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One of the most common questions I'm asked is: "What's wrong with small caps?" This concern usually stems from relative returns over the past 10 years, during which US small caps underperformed the S&P 500 Index by a little over 4 percentage points.

But which one of these asset classes has been behaving abnormally?

As the graph shows, US small cap's return over the last decade was within 1 percentage point of its average since 1927, at 11.01% versus 12.00%. The large cap S&P 500, on the other hand, was far from its long-run average. The index returned more than 15% over the last 10 years, nearly 50% more than its average since 1927 of 10.39%.

The S&P 500 has substantial weight in companies like the Magnificent 7, which have exceeded investor expectations with their earnings growth in recent years. When investors are surprised in a good way, outsize returns may follow. That's a windfall for investors with diversified portfolios. But expecting a continuation of large cap returns well in excess of the historical norm is betting on further unexpected success stories for these firms.

I am a big believer in means reversion, where over long periods of time, all things being equal, things will revert to their long term historical averages. Where this eventuality materializes, it would mean that the very large cap stocks which have produced better-than-expected results, would underperform going forward.

Many people have been searching for stories to explain US small cap underperformance. We've written previously about looking at the bigger picture with small cap returns and how some of the concerns over the current opportunity set may be overblown. But the stark contrast between short-term and long-term large cap returns suggests maybe investors are questioning the wrong segment of the market.

Thanks for reading!

Martin

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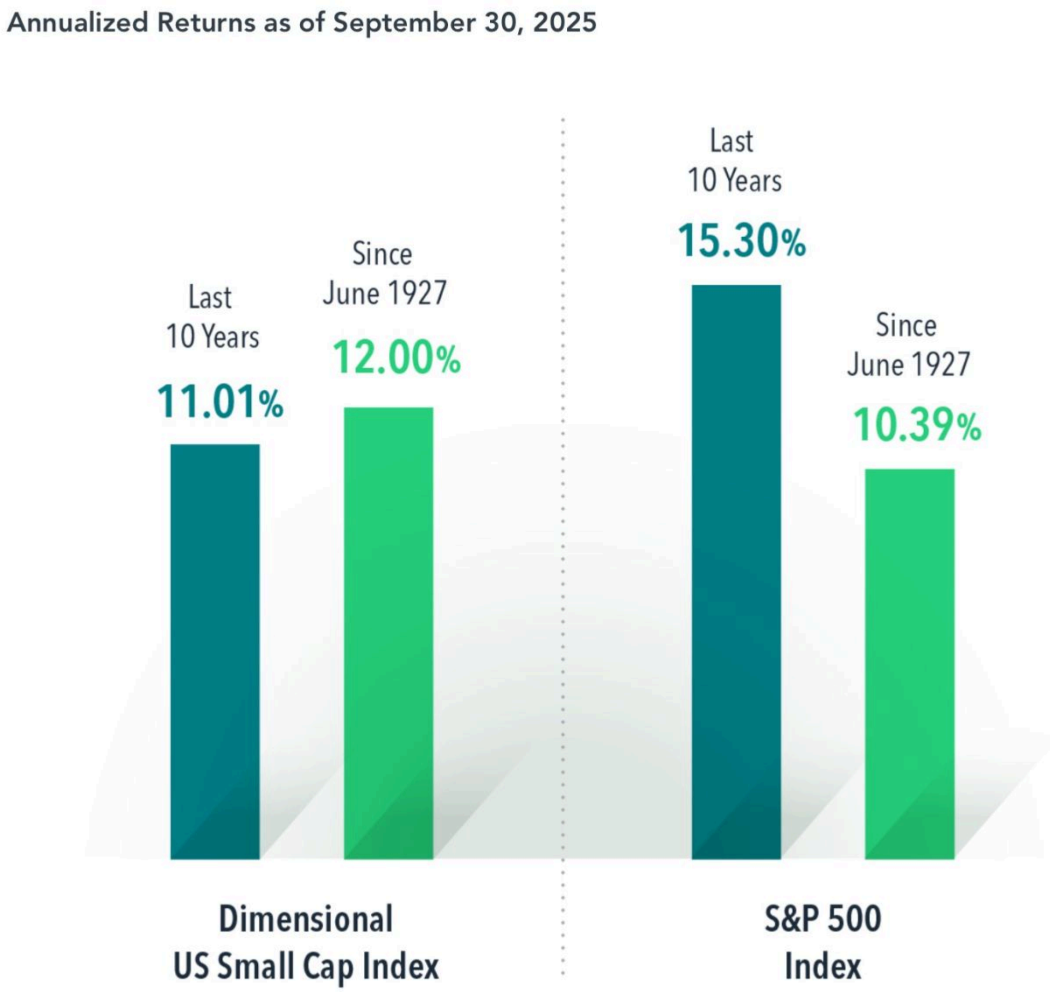

Source 1: Dimensional

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