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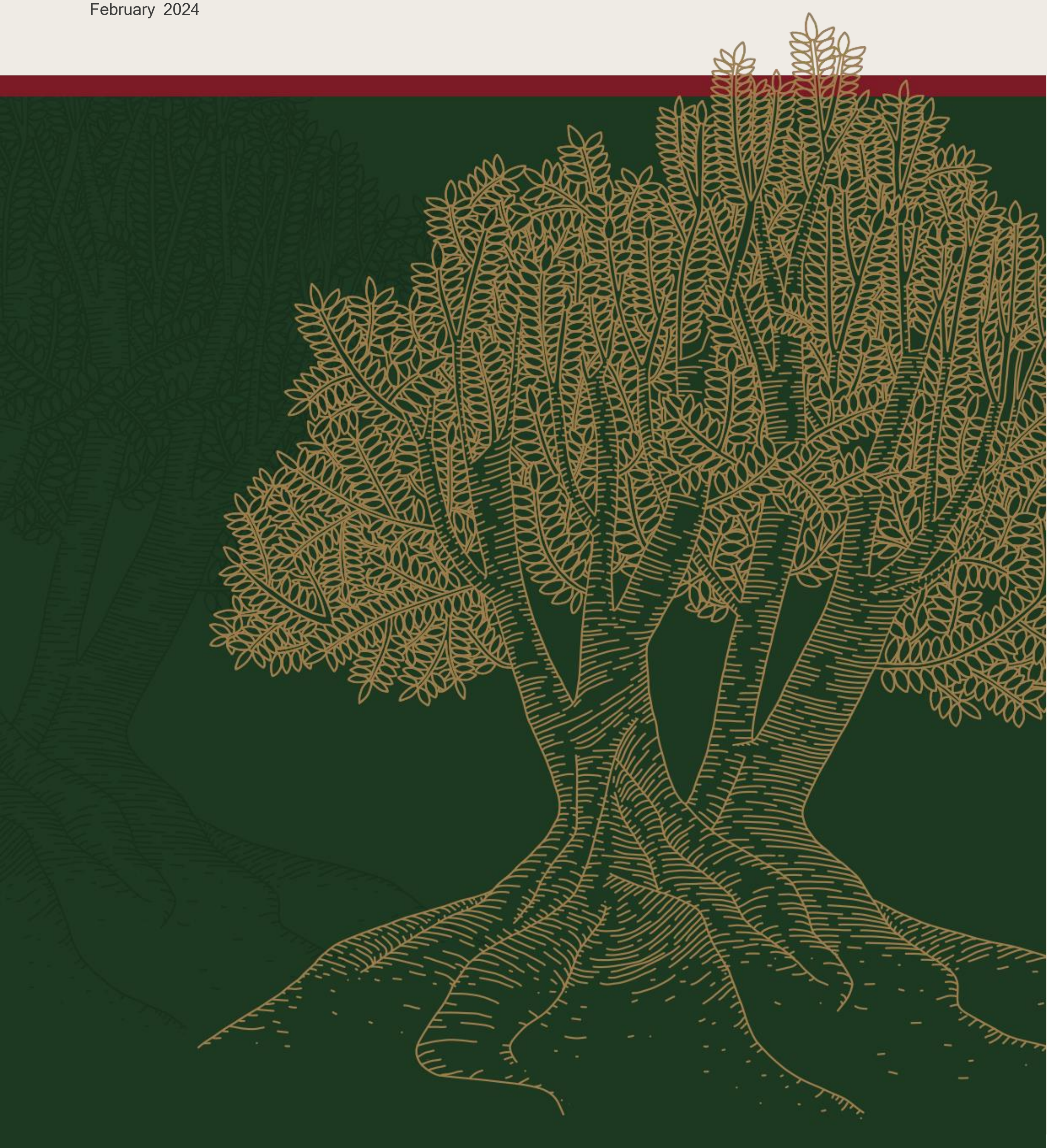
DISSECTING THE PERFORMANCE OF US LARGE CAPS (S&P500) VS MID-CAPS (S&P400)

