MassMutual Investments

Going Active in Small-Cap Blend

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MassMutual Investments

MassMutual Investments | White Paper
2023

Summary

- The profile of the Russell 2000® Index varies meaningfully relative to small-cap blend and large-cap peers.
- There are risks inherent with passive (index) investing, which is an investing strategy that intends to replicate the performance of benchmark indexes such as the Russell 2000 Index.[1]
- As many investors have implemented exposure through index investing, a blend of active small-cap solutions can be an effective way to generate risk-aware returns.

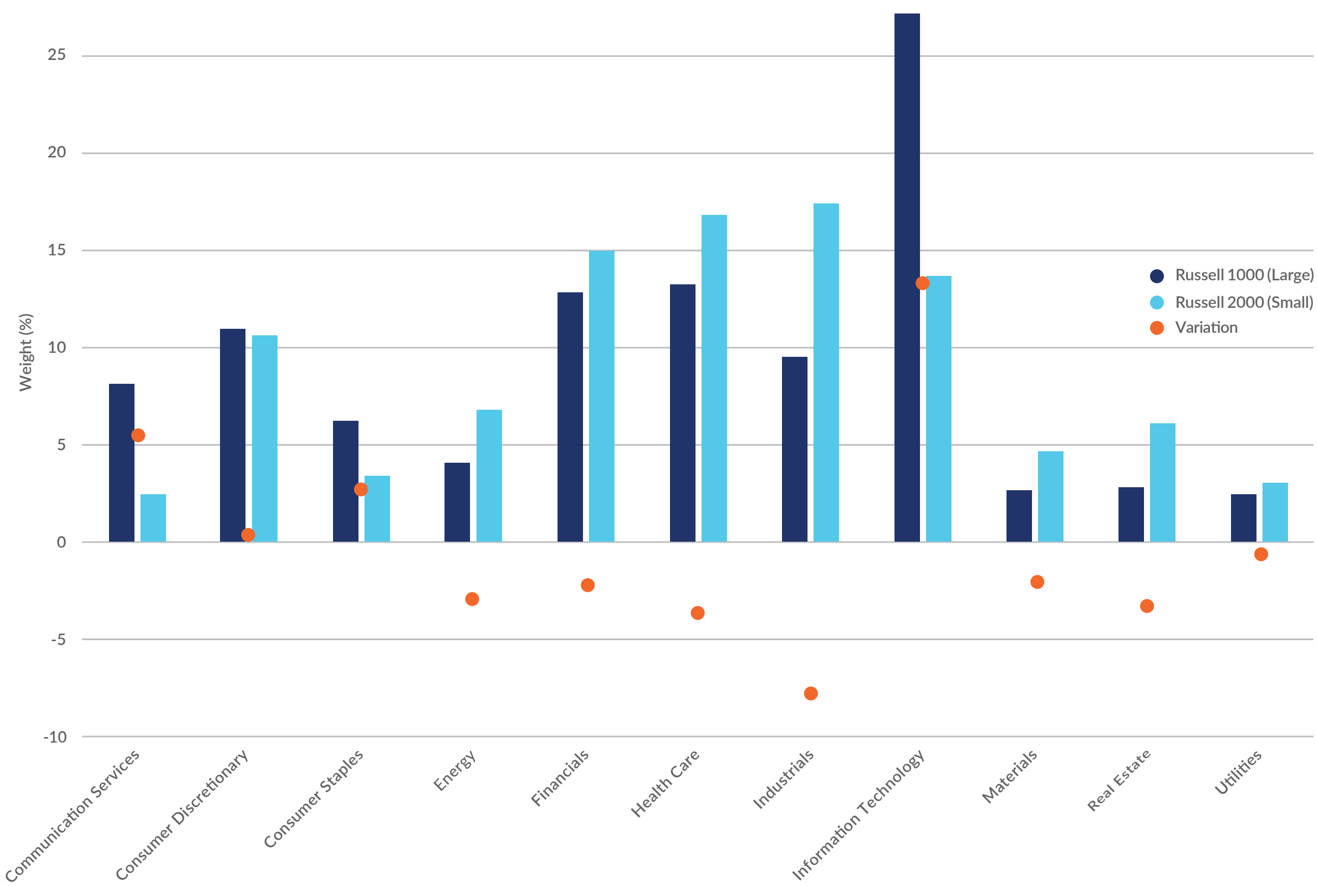
Small-cap equities are an important component of an investor portfolio as they provide access to invest in innovative companies in the formative stage of their development.

[1] Indexes cannot be purchased directly by investors.

The small-cap profile

The small-cap universe is represented by the Russell 2000® Index, whose companies tend to be more specialized than those of the more diversified large-cap Russell 1000® Index.[2] From a valuation standpoint, this might suggest that large-cap companies could potentially be more exposed to economic or industry-specific shocks. This disparity is also highlighted by the variation of the sector composition of both indexes (as shown below).

SECTOR VARIATION: SMALL CAP VS. LARGE CAP



Source: FTSE Russell. As of June 30, 2023.

