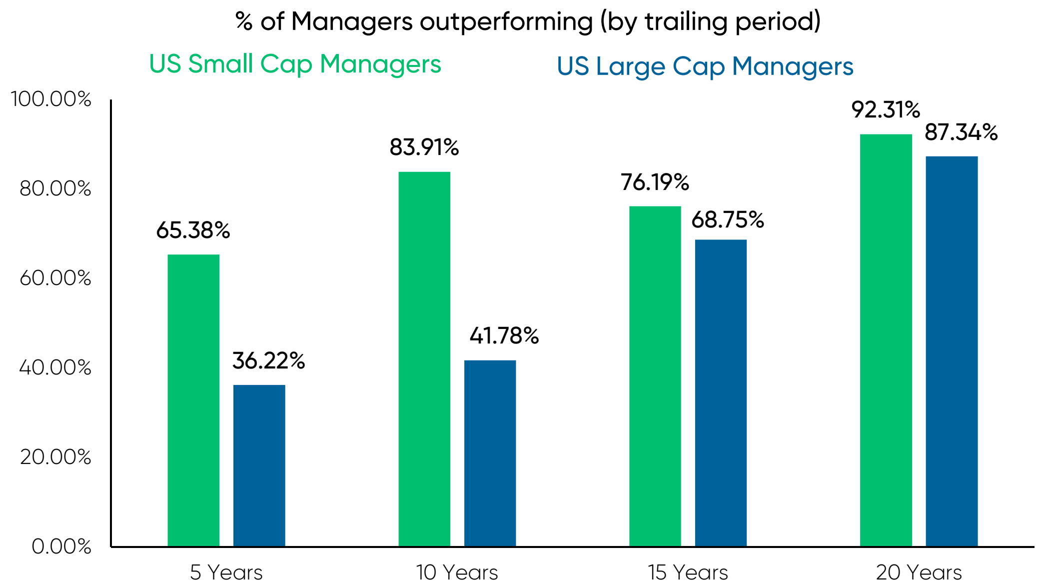
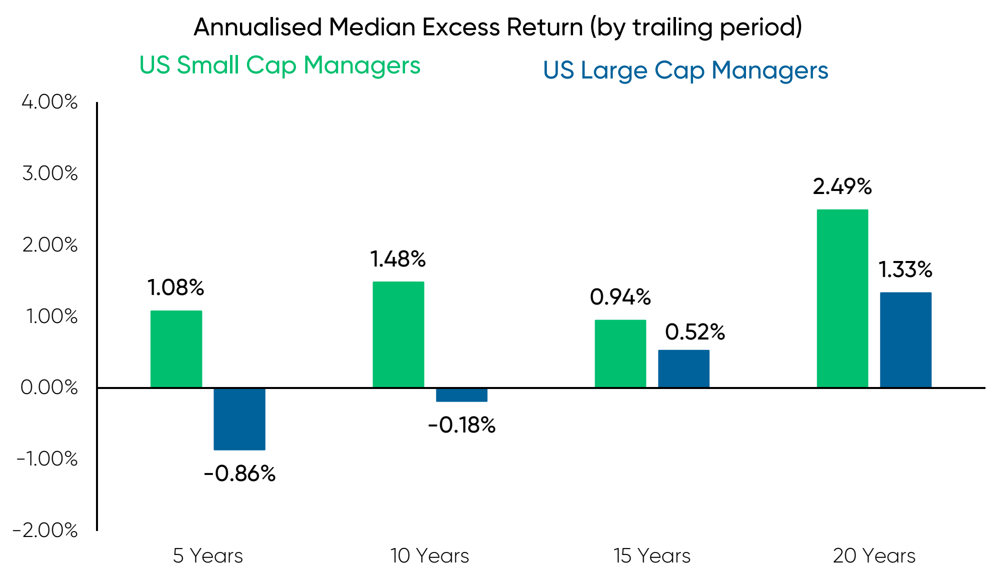


Exhibit 10: Magnitude of outperformance in US Small Cap and Large Cap



Source: eVestment as of 31/05/2020, based on USD returns. Small Cap Managers are compared to the Russell 2000, Large Cap managers are compared to the S&P 500. Manager sample is based on the eVestment US Small Cap Core Equity and US Large Cap Core Equity universes. Sample sizes: US SC (5 Years): 104, US LC (5 Years): 196; US SC (10 Years): 87, US LC (10 Years): 146; US SC (15 Years): 63, US LC (15 Years): 112; US SC (20 Years): 39, US LC (20 Years): 79.

SUMMARY

A well-diversified portfolio includes exposure to different countries, styles, and sizes. US small cap has a large investable universe with domestically sourced revenue and a performance history of strong, consistent returns. A mandate devoted to US small cap equities can improve diversification, increase direct exposure to the US market and provide a potential for increased returns. Further, the asset class is ideally suited for active management, as active managers have historically been able to generate excess returns in the space.

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