February 2024

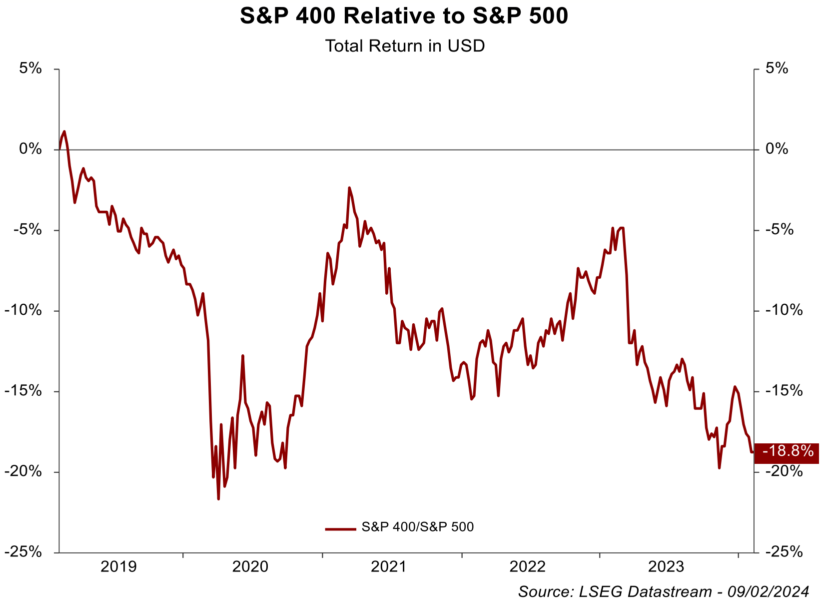


OVERVIEW

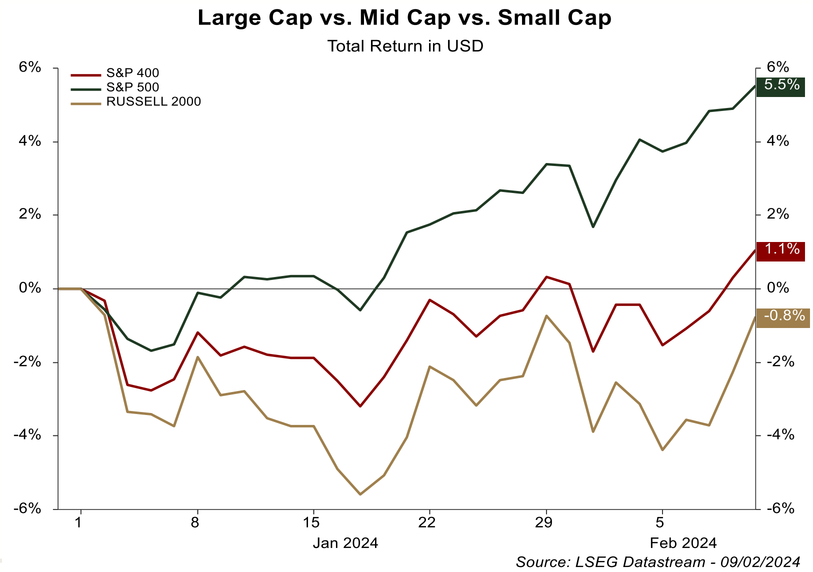
It is well-documented that the benchmark US index, the S&P500, has been led by a relatively small number of big winners over the past year, with the remaining stocks languishing in relative terms. There appears to be a persistent size factor at play here, but this phenomenon extends beyond the S&P500 to the midcap (S&P400), and indeed, small cap indices (e.g. Russell 2000). In this note, we explore this dynamic and make some observations about index construction and considerations in expressing one's view on US equities.

S&P400 RELATIVE TO S&P500

Over the last five years, the midcap index in the US has underperformed the S&P500 by almost 20% on a cumulative basis.



Year to date, the underperformance is already over 4%, with the S&P500 up 5.5%, the mid cap index +1.1% and small cap Russell 2000 index faring the worst, down 0.8%.



