When Does Small-Capitalization Fundamental Indexation Pay?

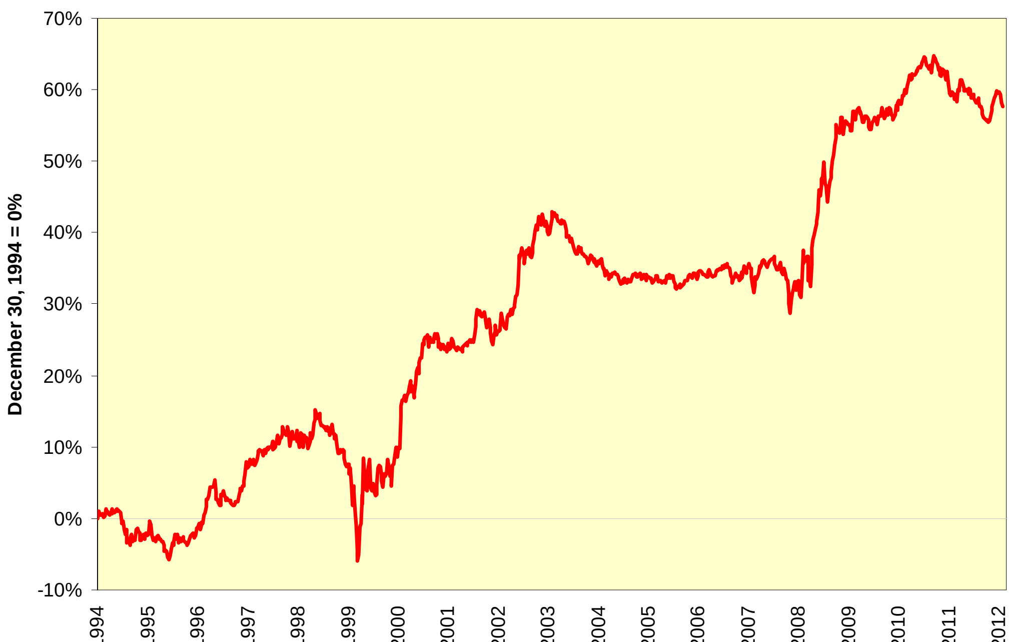
One of the main problems with zealots in any endeavor is they are doctrinaire by definition. True believers in indexation and in passive investing often argue it applies anywhere and everywhere, even in relatively illiquid markets where the cost of information can be high, such as in high-yield convertible bonds or the sort of option-laden mortgage-backed securities you simply do not see as much as you did prior to 2007 for some strange reason.

I was always ready to grant the argument in the case of large-capitalization indices such as the S&P 500, but the indexers have found themselves hoist on their own petards here: From the March 2009 low to the end of 2012, the S&P 500 equal-weighted index has outperformed the regular capitalization-weighted index 174.9% to 122.7%. This has forced an argument whether equal-weighting is somehow superior to capitalization-weighting and while we are at it, whether something called fundamental-weighting is somehow superior to either of them.

Small And Fundamental Is Beautiful

That argument will fill conferences and academic journals forever and without resolution (remember, in the academic world resolution is a precursor to unemployment). Let's take a very narrow focus on one comparison, a small-capitalization fundamental index managed by Research Affiliates versus the S&P 600 index. The history favors the fundamental index.

Incremental Performance Of Small-Capitalization Fundamental Index



The outperformance comes in two bursts, however, one during and after the dotcom implosion when the tech stocks within the S&P 600 might have been overweighted by virtue of their past performance and the other after the March 2009 low. Investors have a tendency to flee from small-capitalization stocks to the large-capitalization cousins during times of markets stress as the larger issues carry a veneer of safety; this perception often turns into a mirage as both recent major bear markets saw plenty of carnage amongst larger issues.

This is when fundamental weighting, what might have been called stock-picking in a simpler day, can show its value. The fundamentals involved include top-line revenue, book value and dividend yield. In case you were wondering, higher sales, larger book value and greater dividend yield are preferable to their opposites.

Economic Environment

At least two other economic and market factors not included in the list of "fundamentals," a club whose membership also leads to academic food-fights, are the strength of the dollar and the shape of the yield curve. My own research into this matter shows the incremental return of the fundamental index declines for any overall market environment when the dollar strengthens. In addition, sharp changes in the yield curve between two and ten years lead to lower incremental returns for the fundamental index.

The reasons behind these divisions are fairly straightforward. The dollar has tended to rally during times of global financial stress. This stress leads investors to trade assets more on a “risk-on/risk-off” basis than on a fundamental basis. Second, whether the yield curve is steepening or flattening abruptly is more of a function of policy decisions than of anything intrinsic to corporate balance sheets and income statements. If the Federal Reserve is slamming expectations for short-term interest rates about, investors have to take a more macro view.

These two instances when capitalization-weighting benefits at the expense of fundamental-weighting underscore one of the drawbacks for fundamental analysis: It must rely on static data reflecting past performance and not on changing perceptions of future performance. As any good academic would say, further research is necessary.