THE SWEET SPOT OF THE US EQUITY MARKET: SMID

Topic Overview

This short piece describes research and analysis Piedmont's equity team completed in a continual search for an additional investment edge. After a comprehensive analysis of market returns over the last 20+ years it became clear that an inherent edge existed within the Russell 3000. By breaking down the Russell 3000 into capitalization tranches we were able to identify an edge favoring medium-sized stocks over a range of market cycles.

Background

The US equity market exhibits observable biases over shorter timeframes, alternately favoring one group of stocks over others: large cap vs. small cap; value vs. growth; defensive vs. dynamic; sector rotation, etc. There are a myriad of investment vehicles that allow investors to allocate across such divisions, including actively or passively managed funds or ETFs. Since most market indices are weighted by capitalization, large stocks dominate the indices more so than small or mid-sized stocks.

How an investor weights the stocks in his/her portfolio is a significant determinant of the resulting performance. For example, the S&P 500 returned 7.1% annualized for the ten-year period ending 12/31/2012, but the equally-weighted S&P 500 returned 10.2% over the same period. Both portfolios held exactly the same stocks, but the traditional cap-weighting methodology biases the portfolio toward the largest stocks, while equal-weighting favors the smaller and midcap stocks. We questioned whether this was a temporary or cyclical bias to the market, or if there is a longer term benefit to favoring one group of stocks over the others.

Hypothesis

Whereas typical market indices and portfolios favor larger stocks due to capitalization-weighting, liquidity, data availability, risk control and institutional coverage, we sought to identify and quantify the investment opportunity/edge within various market capitalization segments.

Analysis

To test this thesis, we divided the Russell 3000 universe into six tranches by market capitalization in order to analyze the equal-weighted returns of the various segments:

Russell 3000© Market Values as of 12/31/2012

	Tranche (Mkt Cap Rank)	Maximum Mkt Cap ($millions)	Minimum Mkt Cap ($millions)	#Stocks	% of R3000
Largest	**1-200**	498,416	15,852	200	66%
	201-500	15,849	5,154	300	17%
	501-1000	5,151	1,811	500	10%
	1001-1500	1,809	796	500	4%
	1501-2000	793	362	500	2%
Smallest	**2001-3000**	362	8	1,000	1%

Source: PIA, FacSet

The tranches were rebalanced quarterly and roughly approximate the divisions of the market as defined by Russell.

- Tranche 1 (largest, stocks 1-200) approximates the Russell Top 200, i.e. mega cap stocks;
- Tranches 2-3 (stocks 201-1000) approximate the Russell Midcap;
- Tranches 4-6 (stocks 1001-3000) approximate the Russell 2000, i.e. small cap stocks; etc.

Findings

The results confirmed our thesis that the risk/return relationship seems favorable when increasing exposure to medium-sized stocks. As shown in the table below, tranches 3 and 4 (market cap ranks 501-1000 and 1001-1500) exhibit a compelling return advantage over the study period from absolute and risk-adjusted points of view.

Equally-Weighted Returns as of 12/31/2012

Tranche (Mkt Cap Rank)	Ann. Return	Std Dev	Rtn/Risk Ratio	1 YR	5 YR	10 YR	20 YR
1-200	8.3%	15.2%	0.55	16.1%	2.2%	8.1%	8.6%
201-500	9.8%	16.9%	0.58	16.8%	2.2%	9.8%	10.0%
501-1000	**10.7%**	17.9%	**0.60**	18.0%	5.6%	11.9%	10.9%
1001-1500	**10.4%**	19.6%	**0.53**	19.8%	6.5%	12.0%	10.6%
1501-2000	9.8%	21.2%	0.46	18.3%	4.3%	10.9%	9.9%
2001-3000	7.3%	26.0%	0.28	14.6%	4.8%	11.4%	7.2%
R3000 eqwt	*9.4%*	*20.2%*	*0.46*	*17.1%*	*4.8%*	*11.3%*	*9.4%*

Source: PIA, FacSet

Additionally, we recognized that the most recent years have been a strong period of performance for smaller and medium-sized stocks, causing a potential bias in this data, so we analyzed the performance over rolling 1, 3 and 5 year periods within the study period . As the table below shows, the results are even more striking from this perspective.

Batting Averages: % of periods outperforming universe				
Tranche (Mkt Cap Rank)	Monthly	Roll 1 yr	Roll 3 yr	Roll 5 yr
# of periods	250	239	215	191
1-200	53%	47%	43%	42%
201-500	53%	64%	60%	53%
501-1000	54%	73%	76%	95%
1001-1500	52%	71%	71%	81%
1501-2000	53%	55%	53%	52%
2001-3000	44%	22%	32%	21%

Source: PIA, FacSet

Again, tranches 3 and 4 stand out, out-performing the universe of stocks in more than 70% of the rolling 1 and 3 year periods and more than 80% of the rolling 5 year periods. Tranche 3 (stocks ranked 501-1000 by market cap) outperformed during an astounding 95% of rolling 5 year segments.