The table below compares the YTD performance of the S&P400 midcap index against the S&P500 by sector. Furthermore, we've presented the median and average returns on a sector basis across both indices:

	Weight in index		YTD performance contribution (bps)		Median return			Average return		
Sector	**S&P400**	**S&P500**	**S&P400**	**S&P500**	**S&P400**	**S&P500**	**Difference**	**S&P400**	**S&P500**	**Difference**
Information Technology	11.0%	30.2%	106.9	296.0	-0.7%	4.7%	-5.4%	5.2%	5.4%	-0.2%
Communication Services	1.6%	9.1%	-12.1	103.3	-10.2%	0.8%	-10.9%	-6.6%	1.4%	-7.9%
Consumer Discretionary	15.8%	10.5%	17.4	25.2	-0.2%	2.9%	-3.0%	-0.1%	0.7%	-0.8%
Consumer Staples	4.5%	6.0%	14.0	12.0	2.0%	-1.5%	3.5%	2.8%	-1.6%	4.4%
Financials	15.3%	12.7%	-0.7	50.5	-0.4%	2.0%	-2.5%	-0.5%	1.7%	-2.3%
Industrials	21.6%	8.5%	69.0	23.5	2.0%	4.7%	-2.7%	1.7%	3.1%	-1.4%
Real Estate	7.8%	2.3%	-47.5	-10.3	-6.3%	-6.4%	0.1%	-6.4%	-5.1%	-1.3%
Utilities	3.1%	2.1%	-11.2	-11.3	-5.9%	-5.2%	-0.7%	-5.5%	-4.6%	-0.9%
Health Care	7.8%	12.6%	16.3	71.8	-0.9%	2.0%	-3.0%	1.0%	2.6%	-1.6%
Energy	4.8%	3.7%	-16.3	-1.9	-3.8%	-3.8%	0.0%	-2.9%	-2.7%	-0.2%
Materials	7.0%	2.3%	-26.6	-6.9	-3.5%	-1.4%	-2.1%	-3.7%	-3.5%	-0.2%
Other	0.0%	0.1%	n/a							
Total	**100.0%**	**100.0%**	**109.1**	**551.9**	**-1.4%**	**0.3%**	-1.6%	**-0.3%**	**0.8%**	-1.2%

Note: YTD performance metrics to close 9th February 2024.

Some interesting & notable observations:

- Across both indices, we **observe a negative / left tail skew in the performance data** – median returns are lower than the average returns, so *a larger number of stocks are poorer-performing*. Looked at differently, average performance is lifted by a relatively small number of winners.

- The **gap between median and average returns is larger at an aggregate index level in the S&P400 than it is for the S&P500** – 110bps versus 50bps. This implies that the left tail of returns is more pronounced for the mid cap index – fewer big winners relative to the number of losers.

- While the "Magnificent 7" continues to dominate the S&P500 return YTD as it did in 2023, it turns out that the mid cap index has had an even bigger skew – *its top two contributors YTD, Super Micro Computer and Deckers Outdoor, while accounting for just 2% of the index market cap, have contributed essentially all the 1% YTD index performance*. **The other 98% of the index has delivered no returns, in aggregate.**

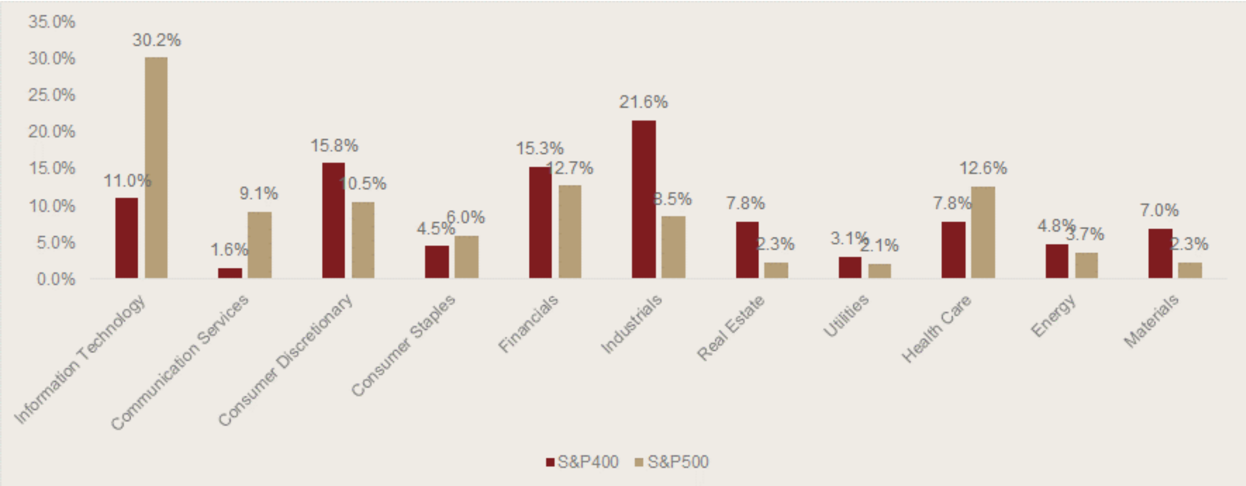
- When drilling down to a sector-by-sector comparison between the S&P400 and S&P500, **there is again persistent underperformance of the S&P400 YTD.**

