The Case for Active Management in US Small Caps

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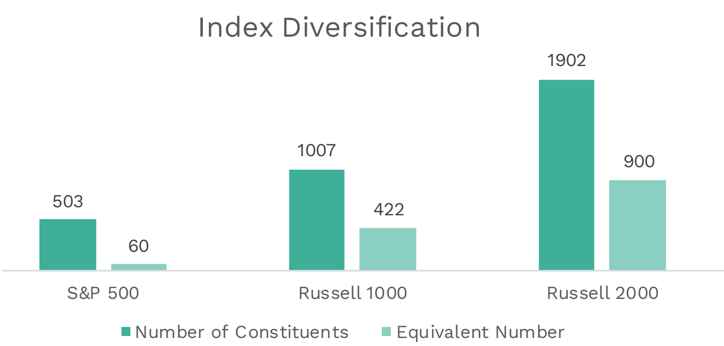
The Case for actively managed US Small Caps

Alignment of Small Cap Indices with Active Management

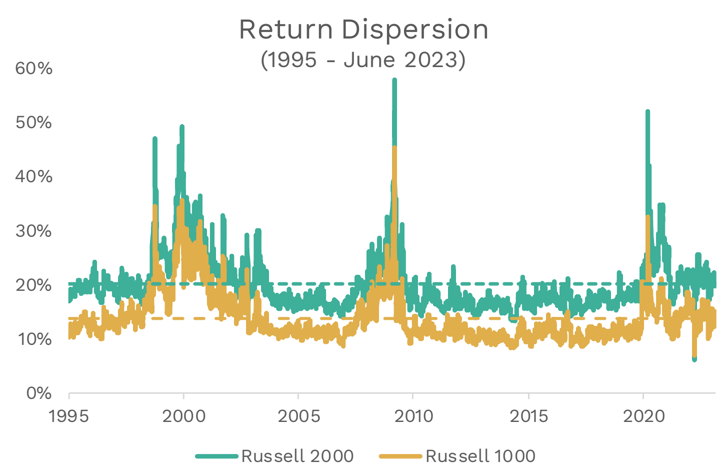
US Small Caps exhibit various characteristics that directly align with the strengths of active managers.



Source: PanAgora Asset Management, Russell, S&P. Data as per May 31, 2023

Firstly, ***Small Cap indices offer a higher level of diversification***. Not only do they encompass a larger number of stocks, but their weight compositions are structured in a manner that minimizes the impact of individual stock performance while expanding the range of investment opportunities available to investors.

For instance, as of the end of May 2023, the S&P 500 consisted of 503 stocks. However, due to the presence of a few exceptionally large stocks (with the largest five stocks accounting for 22.3% of the index), holding the index alone did not provide substantial diversification benefits. From a diversification standpoint, holding the S&P 500 was comparable to maintaining an equally weighted portfolio comprising approximately 60 stocks.



Source: PanAgora Asset Management, Russell, S&P. Dispersion measure as the value weighted annualized cross-sectional volatility of returns over the previous 3 months.

In contrast, the Russell 2000 Index, with its 1902 constituent stocks, displayed a less concentrated weight distribution, equivalent to an equal-weighted universe composed of approximately 900 stocks.

The broader scope of Small Cap indices not only allows for greater diversification, but also presents abundant investment opportunities on which active managers are able to capitalize.

Secondly, ***the potential rewards of picking the right stocks have been notably large within the Small Cap segment***.

This is evident when examining the dispersion in returns among individual stocks in the Russell 2000 and Russell 1000 indices. Since 1995, the average return difference within the smaller index was 20%, surpassing the 14% average return difference within the Russell 1000 Index.

In short, ***active managers who successfully navigate the Small Cap universe have a greater opportunity to generate substantial alpha***.[1]

Finally, ***the scarcity of competition in the Small Cap space represents an additional advantage for active managers***. To illustrate this point, as of May 2023, the average stock within the S&P 500 had earnings forecasts provided by more than 20 analysts, whereas the comparable figure for the Russell 2000 Index was merely six analysts.

Analyst Coverage Count	S&P 500	Russell 1000	Russell 2000
Bottom Decile	9	10	2
Average	20	16	6
Median	21	19	7
Top Decile	33	35	12

Source: PanAgora Asset Management. FactSet. Number of analysts providing EPS estimates. Data as of May 31, 2023

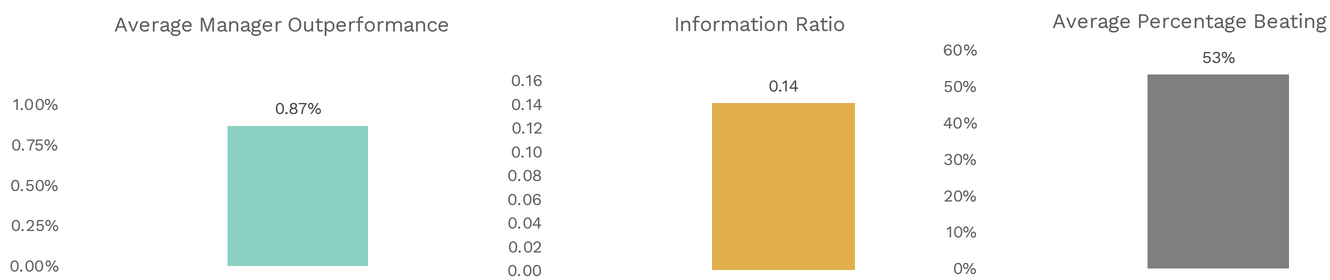
This significant disparity indicates that ***active managers focusing on Small Caps face less crowded, and potentially less efficient, markets***, allowing them to potentially uncover undervalued or overlooked investment prospects that may offer superior returns.

Evidence from Institutional Investors

Active managers' potential to outperform is borne out by an analysis of the performance achieved by institutional investors. An examination of the performance of institutional investors reveals a significantly high degree of success amongst active managers operating within the US Small Cap segment.

Leveraging data compiled by eVestment, we calculated the average excess return, information ratio, and proportion of managers outperforming their benchmark within the Small Cap Universes from March 2003 to March 2023. The study is conducted on returns that are net of stated fees, and all statistics pertain to 12-month holding periods. Our analysis of this data attempts to mitigate any distortions that may result from survivorship bias.

Key Statistics in the US Small Caps Segment



Source: PanAgora Asset Management. eVestment (2003-2023)

The results reveal that, on average, 53% of managers within the US Small Cap Universe have exceeded their benchmark annually. Furthermore, these managers have generated an average outperformance of 87 basis points, a notable accomplishment. This outperformance, adjusted for risk, yields an average information ratio of 0.14, underscoring the value of active management in the Small Cap sector.

[1] Return dispersions are calculated by taking the annualized cross-sectional standard deviation of the returns of the individual components within the index. These dispersions are computed daily, using a look-back window of 3 months starting in 1995.

Conclusion

Active managers have a strong case for investing in US Small Caps. Despite the challenges and risks associated with this segment, active management techniques, including thorough portfolio construction and risk management, can effectively mitigate risk. Our analysis demonstrates that Small Caps offer greater diversification, the potential for higher rewards, and a less competitive environment, making them an attractive investment opportunity for active managers aiming to generate alpha and achieve superior returns. Empirical evidence derived from institutional investors described here substantiates the advantages and potential for outperformance within this asset class.

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The Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 93% of the US market.

The Russell 2000® Index is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small to midsize companies. The smallest 2,000 securities in the Russell 3000® Index are included in this index.

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