No Big Differences Between Big and Small

The Russell 1000 – Russell 2000 Spread Has Converged Over Time

Legend has it most gadgets sold in late-night infomercials were spinoffs from Wall Street. The mindset that gave us the Veg-O-Matic, the Slap-Chop and knives capable of sawing through both your various plumbing fixtures and your salad fixings is the same one that gave us curiosities such as large-capitalization value managers, small-capitalization growth managers and middle-capitalization mediocrities.

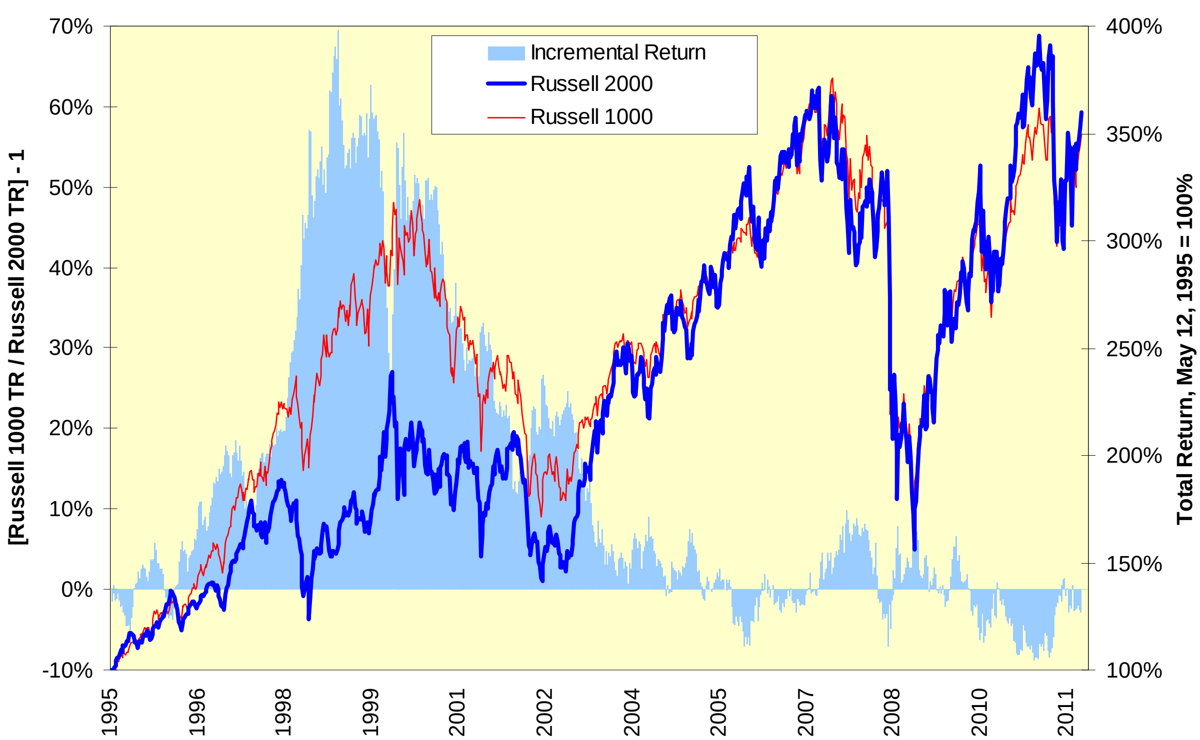
The noble idea behind all of this is size matters; as a stock's capitalization increases, it becomes harder and harder to hit the proverbial ten-bagger. Sometimes even laying down a halfway decent sacrifice bunt can be a chore: The average annual total returns on Microsoft (MSFT) and Intel (INTC) over the past ten years have been 0.815% and -2.04%, respectively.

Convergent Returns

If you throw a rock down Wall Street, you might hit someone, perhaps amongst the Occupiers themselves, issuing a forecast for the relative performance of large-capitalization vs. small-capitalization stocks as measured by the Russell 1000 and 2000 indices, respectively, and ETFs such as the IWB and IWM, also respectively.

