

Trading The Russell Index Spreads

Traders as a whole do not get lost in existential matters during the course of the day, so all is forgiven in advance if few, if any, have given thought as to how many stock market terms are meaningless. Only politics, where terms such as “liberal” and “conservative” represent stances on certain iconic issues but are devoid of content otherwise, can hold a candle to stock market terms such as “growth,” “value,” or “large/small/mid-cap.”

These definitions are inherently elastic and therefore completely useless until we imbue them with meaning via instruments capable of creating self-fulfilling prophecies. These instruments are called indices, of course, and as we have learned over and over since the intellectual triumph of Burton Malkiel’s 1973 classic *A Random Walk Down Wall Street*. The very act of creating an index and then measuring managers’ performance against it changes the behavior and characteristics of that index; this is sort of a twist on the Heisenberg Uncertainty Principle whereby the very act of trying to measure a particle means you cannot know both its position and velocity simultaneously.

Let’s remember a bull market inflates market capitalizations and pushes previously small stocks over certain size thresholds and vice-versa for a bear market and an apparently cheap stock on its way to oblivion is unlikely to represent value.

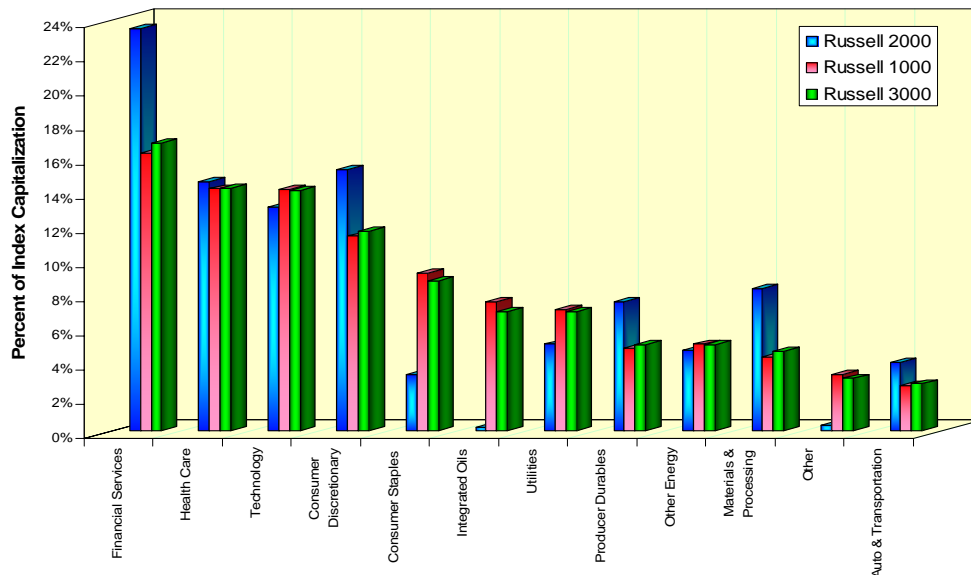
The Russell Indices

Whether the labels assigned to indices are artificial or not, there is little doubt their different composition and characteristics create trading opportunities. Let’s take a look at the Russell indices. The Russell 3000 index is designed to be the broadest measure of tradable stocks in the U.S. market; it is divided into the Russell 1000 and Russell 2000 indices of large- and small-capitalization firms, respectively. And, yes, all of these have been divided further into growth and value subindices, but we will stay with the undivided measures here.

Many stock index trading opportunities arise from differing industry exposures. Over the past three decades, for example, we have witnessed two major bull markets in energy, one spectacular one in technology and a boom and bust in financial shares, just to name a few.

We can see in Chart 1 the Russell 2000 is over-weighted in financials, consumer staples, materials & processing and “other energy.” It is under-weighted in integrated oils, utilities and “other.” Do not snicker at those “other” categories. The category of “other” includes firms such as Dow Jones Industrial Average components 3M and General Electric, and large industrial firms such as Honeywell and Tyco. “Other energy” consists of everything in the energy sector but the integrated oil firms.

