Sector Weights Change. Does Relative Performance?

The Large- and Small-Capitalization Indices Have Ignored Changing Sector Weights Since 2008

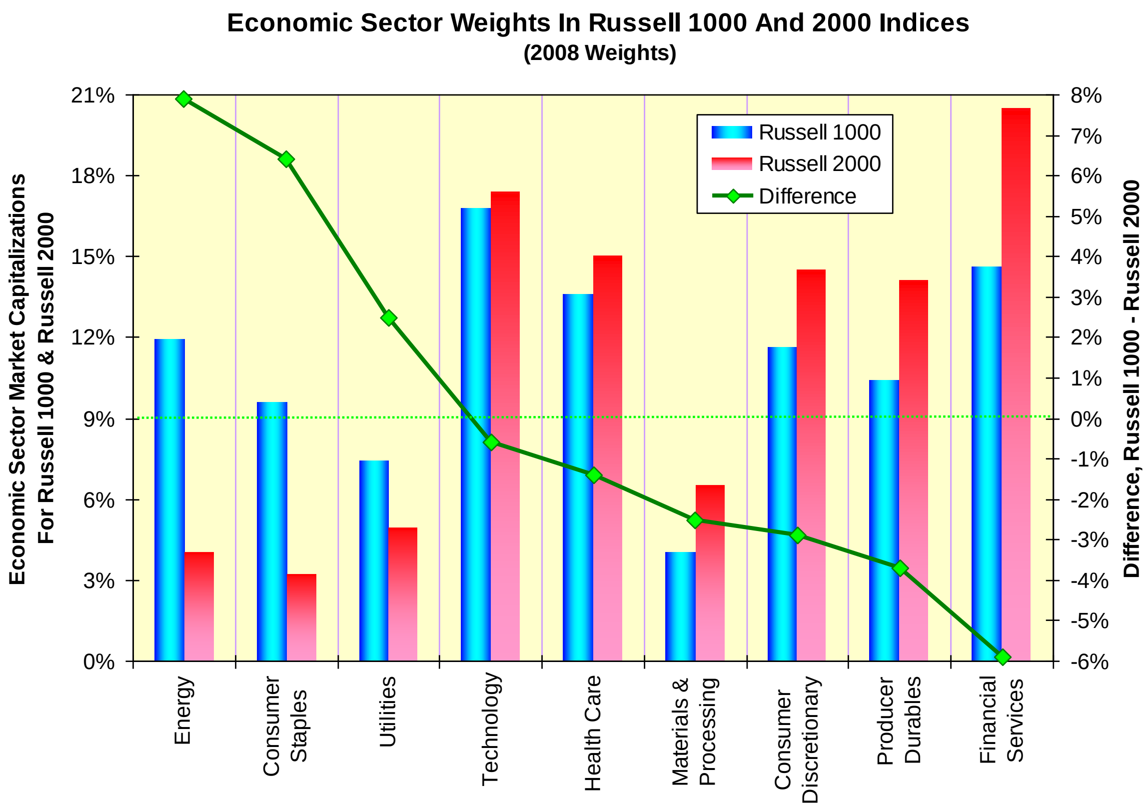
I noted yesterday how the return paths and relative volatilities of the Russell 1000 and Russell 2000 indices moved into a fairly fixed state after the dotcom collapse of nearly ten years ago. This may seem strange to you as more volatile small stocks might be seen as outperforming during bull markets and underperforming during bear markets.

The good folks at Russell Investment Management, never to be caught without an index at the ready and never to be caught downgrading a sovereign issuer who might turn around and clobber them for speaking out of turn, divide the U.S. market into nine economic sectors. As you might expect, these sectors have different representations in the Russell 1000 and 2000 indices.

Let's compare the weights of each of these sectors across the size dimension in two very different years, the 2008 weights calculated before that year's extreme unpleasantness and the weights calculated for the June 2011-June 2012 year. I have sorted these two measures in descending order of difference between the Russell 1000 and Russell 2000.