This might be a very good use for a rock: If we compare the total return paths for the indices since May 1995, we find they had one period of divergence, the late-1990s bull market, and that is it. Once that boom busted, returns converged for the next boom-bust-boom-semi-bust cycle. At the end of more than sixteen and one-half years, all you have to show before taxes, inflation and expenses is an incremental return of 2.88% in favor of the Russell 2000. That is average annual outperformance of 0.175%...and did I mention the Russell 2000 has a higher standard deviation of returns?

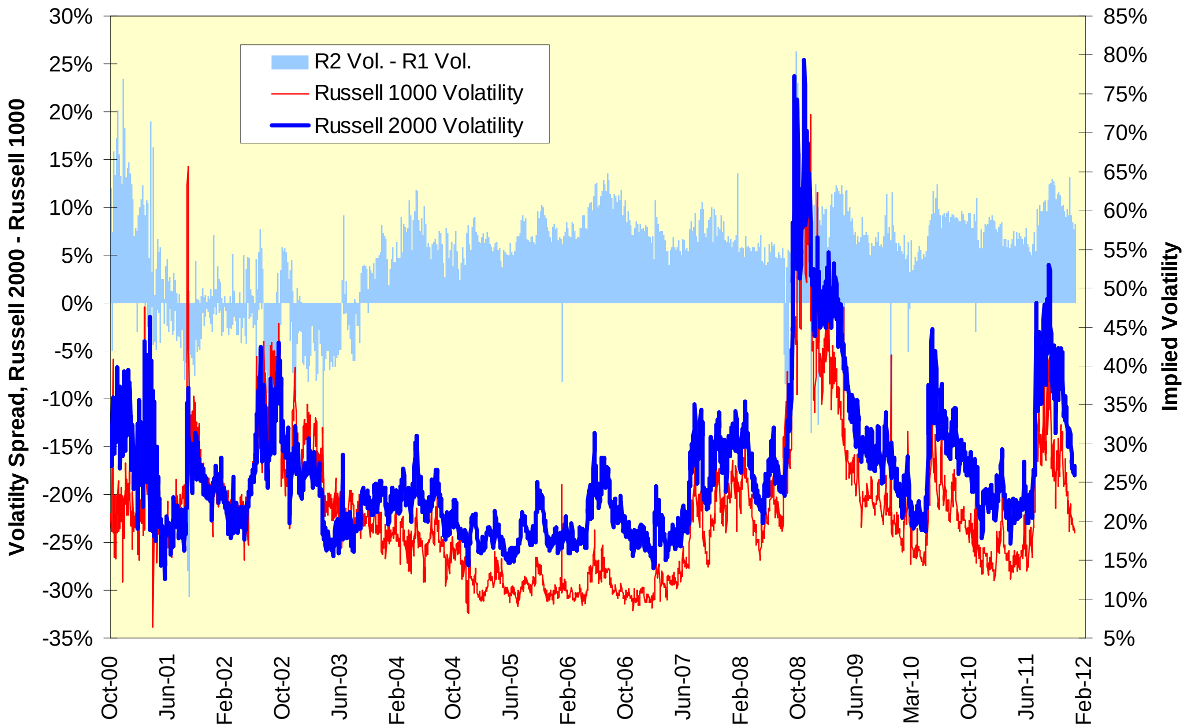
The Russell 1000 - Russell 2000 Spread



Differential Implied Volatility

Not only does the Russell 2000 have a higher historic volatility, option traders give it a higher implied volatility as well. If we map the implied volatilities of the IWB and IWM since October 2000, we find only one period, the dotcom bust, when IWB volatility was higher for any protracted period of time. This period coincided with the large-capitalization large-scale decapitation, particularly in the tech sector.

Russell 2000 Volatility Tends To Be Higher



Is this constancy of relative performance and volatility reason for despair? No; first of all, if you have not despaired by now, you are not going to do so. Second, take heart your selection of U.S. equities is unlikely to be a gamble based on capitalization. It is simply one less source for error.

My own solution is to expose yourself to both capitalization classes at once, in a vehicle such as the IWV ETF based on the broad Russell 3000 index, the combination of the Russell 1000 and Russell 2000 indices (Do these folks make the math easy, or what?). A long-term investor should have an allocation to U.S. equities, period, and if you want to despair over size not mattering, I will not stop you.