A MOMENT IN MARKETS – FOR A SMALL CAP PREMIUM, LOOK TOWARDS EUROPE

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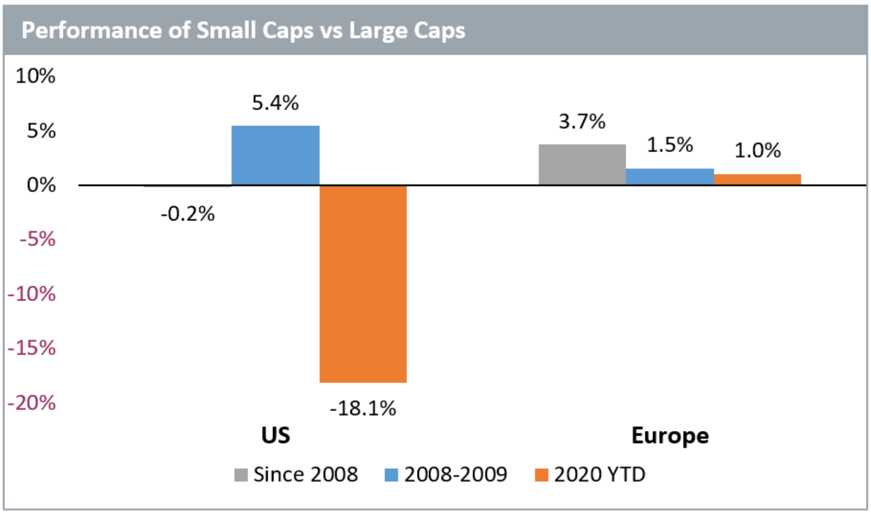
A small cap, or size, premium exists to incentivise investors to take the risk of investing in small companies. Compared to large cap stocks, these businesses typically have a more domestic focus and carry more embedded uncertainty about their future. Over long periods of time, and in aggregate, investors expect this premium to materialise in the form of small cap stocks outperforming large cap stocks.

The story so far this year…

Year-to-date[1], small caps have underperformed large caps significantly in the US. European equities, however, present a sharply contrasting image with small caps outperforming large caps slightly. This presents the key question: is this relative performance symptomatic of the ongoing economic crisis or does it highlight a shifting dynamic for small caps in the US compared to Europe?



Source: WisdomTree, Bloomberg. Data as of 07 August 2020. Large cap indices refer to respective MSCI regional indices and small cap indices refer to respective MSCI small cap regional indices. Net total return indices used in respective currencies, i.e. USD and Euros.

Historical performance is not an indication of future performance and any investments may go down in value.

Has the premium eroded in the US?

Looking back at the global financial crisis (GFC), we observe that small caps did indeed outperform large caps in the US over 2008-2009. In fact, the outperformance was much larger in the US compared to Europe. Could it then be that the premium has eroded over time in the US?

Since the start of 2008, the performance of small caps has been flat relative to large caps in the US whereas a healthy outperformance is clearly visible in Europe. It appears that the outperformance of small caps has eroded in the US over this period while small caps have maintained their lead in Europe.

What explains these dynamics?

The following observations are useful in making sense of the above:

1. **Tech dominance:** The performance of US large caps is increasingly determined by tech stocks – especially so in 2020. This was not the case back in 2008/2009. In August 2020, information technology and communication services together account for around 38% of the total weight in the S&P 500 Index compared to around 20% in August 2008. In contrast, the collective weight of the two sectors in the Bloomberg European 500 Index is around 12.5% in August 2020 and was around 11% in August 2008.
2. **Absolute outperformance of the US:** Despite their underperformance to large caps, US small caps have outperformed European small caps year-to-date in 2020. The MSCI USA Small Cap Index is down 5.2% while MSCI Europe Small Cap Index is down 11.7%[2]. Among the reasons has been a swifter fiscal response with targeted support for small businesses from the US compared to a coordinated fiscal package from the European Union which took much longer.
3. **Picking the right exposure for the right geography:** Investors seeking to make gains from specific factors would do well to identify the geographies where those factors are delivering at their best. The performance of factors is not uniform across geographies due to idiosyncratic reasons within those markets.

All data sourced from Bloomberg as of 07 August 2020.

Sources

1 Up to 7 August 2020

2 Net total returns basis in respective local currency, i.e. USD for USA and EUR for Europe. Data as of 07 August 2020.

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