Is Investing in the Total Stock Market a Total Stock Mistake?

Do investors benefit from long-term total stock market exposure?

Modern Portfolio Theory tells us that over the long-term, small cap companies should outperform large caps because investors should be paid for the added risk they take on. However, given the data set and conclusions below, this theory is not exactly proven. We believe small and mid cap companies add value when they are tactically added at strategic points over time but can add more risk and less return on the long run, causing portfolio "diworstification" instead of intended diversification.

Total Market Exposure

Holding all the large, mid and small cap companies in the public marketplace that are available to investors. In the U.S., this represents approximately 3000 stocks. The Russell 3000 Index is a popular way to track this exposure, however there are several other indexes which aim to represent the total U.S. stock market. Large, mid and small cap companies all look different from a risk return standpoint. They can also carry different sector breakdowns.

Large Caps

Large cap companies are developed, have less competition, less debt and generally strong cash flows and earnings. They often have global reach and generate many of their revenue streams outside of the U.S.

Small Caps

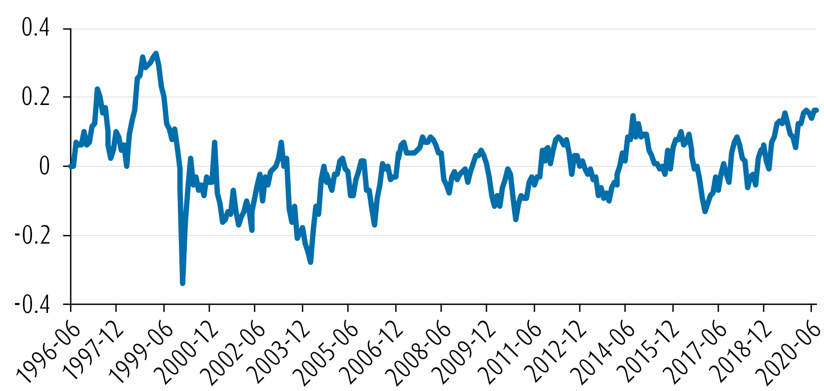
Small cap companies carry more risk because they are less developed, have yet to prove themselves in the marketplace, have higher levels of debt on their balance sheets and often have negative earnings. The higher risk provides the ability to outperform during certain times in the economic cycle.

Small caps can outperform large caps, but it's dependent on economic conditions making small caps a tactical trade rather than a buy-and-hold. This requires market monitoring and timing as well as a strong understanding of the economic tail and head winds for small caps to get this trade right. In order to make a call on small caps, you must have a view on where the market is going – if the market is overly rich you may be better off in large caps. Therefore, over the long term, passively holding the small cap universe in addition to large caps, at market cap weights – the "total market" trade – might not be adding as much value as one might think.

Let's look at the data.

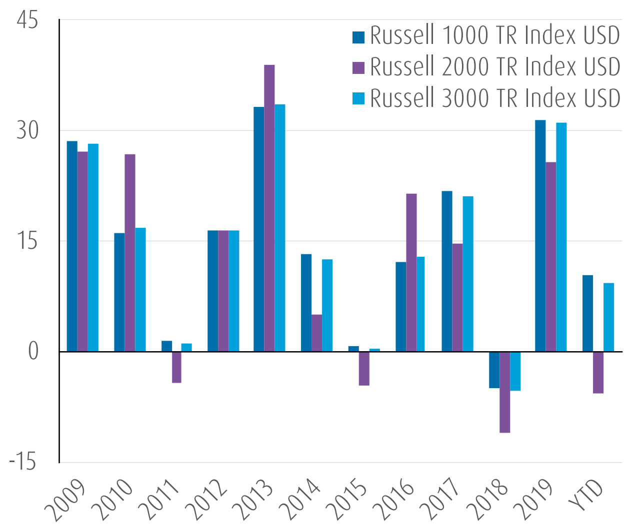
- Returns in the U.S. stock market over the last 20 years have been dominated by large caps, which during this time have turned into mega caps.
- Over the last 24 years, the Russell 1000 has outperformed the Russell 2000 62% of the time on a monthly basis. During this time, it outperformed by an average of 7% and under-performed an average of 5%.[1]

Rolling 1 year performance differential of large caps over small caps[1]

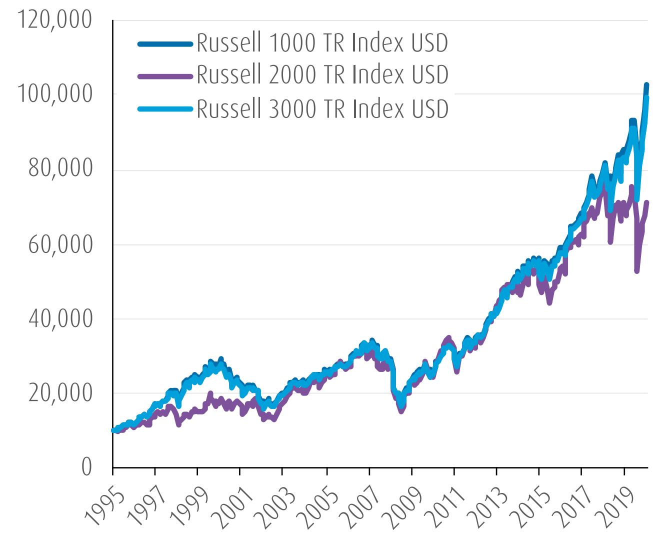


- The argument for large caps becomes even more pronounced if we look more recently, on an annual return basis. Large caps (Russell 1000) have outperformed small caps (Russell 2000) 8 out of 11 years. YTD, large caps are outperforming small caps by about 15%.[1]
- Looking at the cumulative returns, owning the Russell 3000 – the "total market" exposure – over the pure large caps has not added any value on the long term. The Russell 1000 outperforms the Russell 2000 on a cumulative basis over the past 25 years.

Annual Returns[1]



Cumulative Returns Monthly, over 25 Years[1]



[*]Please note you cannot invest directly in an index.

Instead of a passive total market approach, we believe that holdings in large caps should be the core position of your portfolio and tactical rotations into and out of small and mid caps as satellite positions over the short term will add the most value for the long run.

For investors looking to add some small or mid cap to their portfolios, they must consider which product will provide the best exposure. Investors should look for indexes or products that use quality screens on their portfolios to get the best exposure possible and to maximize returns. For further reading, check out our report on investing in Large, Mid and Small caps using BMO ETFs and the S&P Indexes.

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[1] Source: Morning Star Direct September 20, 2020. The Russell 1000 Index represents the 1000 largest companies, by market cap weight, in the U.S. The Russell 2000 represents the 2000 smallest cap companies in the U.S. and is generally considered the best proxy for small cap companies.