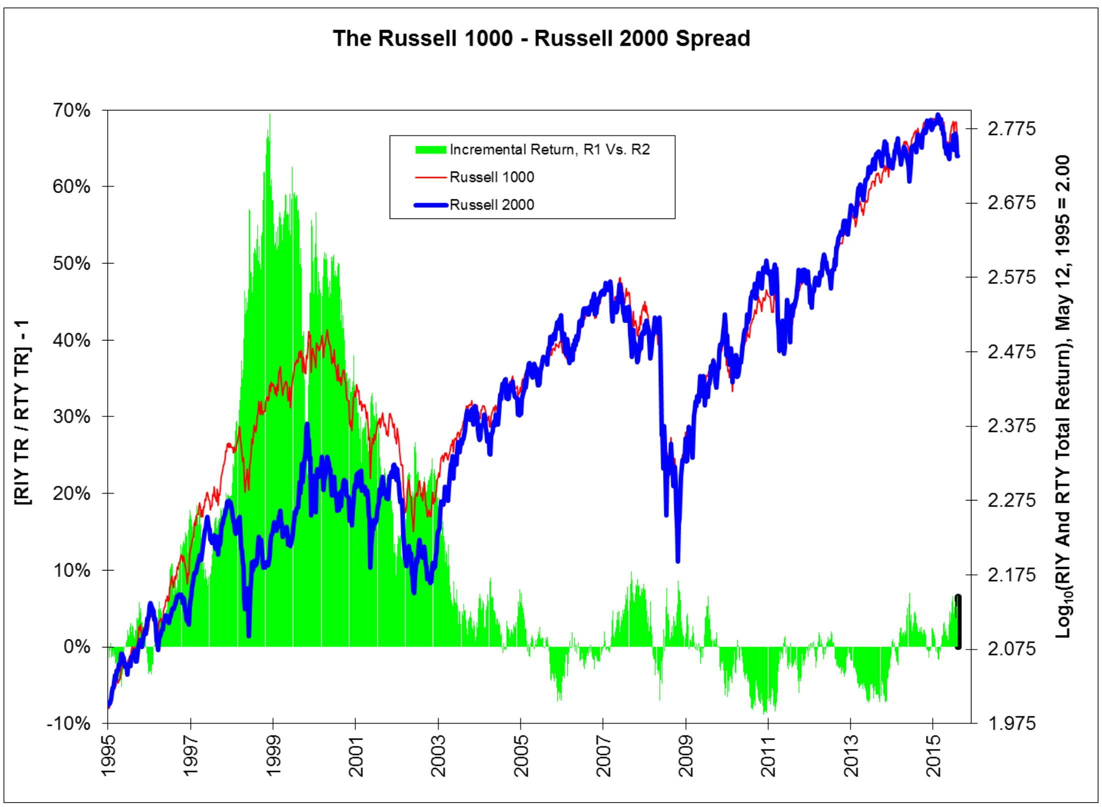
# The Conditions Wherein Size Matters

Any profession ultimately creates a priestly caste complete with ceremonies and jargon to distinguish itself from the Great Unwashed. The financial services industry is no exception. It is not enough to say something like, "Stocks; just fill your pockets and hope for the best." No, that would mean anyone and everyone would have an incentive to abandon active investing and issue selection and simply gravitate toward low-cost index funds. I have heard many times the impending market is one where you have to be "selective." Have you ever heard someone say, "Just buy 'em?"

### Large Vs. Small-Capitalization

Let's take a look at the comparative total return paths of the Russell 1000 and Russell 2000 large- and small-capitalization indices going back twenty years. If we plot these two return paths on a common logarithmic scale, they look pretty much alike except for the late 1990s technology bubble when the Russell 1000 outperformed mightily.

The Russell 1000 and 2000 total return indices peaked on May 21 and June 23, 2015, respectively. While the Russell 1000 has retreated 5.51% from its total return high, the Russell 2000 has pulled back a more significant 12.87%. Still, market capitalization has not been a significant driver of relative performance since the market began to price in higher interest rates in April 2004. The Russell 1000 has not outperformed by more than 9.8% or underperformed by less than -8.9% over this period. As the two indices have had a near-unitary weekly beta of 1.021 and an r-squared or percentage of variance explained of 0.983 since then, this similarity of returns should not be surprising.