And while the Russell 1000 is heavily weighted with technology stocks, the Russell 2000 is more balanced from a sector perspective and is not as reliant on a single industry. However, the relatively higher risk profile of small-cap stocks has likely translated into the higher volatility of Russell 2000 versus Russell 1000 returns. The composition of the Russell 2000 is quite diverse and includes a significant group of companies with high leverage, no or negative earnings, and low liquidity.

The Russell 2000 has the following fundamental characteristics:[3]

- Is trading at 53x free cash flow (highly levered).
- 40% of its companies have negative earnings (or are non-earners).
- A quarter of the index has a market cap below $1.8 billion.

[2] Source: FTSE Russell as of June 30, 2023.

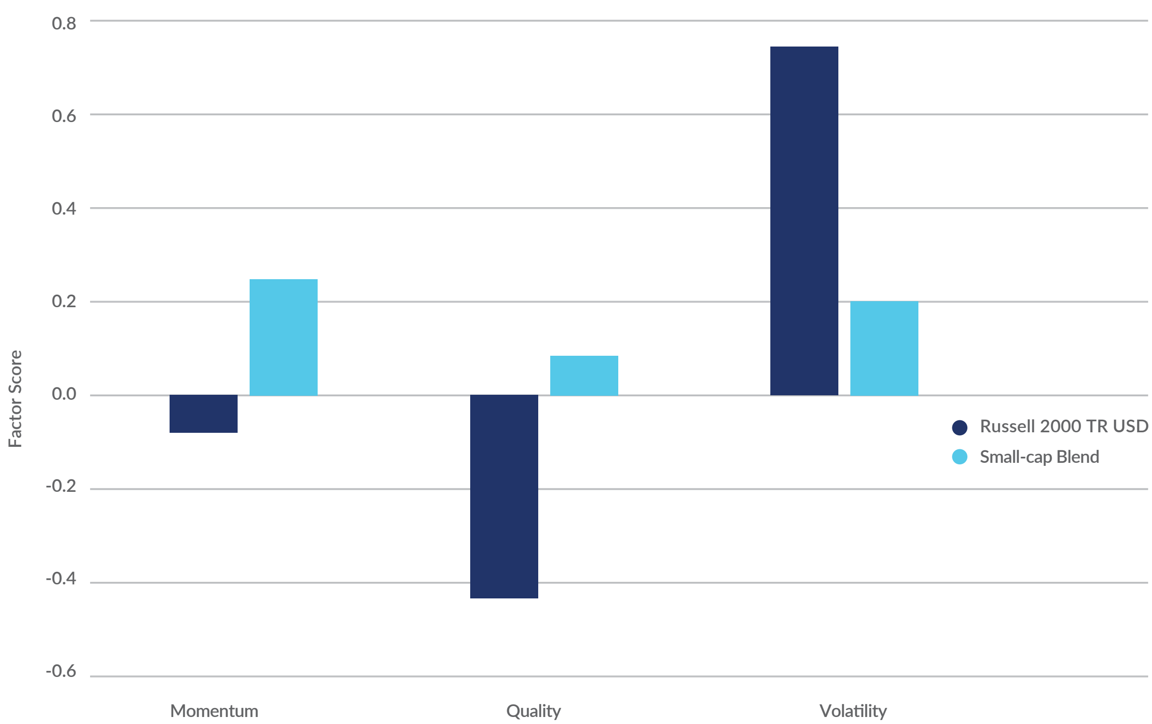
[3] Source: FactSet as of June 30, 2023.

A discussion of risk

Small caps could potentially be the riskiest investment in a plan lineup as they have historically averaged a 45% steeper drawdown than large caps.[4] And the Russell 2000, like other benchmarks, can be a risky form of accessing an opportunity set, although many investors view passive investing as low risk because there is little or no tracking error. This comes from active selection risk, as tracking error is the difference in returns between an active portfolio and a benchmark (target index). However, index investing carries with it the potential to incur total risk (as measured by standard deviation), market risk (beta), and factor risk. Factor risk is a much greater component of overall risk – and driver of return (both positive and negative) – as compared to stock-specific risk.

The factor composition of an index changes over time as a result of market leadership, which means that there is an inherent momentum bias in market cap-weighted indexes. Simply, the segments of the market that have done well (relative to others) will constitute an increasing weight. This may expose investors to different risks over time due to the overweighting of securities that could have peaked before heading to a decline. The chart below shows the factor profile of the Russell 2000 (dark blue) and the small blend category (light blue). The index has a higher exposure to volatility, and lower exposure to quality and momentum. These style factors help explain returns and risk within asset classes, as volatility is closely associated with risk, quality companies generally have strong earnings and stable balance sheets, and momentum focuses on stocks that have performed well in defined periods.

RUSSELL 2000: BIAS TOWARD UNDESIRABLE FACTOR EXPOSURES



Source: Morningstar Direct as of June 30, 2023.