    - YTD, Consumer Staples was the only sector where the average return in the mid cap index was higher than in the S&P500. Outside of this, the average underperformance across other sectors has been 1.2% YTD for the S&P400.
    - This issue isolates the impact of different sector weightings between the two indices, and likely **highlights a persistent size factor in driving performance.**

- Further compounding the performance issue for midcaps YTD, the **S&P400 is significantly overweight to sectors that have severely underperformed in both indices**. While the weighting of Information Technology in the S&P400 is far lower than its large cap counterpart, it is also notable that the median stock performance of the tech sector in the S&P400 was negative – a diametrically opposed outcome to the S&P500's tech sector median returns. Despite this, the *average* return for the tech sector in the S&P400 was close to that of the S&P500 – skewed entirely by Super Micro Compute's 160% rise YTD.

- **Real estate** accounts for close to 8% of the mid cap index compared to just 2.5% of the S&P500, and this has been a very poorly performing sector in both indices YTD.
- Within **Financials,** the performance differential between the midcap index and S&P500 has been stark YTD – the average stock return in this sector in the S&P500 is +1.7% against -0.5% for the midcap index. The difference has stemmed from a disproportionate exposure to the small banking sector in the US for the midcap index – and the travails here are well documented. Banks account for 5% of the S&P400 and detracted 50bps from overall performance YTD – with one company losing over half its value YTD (New York Community Bancorp; -52% YTD). By contrast, Banks account for only 3% of the S&P500 and contributed close to zero return YTD – but again there was a size factor at play: the 4 largest banks (2.5% weight) contributed 4bps, and everything else was negative in aggregate.

COMPARING SECTOR WEIGHTS: S&P400 VS S&P500



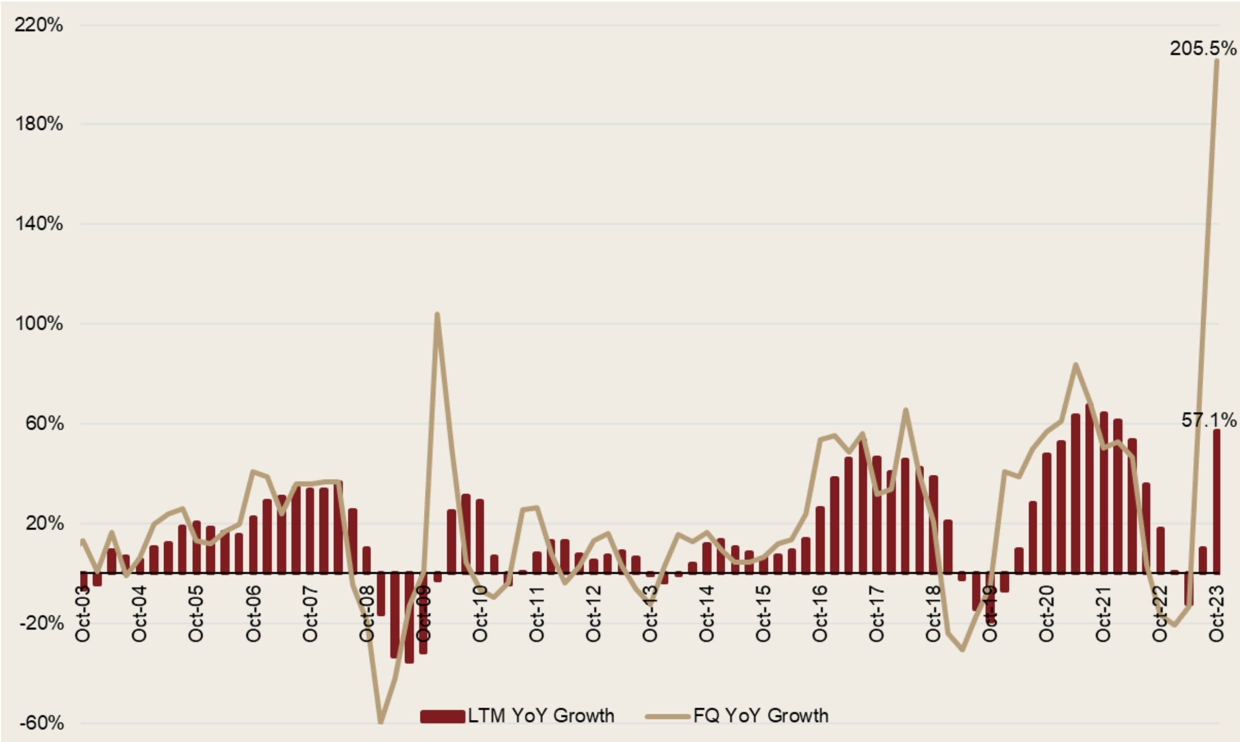
WHERE ARE ALL THE WINNERS IN MIDCAPS?