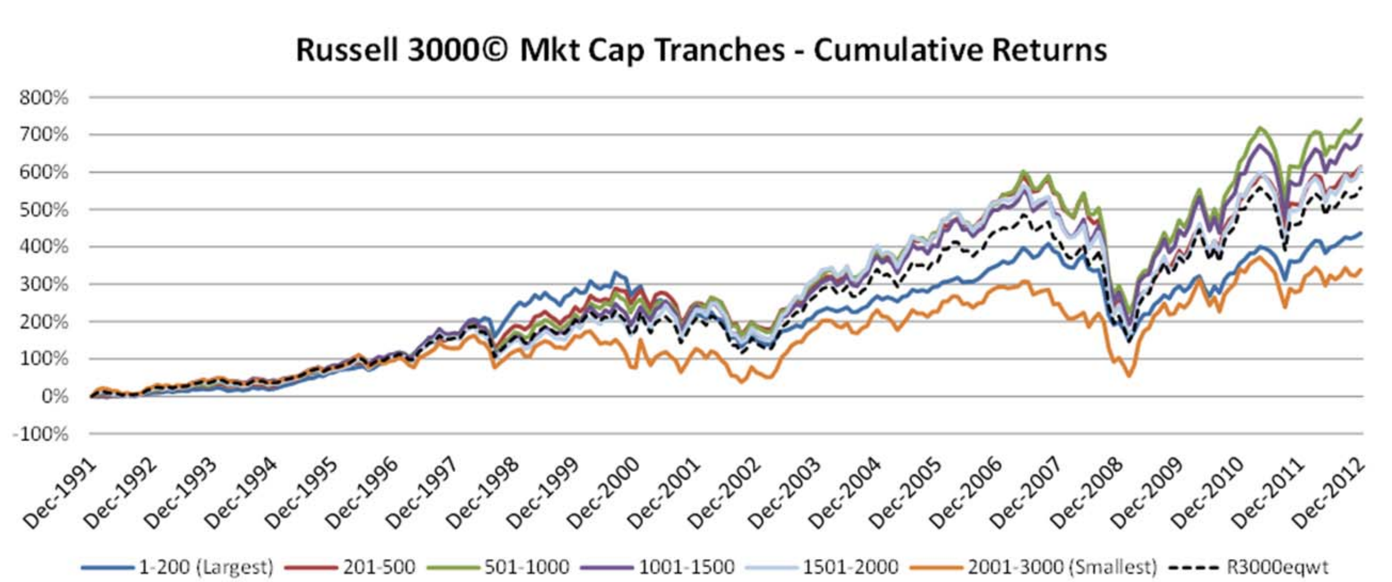
Summary

The result of this analysis has informed our investment philosophy in the SMid (small and midcap) segment of the US equity market. While other SMid managers may venture into the medium sized stocks as they seek to "let winners run" or expand their capacity, we view this part of the market as the true "sweet spot" and anchor our strategy in this area. Most similar strategies are benchmarked against the Russell 2500, an index that covers stocks ranked 501-3000 by market value (our tranches 3-6). We note that the largest 1000 stocks in that index (i.e., stocks ranked 501-1500 in the Russell 3000, our tranches 3 and 4) comprise 85% of the SMid benchmark by weight. A "tailwind" exists for those who recognize and are able to exploit this "sweet spot."

Why does this anomaly exist (and persist)? While we can offer no concrete proof, other than it just is, extensive discussions with members of Piedmont's Unified Investment team offer various theoretical and practical justifications:

- These medium-sized companies represent the "successful" small caps.
- Once a company reaches the $1-$5 billion capitalization range, their strategic options improve:
  - Balance Sheet flexibility – Financing options improve as the cost of capital decreases relative to small- or micro-cap stocks. Debt financing becomes a viable alternative.
  - Economies of scale – Flexibility and scale to implement growth initiatives.
- Liquidity – The average trading volume is sufficient for managers to commit to impactful position sizes.
- M&A – Larger firms seek to acquire smaller firms, but favor those that can meaningfully impact the P&L of the larger firm.
- Good data – While mega cap stocks may be viewed as an efficient market segment from a valuation/analysis perspective, and small caps are viewed as highly inefficient, the SMid segment combines the best of both worlds: plentiful data and investment opportunity.

Whatever the cause, it is clear that investors can capture an edge by focusing on this "sweet spot".



Source: PIA, FacSet