The 2008 Picture

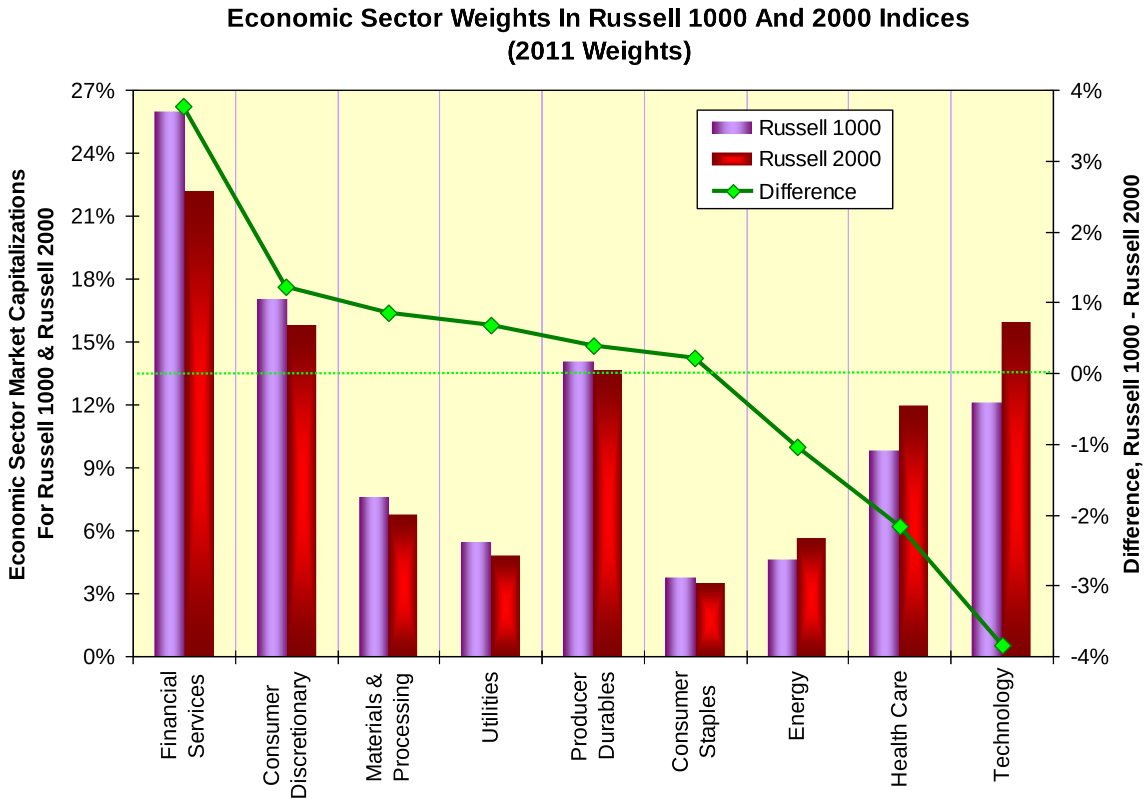
The largest bias toward large-capitalization in 2008 belonged to the energy sector; this seems unremarkable given the massive investment needed to participate in global energy markets. Both the consumer staples and utility sectors also tilted toward large-capitalization.



The biggest difference on the other end of the spectrum occurred in the financial sector. Here there were numerous regional banks, mortgage firms, asset managers, etc. You could say the financial sector was a thriving ecosystem with a few large apex predators, including at least one vampire squid, and a large number of slow-footed herbivores.

After The Storm

Now let's take a look at relative weights in 2011. Here the largest bias toward size is in – drum roll, please – the financial sector. The effect of the financial crisis was the exact opposite of what you might expect in a biological extinction event where the high and mighty disappear and the small and slimy survive to re-propagate: Here the high and mighty flourished and everyone else was turned into cannon fodder.



If there is reason to cheer, and there always is, it might be in the reappearance of thriving small-capitalization health care and technology firms. These sectors are repositories of creativity and have proven it time and again.

Of course, I remember making similar statements extolling the virtues of technology firms back in the late 1990s, which seemed to make sense at the time, only to see another and different wave of destruction. Sigh.

But what is remarkable is how the two capitalization-based indices have matched each other since the June 30, 2008 reconstitution of the Russell indices. The large-capitalization Russell 1000 has returned 11.265%, while the small-capitalization Russell 2000 has had a period return of 20.679%. An average annual difference of 2.40% in the Russell 2000's favor when its standard deviation of returns is more than 30% greater is fairly trivial.

Sometimes clichés are appropriate. In this case, we can say knowingly that a relative calm on the surface has hidden a great deal of meaningful churning underneath.