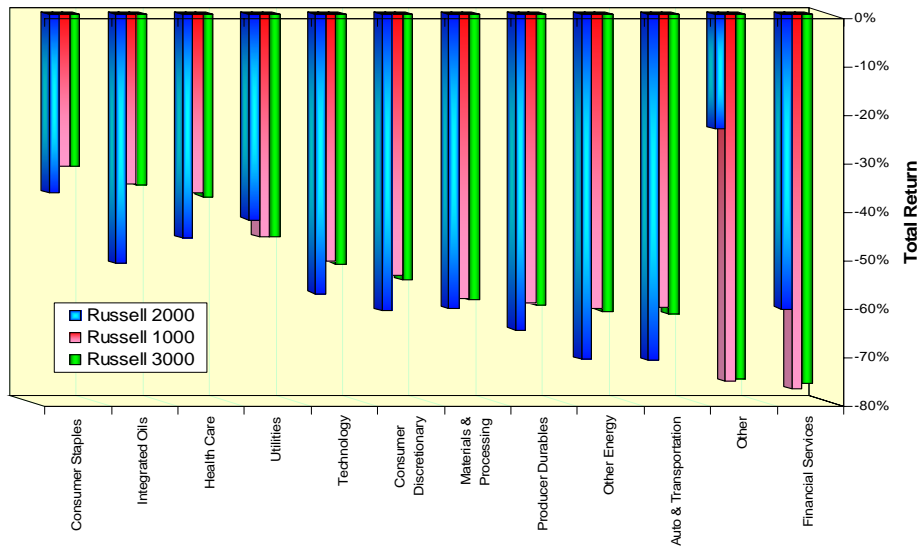
Chart 1: Comparative Economic Sector Weights



How did total returns between these economic sectors differ during the October 11, 2007 – March 9, 2009 bear market? The worst relative returns for the Russell 1000 were in the automobile and producer durable sectors; the

worst relative returns for the Russell 2000 were in the “other” and financial services sectors. The best relative returns in the Russell 2000 were in the integrated oils: If anyone is wondering what a small-capitalization integrated oil company is, the list includes Delta Petroleum, GMX Resources, RAM Energy and Vaalco Energy. ExxonMobil and Chevron they are not.