Are small and midcap indices destined by design to underperform?

Companies that achieve sufficient success to graduate to large cap status will move out of mid and small cap indices and become S&P500 companies. Financial markets can and do exhibit power laws where the large can get *much* larger, economics and wealth become concentrated in the hands of a select few (companies and individuals are very alike in this regard) and, in many cases, the *rate of growth* can *accelerate* as companies become larger (belying the "law of diminishing returns" principle).

A recent and very relevant example is Nvidia: barely a year ago, this company had an index weighting of 1.7% in the S&P500 – today its weighting is 4.2%. Over the past three years, the company's market cap has expanded from $330bn to today's $1.8 trillion – a five-fold increase. Despite the much larger scale in both market value as well as operational metrics (annualized revenue today is around $70bn versus $11bn as recently as in FY20), Nvidia today is achieving its best revenue *growth rates* ever.

Nvidia revenue growth rates – last 12 months (LTM YoY growth) vs most recent quarter year on year (FQ YoY growth)



If there was an index of "hyper" market caps only (say, $500bn+ in size), Nvidia would have long since graduated from the S&P500 to this index and hence "robbed" the S&P500 of its spectacular subsequent performance. Counterintuitively, this is perhaps the beauty of the S&P500 – its biggest winners have nowhere else to go when they get "too large". This means that this index is forced to "hold onto winners" - hence the index concentration that we see at the very top (5 companies comprise ¼ of the index). Having said this, last year the Nasdaq-100 trimmed its weights of many of the "magnificent 7" stocks down due to this exact point – the names became too large a weight. This is admittedly more of an issue for an index with only 100 stocks against one with 500 constituents.

Turning back to our earlier analysis and observation of the skewness in the mid-cap index's performance YTD: the largest stock in the S&P400 index today is Super Micro Computer, at an index weighting of 1.3% (incidentally, it has returned >160% YTD in just over a month - perhaps it will go on to be a multi-year winner?). SMCI's market cap today is $41bn – surely at some point it will move into the S&P500 (it displaced Steel Dynamics in the S&P400 as recently as December 2022). *If* it proves a persistent, secular winner, the S&P400 will lose out on this subsequent performance.

