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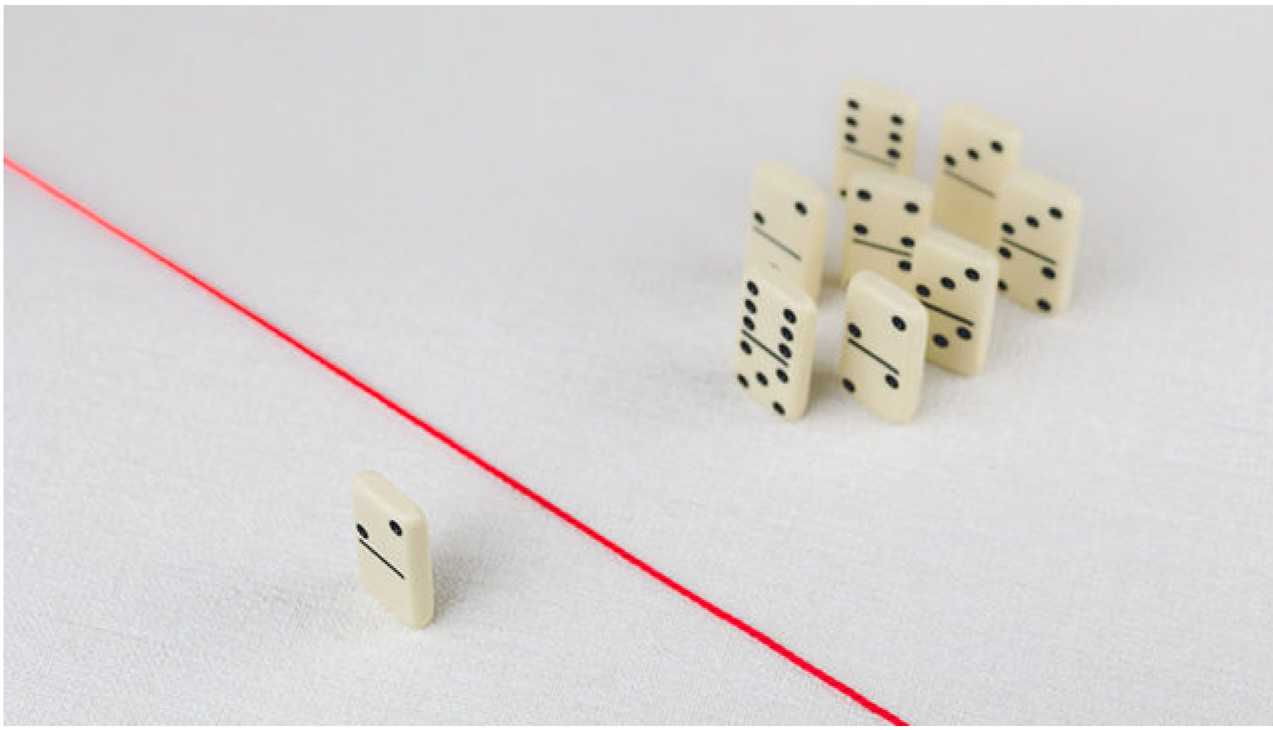
# Is something wrong with U.S. small cap stocks?



2017 has been a strong year for many investors. Year to date as of August 31, 2017,

- large cap U.S. stocks (Russell 1000® Index) are up almost 12%
- international developed stocks are up more at +17% (MSCI EAFE Index)
- emerging markets are approaching +30% (+28.3% for the MSCI Emerging Markets Index)
- even bonds are beating expectations at +3.6% (Bloomberg Barclays U.S. Aggregate Bond Index).

The one segment of the market that seems to be lagging is small cap stocks. The Russell 2000® Index is up "only" 4.4% year to date through August. Small cap value stocks are faring even worse, down -1.3% for the year so far as of August 31 (Russell 2000® Value Index).

It begs the question: Is something wrong with U.S. small cap stocks? Should investors be shifting their focus away from this segment of the market? At Russell Investments, we believe not. We hold a long-term strategic belief that investors get rewarded for small cap exposure in the portfolio. Here's why:

## What's underlying year to date performance

If we rewind the clock back to the beginning of this year, you may recall that given relatively high market valuations and low interest rates coming into 2017, many market observers expected capital market returns to be somewhat muted this year. The one area of the market that was generally anticipated to buck that trend? Small cap stocks.