Chart 2: Comparative Economic Sector Returns

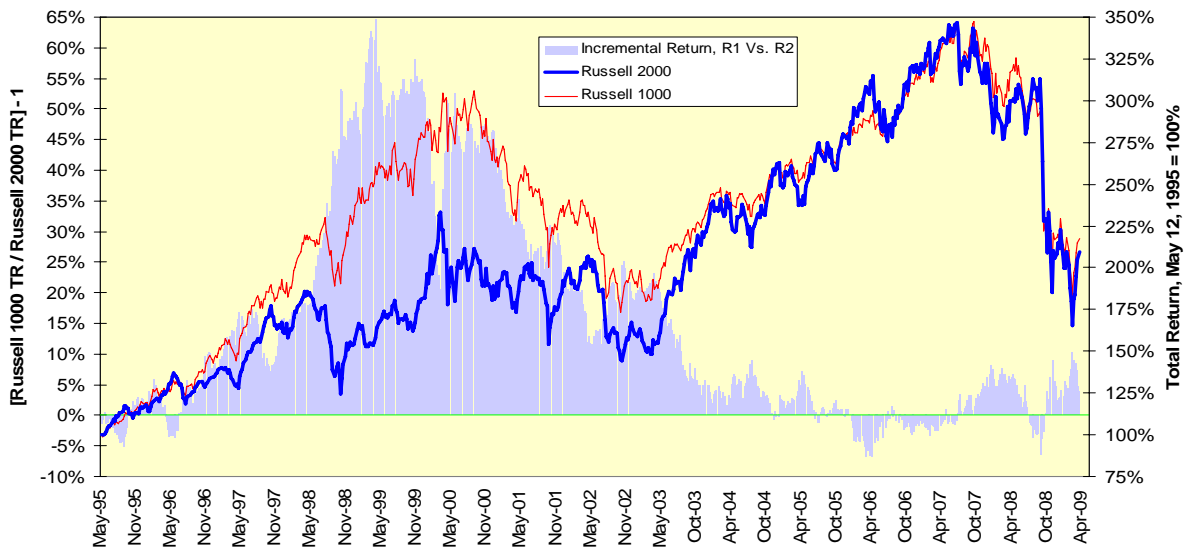


The Spread

If we back away from a single bear market to the first date from which we can calculate total returns and map the Russell 1000 and 2000 indices along with a normalized spread between the two, we see the history has been dominated by the late 1990s technology boom and its subsequent bust. The late 1990s bull market turned large technology firms into mega-capitalization stocks and propelled the Russell 1000 higher against the Russell 2000. The unwinding was just as pronounced.

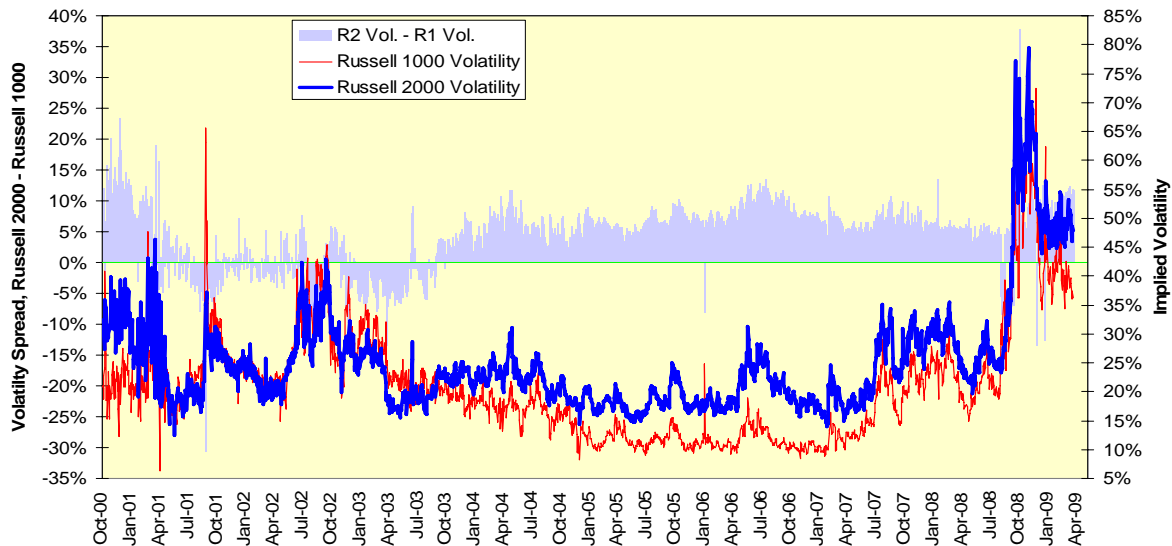
Once this massive up-and-down in the spread was complete, the trade turned quiet. With a modest exception between August and October 2008, the Russell 1000 has outperformed the Russell 2000, but the pace of outperformance has been modest at best. What is interesting is, for all of the perennial talk about a period of small stocks outperforming large ones, the track record over the past fifteen years shows no such real periods. Outperformance by small stocks generally has been underperformance by large stocks.

Chart 3: The Russell 1000 - Russell 2000 Spread



What has been true in the case of the Russell 2000 is its implied volatility has been greater than that of the Russell 1000. This stands to reason: Not only can small stocks' prices be buffeted more by fund flows, their bid-ask spreads tend to be wider as a percentage of prices. The differential level of volatility has not been great enough, however, to warrant employing a hedge ratio between the Russell 1000 and Russell 2000 futures as traded on the Intercontinental Exchange. The hedge ratio, for purists, would be 1.02 Russell 1000 futures to 1.00 Russell 2000 futures.

