US Small and SMID Cap Growth Equity Trends

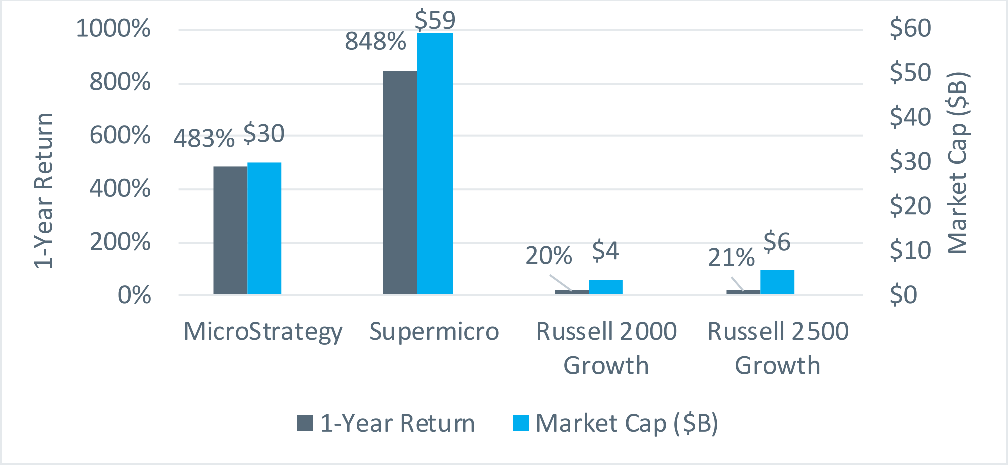
RVK has observed a consistent theme in recent meetings with US small cap and SMID (small and mid) cap equity managers—primarily on the growth side. Market concentration is not reserved only for US large cap, and the return contribution of two specific companies has become a significant factor impacting active manager results in the US small/SMID cap space, calendar year-to-date. These two companies are Supermicro and MicroStrategy, which have grown to be significant allocations in the core and growth versions of the Russell 2500 and Russell 2000 Indices.

Background

Supermicro is a key service provider for AI technology. MicroStrategy, a cloud-based services company, is being treated by the market primarily as a bitcoin holding company because it has heavily invested the firm's balance sheet in this cryptocurrency. After substantial price appreciation, these companies had market capitalizations of $59B and $30B as of March 31, 2024, respectively, pushing them beyond the normal purchase ranges for many small/SMID active managers. The upcoming Russell reconstitution will see these companies added to the Russell 1000 Index, creating an additional barrier of purchase for most small/SMID active managers.

Similar to how Tesla's market capitalization growth impacted mid cap managers a few years prior, these companies have grown too quickly for many active managers to invest significantly. While we have seen the relative performance of these companies revert since quarter-end March 31, 2024, any future depreciation will not become a relative performance tailwind for impacted active small/SMID managers once the stocks leave their respective benchmarks. This differs from the recent "Meme-stock" theme because those stocks remained in their selection universe and active managers who were underweight to that group of stocks eventually benefited from a performance reversal. The trailing 1-year returns as of March 31, 2024, and market cap (average levels for the indexes) for the stocks and indexes are shown in **Figure 1**.

Figure 1: 1-Year Returns and Market Cap Comparison



Source: Morningstar. Data as of March 31, 2024

Conclusion

Managers are ultimately responsible for outperforming indices within their space and, while these may or may not have been appropriate holdings for small/SMID strategies at points in the past, the short-term impact of these companies has been heavily detrimental to relative performance for a substantial percentage of the peer group.

As of March 31, 2024, Supermicro and MicroStrategy have accounted for over a quarter of the 1-year return contribution for the Russell 2000 Growth Index (20.3% return for the Index over this time period), despite their accounting for less than 5% of the index. This is a striking contribution for an index that includes over 1,000 stocks. For managers that did not hold either company, this equates to a direct return headwind of ~5% relative to the index.

Relatedly, the biotechnology industry has accounted for another 15% of the Russell 2000 Growth Index return contribution (another 3% of the total 20.3% index return that many managers may not have fully captured). While many managers provide exposure to the biotechnology industry, it tends to be an underweight relative to the index across the peer group. The combined impact of likely underweights to Supermicro, MicroStrategy, and biotechnology has created a difficult environment, especially for managers who prefer a more diversified or valuation-sensitive approach in the small or SMID growth spaces. For example, the net-of-fees returns reported to eVestment as of March 31, 2024, suggest that the median small cap growth manager has underperformed the index by nearly 3% over the trailing 12-month period.

Though this environment has significantly impacted shorter-term performance, it is important to note that the small and SMID cap asset classes have been a relatively attractive area for active risk when examining longer-term trends, compared to the large cap segment in the US, as shown by **Figure 2**.

Figure 2: US Equity Manager Excess Returns, %
Long-Term 3-Year Rolling Average (Net of Fees)

	25th Percentile	Median	75th Percentile
US Large Cap Core Equity	1.11	-0.43	-2.02
US Large Cap Growth Equity	1.00	-0.89	-2.81
US Large Cap Value Equity	2.07	0.28	-1.35
US Mid Cap Core Equity	1.51	-0.51	-2.40
US Mid Cap Growth Equity	1.61	-0.53	-2.56
US Mid Cap Value Equity	1.33	-0.41	-2.20
US Small-Mid Cap Core Equity	2.39	0.16	-1.97
US Small-Mid Cap Growth Equity	2.60	-0.10	-2.71
US Small-Mid Cap Value Equity	2.46	0.24	-1.75
US Small Cap Core Equity	2.82	0.53	-1.61
US Small Cap Growth Equity	3.62	0.78	-1.93
US Small Cap Value Equity	3.07	0.79	-1.31

Source: 2024 RVK Annual Active/Passive Study using data from eVestment.com. Excess return is calculated versus universe-specific benchmark. January 2001 represents the start of the first 3-year period and ends December 2023. Performance shown represents rolling 3-year performance at each quartile, and does not correspond to the long-term experience of any specific manager. Peer group constituents and managers' rankings change over time.

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