Big Trouble For Small Value?

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It was a good year for stocks in 2019. As always, some companies did better than others. Unfortunately for asset class investors, last year mirrored the previous few—the largest stocks in the US with the highest prices ("large cap growth" shares) had by far the best returns. It has been disappointing to be diversified.

The S&P 500 Index, as the name implies, holds about 500 different stocks, yet a handful of the highest priced technology companies such as Apple, Amazon, and Microsoft, make up a disproportionate weight. Its returns reflect this—thanks to an average return of +56.5% on these three stocks last year, the DFA US Large Company (S&P 500) Fund gained +31.4%, well above the S&P 500’s long-term return of about 10% since 1928. What about other core stock asset classes? They didn’t do poorly but failed to match the S&P 500’s results.

The chart below begins by looking at US and international stock asset classes over the last one-, three-, and ten-year periods. After a difficult few years for US small cap and international stocks, large US companies have emerged as clear leaders in recent times. Over every period mentioned, the S&P 500 has achieved above-average returns while other asset classes, especially small cap value stocks, have performed well below expectations.

If you’re not thinking about shifting more of your portfolio to these leading US companies at this point, you’re at least wondering what’s going on and what we can expect going forward. This month I’ll offer some perspective on the sub-par returns for small value stocks and the diversified portfolios that hold them.

Long Term Is Longer Than You Think

People tend to have short-term thinking, so monthly or yearly returns are what we focus on most. Five or ten-year periods seem like an eternity. Yet when it comes to investing, even decade-long stretches aren’t that significant. A trend that emerges during one ten-year period can (and often does) completely reverse over the next.

The chart below also reports stock asset class returns for the first decade of the 2000s, 2000-2009. The results are almost a mirror image of the 2010-2019 period. The S&P 500, +13.5% in the last decade, lost -1.0% per year in the first decade of this century! US and international small value stocks, which only returned +10.7% and +7.2% from 2010-2019, and noticeably underperformed the S&P 500, gained +9.1% and +11.3% during the first decade of the 2000s, registering +10% to +12% per year S&P 500 outperformance.

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**Diversification Can Be Disappointing**

The chart above also reports the periodic returns of a hypothetical portfolio allocation, the “Asset Class Mix,” which is diversified globally and includes a meaningful allocation to US and non-US small cap value stocks. During the last ten years, it earned a respectable +10.3% but frustrated those investors who expect *always* to outperform the S&P 500. Investors with more realistic expectations can instead look at its 3.2% per year underperformance over the last decade compared to the S&P 500 as the “price” for potentially higher returns when the S&P 500 is floundering. This, too, can happen.

During the 2000-2009 decade, the Asset Class Mix had a lower overall return—+6.1% per year—but outperformed the S&P 500 by over 7% per year. Small cap stocks offer diversification to a portfolio that holds larger companies. But being diversified means you sometimes have to accept temporarily lower returns to achieve higher overall results.

Looking at the entire 20-year period, one that includes a decade of outperformance and then underperformance for small cap value stocks (relative to the S&P 500), a more definite trend emerges. While all stocks have had below-average gains this century, small cap value stocks have achieved noticeable outperformance. The S&P 500’s gain of +6.0% per year is 3.9% per year less than US small value stocks and 3.2% less than international small value stocks. Compared to the diversified Asset Class Mix, the S&P 500 has underperformed by 2.2% per year—in line with reasonable expectations over an investing lifetime.

With a longer perspective, we find that the higher expected returns of small cap stocks may not have disappeared, but instead could be temporarily dormant.

**Setting Expectations: History Helps**

Adding to our confidence that small cap value stock advantage hasn’t permanently disappeared is the fact that we’ve seen plenty of periods historically where small cap value has underperformed.

If we look at all 10-year rolling periods since 1928 for a diversified index portfolio that includes the S&P 500 as well as large and small cap value stocks (the “Asset Class Index”), we find that decade-long droughts aren’t the norm, but they’re not unprecedented, either.

With an average return over all ten-year periods of +13.3% per year, the Asset Class Index outperformed the S&P 500 during 82% of all 10-year periods by an average of +2.8% per year (the S&P 500 averaged +10.5%). Only 18% of periods, one of which was the last ten years, saw the large cap growth dominated S&P 500 Index win out.

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<tr>
<th>1928-2019</th>
<th>Ave of All 10-YR Periods</th>
<th>% of 10YRs Beating S&amp;P 500</th>
<th>Ave 10YRs AFTER Trailing S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>10.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Asset Class Index”</td>
<td>13.3%</td>
<td>82%</td>
<td>4.9%</td>
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What might we expect in the future? The past offers clues. The average outperformance for the small cap value-centric Asset Class Index *after a ten-year period in which it underperformed the S&P 500* jumps to +4.9% per year! The percentage of time over these ensuing decades where the Asset Class Index (and small value stocks) outperformed the S&P 500? **100%** (132 for 132).

**Small Value—Down But Not Out**

The last few years have been challenging for investors who target the small cap value segment of the stock market with a portion of their portfolio. US and international small value stocks have underperformed not only their long-term averages but also the well-known and oft-cited S&P 500. The case for remaining diversified and sticking with small cap value stocks, however, hasn’t diminished.

Being diversified means that you will never achieve the absolute *best* returns, but you’ll avoid the absolute *worst*. The first two decades of the 2000s are a vivid illustration of this. Periods of underperformance aren’t an indicator that we should chase recent returns. If history is any guide, we should expect relative future results for portfolios that include small value stocks to be even better than their long-term averages—what’s down should eventually come back up.

If you can stay disciplined, you give yourself the best shot at a better investment outcome.

*Source of data: DFA ReturnsWeb, Portfolio Visualizer*

DFA S&P 500 Fund = DFUSX, DFA US Large Value Fund = DFLVX, DFA US Small Value Fund = DFSVX, DFA Intl Value Fund = DFVX, DFA Intl Small Value Fund = DISVX

**Asset Class Mix** = 21% S&P DFUSX, 21% DFLVX, 28% DFSVX, 18% DFVX, 12% DISVX, rebalanced annually.

“Asset Class Index” = 30% S&P 500 Index, 30% Dimensional US Large Value Index, 40% Dimensional US Small Value Index, rebalanced annually.

*Past performance is not a guarantee of future results.* Diversification does not eliminate the risk of loss. Index and mutual fund returns include the reinvestment of dividends but not expenses or additional advisory fees. This article is for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, product, or service. Servo is a Registered Investment Advisor (RIA) with clients nationwide. Unauthorized copying, reproducing, duplicating, or transmitting of this material is prohibited. For past *Factors In Focus* newsletters, please visit Servo’s website at servowealth.com.

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