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A Tale of Two Indexes

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Small-cap investors may be measuring their performance against the wrong benchmark. Russell 2000 or S&P SmallCap 600?

Are investors following the wrong small-company stock index?

The most commonly used benchmark is the Russell 2000, and over 90% of investment funds focusing on U.S. small-cap stocks use it to peg their performance. But for more than two decades, it consistently has done worse than the lesser-known S&P SmallCap 600 index.

The difference isn't trivial, either. Over 20 years, when you include reinvested dividends, the S&P index has outperformed its better-known Russell counterpart by an average of nearly two full percentage points annually, 10.2% to 8.3%.

To put that more simply: Ignoring fees and taxes, an investment in the Russell would have grown by nearly 400% over that time. An investment in the S&P index: nearly 600%.

Why? And, more importantly, should investors switch their focus?

"There are two main factors that may drive the outperformance," says Jodie Gunzberg, managing director of U.S. equities at Standard & Poor's. S&P filters out companies with weaker financials, she says, and maintains its screening process throughout the year, dropping or adding stocks as needed.

The Russell 2000, maintained by FTSE Russell, is simpler. FTSE Russell ranks the top 3,000 investable companies in the U.S. stock market, as measured by market value. The top 1,000 go into the Russell 1000 index. The next 2,000 go into the small-cap benchmark. "Our intention is just to capture the market," says Tom Goodwin, senior research director at FTSE Russell. "We want to provide a complete picture of what the small-cap space is. We do not have quality requirements. We do not look at profitability."

As the S&P SmallCap 600's name implies, it includes less than a third as many stocks. For inclusion, says Gunzberg, companies must show positive net income over the previous 12 months, including for the most recent quarter. At least 50% of the stock must be publicly traded. Companies can't be included until they've been on the stock market for at least a year. A committee continually looks at the member companies and updates the index as its members see fit.

In other words, it's not a purely passive index. The membership is adjusted to take account of what is most commonly called the "quality" factor. "The quality factor is significant in explaining the outperformance," says Gunzberg. "That's the main driver."

FTSE Russell argues that this makes the S&P index a "sample" of the small-cap market, rather than a true reflection.

There's some justice in that argument. But it might not be the only reason the Russell 2000 is so widely used. It has been around for longer, so everyone is familiar with it. And, notes S&P's Gunzberg dryly, small-cap fund managers may prefer it as a benchmark because it's "easier to beat."

So should you switch your small-cap exposure from a fund that tracks the Russell 2000 to one that tracks the lesser-known index? There are some reasons you might.

Ground-breaking research by analysts at hedge-fund firm AQR Capital several years ago found that higher-quality small-cap stocks had outpaced those with weaker financials for decades—and with less volatility. The world of small-caps, inevitably, always includes a lot more flotsam than you find among bigger stocks. Where companies are small and stocks are thinly traded, their risks are often not efficiently reflected in their prices, either.

There is still debate about which "quality" factors are most useful for investors. But the S&P index isn't trying to find the best companies, just to avoid the worst. It certainly has worked so far. The simplest solution for investors wanting to embrace the smaller, quality-controlled index is to buy a low-cost exchange-traded fund which does that for them. BlackRock offers the iShares Core S&P Small-Cap ETF (ticker: IJR), with a low expense ratio of just 0.07%.

There is, of course, no guarantee that higher-quality small-caps will continue to outstrip the rest in the future. But it seems logical. As Damon Runyon said, "The race is not always to the swift, nor the battle to the strong, but that's the way to bet."

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