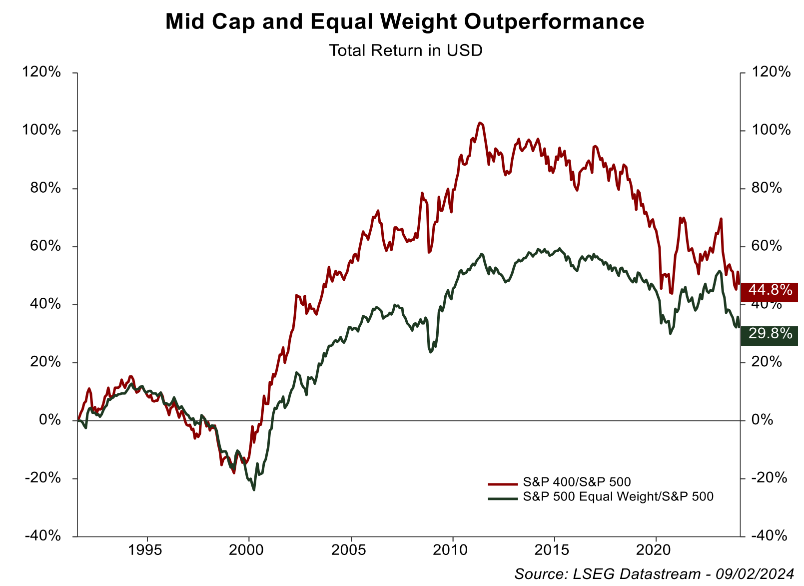
What if Super Micro had been, say, 4% of the S&P400 index at the start of this year and delivered the return it has? The index performance would have been +6.7% YTD instead of 1.1%. This highlights just how much influence one or two stocks can have in a supposedly diversified index – performance characteristics exhibits elements of venture capital, where one or two big winners can account for an outsized contribution to overall return, often dwarfing the cumulative detraction of many losers.

However, in the case of small and mid-cap indices, these winners are "not allowed" to become too big because they ultimately leave those indices for greener pastures (ie S&P500). The top 5 largest stocks in the S&P400 comprise around 4% of the index, while the top five in the S&P500 comprise almost ¼ of the index. Perhaps this is what makes the S&P500 such a robust index: winners are *allowed to run*, the most promising stocks from smaller indices ultimately get included, which eventually knocks out the laggards toward the bottom of the market cap rung in the S&P500. It is the ultimate "survivorship bias" vehicle. By contrast, it seems unlikely we will ever witness similar concentration in the midcap index because the winners will ultimately move on.

CONCLUSION

Mid and small cap indices will, almost by definition, likely remain somewhat value plays where winners get systematically pared back and "losers" could be added to (if a stock drops out of the S&P500, it could land up in the mid cap index). This means that index concentration will be less of an issue for the mid and small cap indices, but the corollary of this is that winners may have their wings clipped too soon for those indices to see the full benefit. By contrast, the S&P500 (and in fact most market cap-based indices) systematically allows winners to run and pares losers. Depending on one's investment style, these will find very different audiences.

Of course, it is also worth noting that the period from 2022-2023 was very unusual in that the big index weights in the S&P500 were very big losers during the tech bear market of 2022, and this position reversed spectacularly in 2023. Nevertheless, the secular winners that have become index heavyweights have systematically grown significantly in relative importance in the past 5+ years. This doesn't mean they will outperform in all periods, and there may well be periods of mean reversion where it can be a very profitable trade to allocate to smaller, cheaper stocks. Indeed, this would probably be a healthy sign for a sustained bull market to see broader participation than we have today.



Over the longer term, it is interesting to observe that the Mid-Cap S&P400 (going back to August 1991, the start of the index) has in fact outperformed the S&P500 as has the S&P500 equal weighted index vs the S&P500 – by a cumulative margin of almost 45% in the case of the S&P400. However, all this outperformance (and more) happened prior to 2011. A potential issue with using this data is that we may have gone through a meaningful regime change over time, with increasing globalisation and the spawning of new business models that thrive on network effects allowing for "winner takes all" economics. Facebook and Google are great examples – two companies comprising half the global advertising industry revenue pool would have been unthinkable in the 80s and 90s. This supports the notion that bigger and better keep getting bigger and better and scale is what wins in a digitally connected world.

To end with some further confusion, market cap indices are inherently momentum plays as one owns more of the larger names doing well and equal weighted indices are value plays as winners get trimmed back to equal weight and losers get topped up on rebalancing. Investors should think about whether they're "value" investors or have an investment style which incorporates a greater emphasis on momentum (both operationally and share price wise). Finally, in the context of the current market cycle it would be an encouraging sign to see participation broadening out to small to mid-cap stocks as it would likely signal a more sustainable rally in equities generally.

Using a specialist ETF manager such as Omba can serve investors well in navigating this complex dynamic.

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