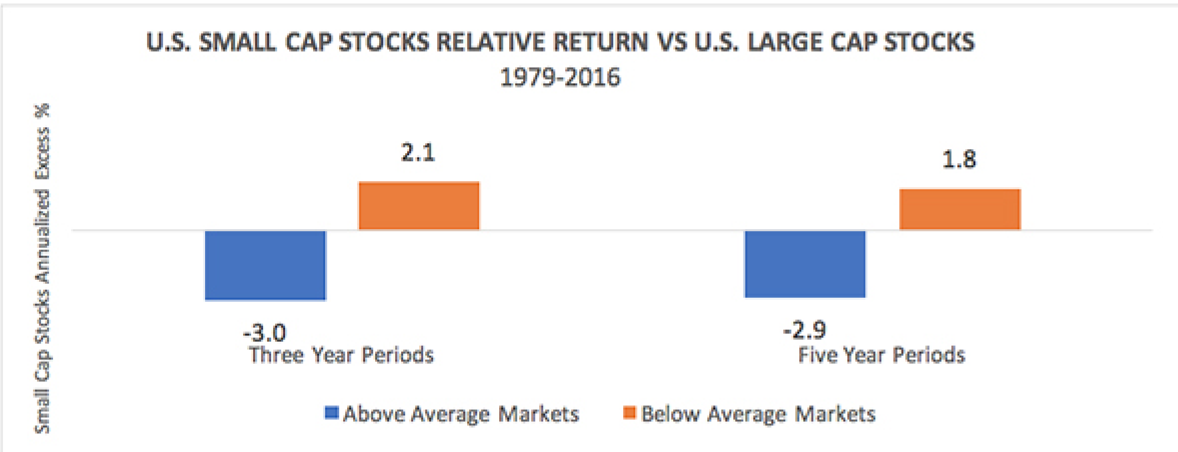
The rationale was: Traditionally, small cap U.S. stocks have benefited from lower corporate taxes and fewer regulations. Both items were near the top of the new administration's to-do list—thus the belief for a favorable small cap environment.

Fast-forward to today: The policy changes haven't occurred as swiftly as initially anticipated. In turn, small cap returns have lagged expectations and other parts of the U.S. stock market year to date.

## Potential bright spots ahead

In our view at Russell Investments, there are potential bright spots on the horizon for small cap stocks, justifying continued exposure to the asset class.

- **Tax reform and regulatory change** The current administration has expressed firm commitment to delivering on its campaign promise of tax reform and regulatory changes. Any movement in this direction will likely be viewed as a positive for small stocks.
- **Rising interest rates could be a boon** A big portion of the relative struggles for small cap stocks has been the poor results of the financial services sector, and in particular, regional banks—financial services represent 26% of the Russell 2000 Index. Lower intermediate interest rates, combined with increasing short-term rates, have created a difficult environment for these banks that rely heavily on lending for their profits. An increase in interest rates could help the outlook for this sector. Our Investment Strategist team expects the 10-year Treasury yield to edge up to a range of 2.5-2.75% over the next 12 months. An upward trend in long-term rates has the potential to raise intermediate rates, too—which could help regional banks and hence small cap stocks.
- **Low return environment has historically been good for small cap stocks** Small cap stocks have historically outperformed large cap stocks in periods of below average stock market returns. Regardless of the strong returns in 2017, the elevated valuations of the market suggest that the next three to five years could see lower than average results. In similar periods since 1979, small cap stocks have topped large cap stocks by approximately 2%.




*Sources: Large Cap Stocks: Russell 1000 Index; Small Cap Stocks: Russell 2000 Index, 1979 - 2016. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.*

One doesn't have to go back further than the "lost decade" to see this relationship occur over a long stretch of time: from 2000-2009, large cap stocks returned 0% and the Russell 2000 Index averaged 3.5% per year. We are not suggesting a similar environment, but in a period of lower capital market returns, every additional basis point in return helps.

- **The U.S. small cap cycle appears attractive** Finally, there is historical support that the current U.S. small cap cycle still has room to run. Tom Goodwin of FTSE Russell demonstrated in a recent blog post that the average small cap expansion (trough to next peak) has historically lasted an average of 750 trading days and has experienced an average return of 133.8%. Since the last trough of February 2016, the Russell 2000 Index has returned 39% over approximately 400 trading days. Both figures are still well short of the typical small cap cycle.

## The bottom line

There's no doubt about it: U.S. small cap stocks have disappointed this year as of August 2017. They have lagged U.S. large cap stocks and have not lived up to the high expectations that tax and regulatory reform set for the asset class at the start of 2017. However, without a crystal ball to help precisely forecast when small cap stock performance will improve, we believe investors with appropriate risk tolerance have the potential to gain from exposure to the asset class. It's the only way to be sure their portfolio can participate in a rally as it occurs—rather than watching it from the sidelines.

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**Russell 1000® Index:** Measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

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**MSCI EAFE (Europe, Australasia, Far East) Index:** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

**MSCI Emerging Markets Index:** A float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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