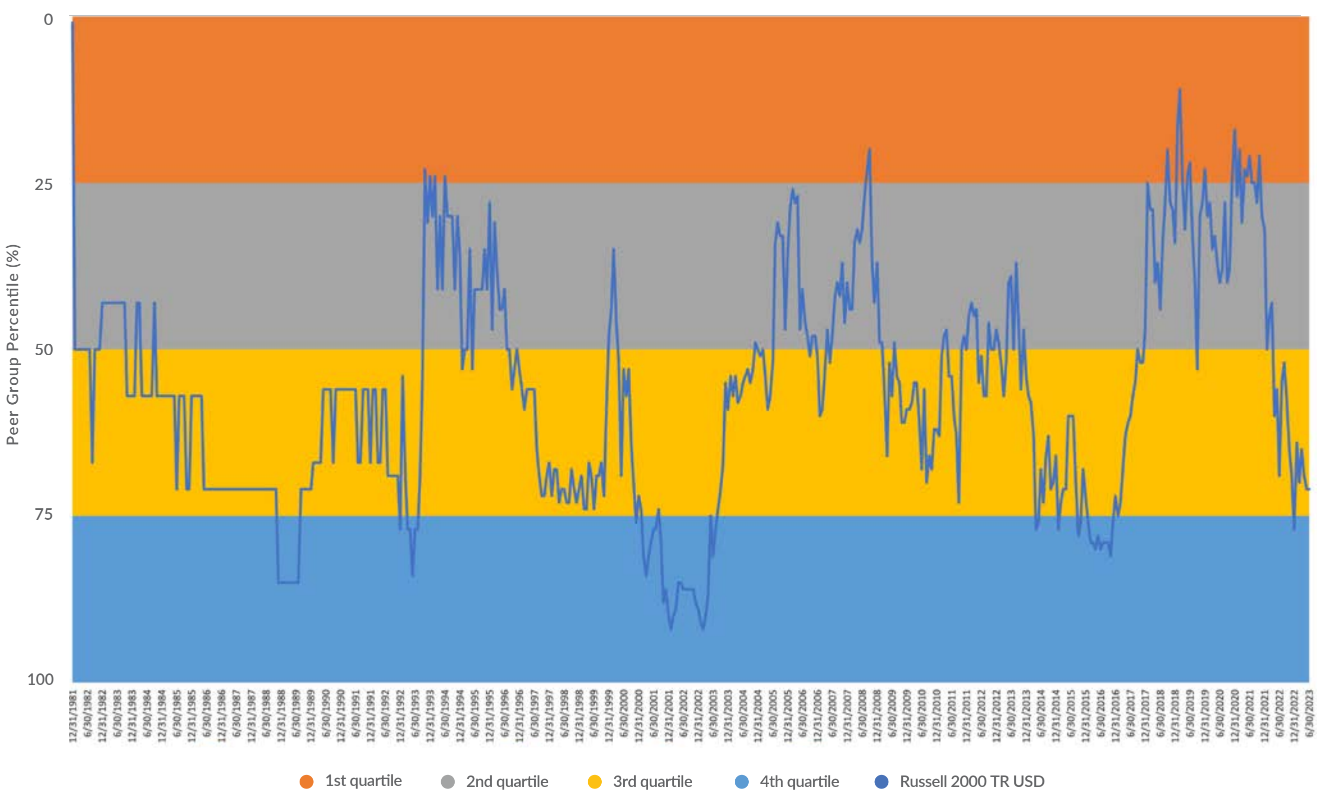
[4] Source: Morningstar Direct as of June 30, 2023.

Shift to passive, need for active

Many investors have implemented small-cap exposure through passive index investing. And while that had been a successful approach over the second half of the last decade, we believe the unique characteristics of small caps require prudent active oversight.

The performance of the Russell 2000 has been historically strong relative to its small-cap blend peers. This has resulted in an increasing shift by investors to passive vehicles in order to reduce fees. In fact, 46% of Morningstar Small Blend assets are passive, up from 37% five years ago prior.[5] The chart below details rolling three-year returns of the index since its inception in 1979. The current rolling three-year performance of roughly the 25th percentile is at the high end of prior cycle relative performance peaks.

RUSSELL 2000: PEER RELATIVE PERFORMANCE IS CYCLICAL



Source: Morningstar Direct as of June 30, 2023. Rolling three-year return.

[5] Source: Morningstar Direct as of June 30, 2023.

Threading the needle

The primary rationale for being active in small-cap blend is risk based, with skilled active managers focusing on risk management and deciding what to own (and what not to own). While going passive in small-cap blend may appear to be a simple decision, in the end it might include preventable complications. A skilled active manager can provide risk-aware returns across a variety of market environments, not just in times of volatility.

Our open-architecture platform has the potential to identify optimal investment solutions across asset classes and investment styles. We seek to provide style purity and consistency of performance with less risk by building investment solutions with world-class investment managers who specialize in their respective asset classes (such as small-cap blend). The multiple-manager design utilizes independent investment firms that thread the needle to provide additional diversification benefits and risk management to help create consistent, durable returns.

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MM202608-306559