Chart 4: Russell 2000 Volatility Tends To Be Higher

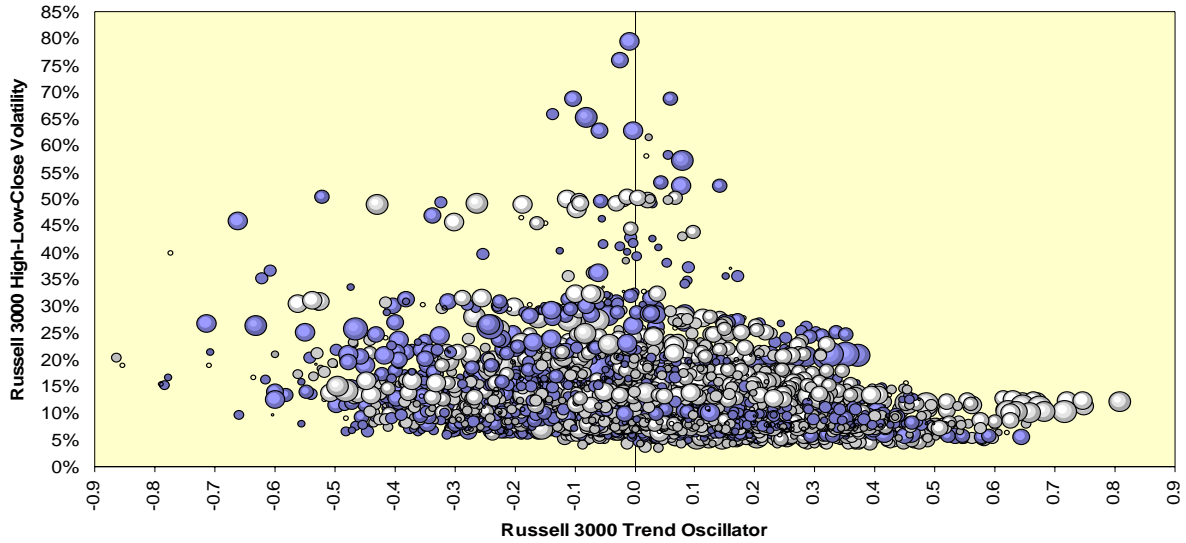


A Predictive Driver

Is there an indicator a trader can use for assessing the direction of the spread? Let's map the high-low-close volatility, a measure that accounts for intraday range as well as interday change, for the inclusive Russell 3000 against its trend oscillator and see whether one month-ahead returns on the spread exhibit any sort of relationship to these measures.

Chart 5 depicts those returns as bubbles; positive returns are market with blue bubbles; negative returns with white bubbles. The size of the bubbles corresponds to the magnitude of the return. We can see a cluster of white bubbles, corresponding to Russell 2000 outperformance, when the Russell 3000 trend is strongly positive. The opposite, a cluster of blue bubbles corresponding to Russell 1000 outperformance when the Russell 3000 trend is strongly negative, is visible as well. In addition, the very highest levels of Russell 3000 high-low-close volatility produce periods of Russell 1000 outperformance.

Chart 5: One Month-Ahead Return On Russell 1000 - Russell 2000 Spread



The implications of this map are clear: Should a low-volatility bull market emerge, we should see the Russell 2000 outperform the Russell 1000. The opposite, Russell 1000 outperformance, is to be expected in a high-volatility bear market. Once again, this stands to reason: A strong bull market with its associated lower levels of volatility will drive the smaller stocks in the Russell 2000 higher under the sheer weight of fund flows. In a risk-averse bear market, money sticks to the more liquid larger stocks.