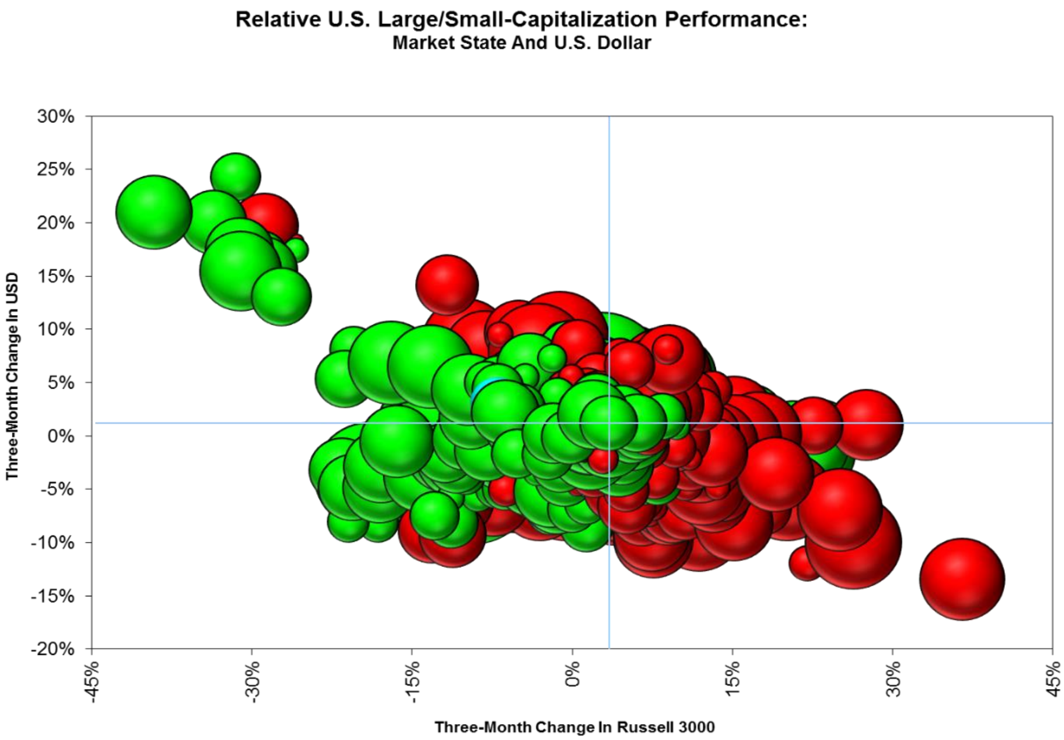

### Market State And Two Financial Factors

Is capitalization-based relative performance a function of market states and key financial market factors? Let's map three month relative returns between the Russell 1000 and Russell 2000 indices as functions of three-month changes in the Bloomberg correlation-weighted dollar index and 7-10 year Treasury returns and of three-month changes in the broad Russell 3000 index. Russell 1000 outperformance is depicted with green bubbles, Russell 2000 outperformance is depicted with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the performance differential. The current environment is marked with a bombsight and the datum from three months ago is highlighted.

The USD environment has been moving to the east-southeast and remains in a zone of prospective outperformance by the Russell 1000. Please note how large-capitalization outperformance is not so much a function of dollar strength or weakness, but rather of the market's state at the time.

The map based on 7-10 year UST is moving to the southeast and also remains in a zone of prospective outperformance by the Russell 1000. Please note how large-capitalization outperformance is state-dependent here, too: A stronger Treasury market leads to large-capitalization outperformance during bearish phases and a weaker Treasury market leads to small-capitalization outperformance during bullish phases.

In other words, there are no hard and fast rules about either the dollar or the Treasury market leading to relative large-capitalization out- or underperformance. You have to incorporate the state of the market itself in both cases.



**Relative U.S. Large/Small-Capitalization Performance:**
**Market State And 7-10 Year UST**