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How Big Tech Broke Smaller-Company Investing

The behemoths of the stock market have become so big that they're distorting gauges that define company size

By James Mackintosh Follow

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Traders who want to focus on small stocks face a variety of approaches by indexes to sorting companies by size.
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Investors in smaller companies don't often find household names in their funds. But that's changing: American Airlines, Molson Coors, Caesars Entertainment, Wynn Resorts, Whirlpool and Zions Bancorp all feature in Vanguard's most popular small-stock index fund.

They're among 65 members of the S&P 500—by far the most important measure of large-company stocks—that also qualify for the index behind Vanguard's $46 billion CRSP U.S. Small Cap index fund.

Blame the top-heavy stock market. The behemoths of Big Tech have become so big that they're distorting gauges that define company size by share of total value, as the Vanguard fund does. Fewer giant firms are needed to fill the large-company index's quota, relegating everything else to the realm of smaller-company investing.

Vanguard bases its fund on an index from CRSP, the Center for Research in Security Prices —spun off from a project at the University of Chicago that collected stock-price data through history. CRSP's definition of large stocks includes those in the top 85% of the entire market, as measured by market value. The rest are downgraded to the status of "small."

Back in 1983, the top 85% included more than 800 firms, so smaller companies were true tiddlers. Today it captures only 385 companies. Divvy things up the other way round for another way to think about it: The biggest 500 companies now make up about 90% of all market value, up from 75% in 1983.

The overlap with the S&P 500 is further confused by S&P's rules, which give its index committee leeway on which companies to choose, and require firms to have made a profit before inclusion. Not all the 500 biggest qualify for the S&P 500 as a result.

This matters for investors. By using a definition that includes larger companies, Vanguard's CRSP-based fund has strongly outperformed the main smaller-companies index, the Russell 2000, during periods when the market has been led up by bigger firms—such as this year.

But investors who buy smaller companies are typically trying to profit from the supposed tendency of market minnows to outperform over long periods, an effect identified by academics decades ago. If the smaller-companies effect reasserts itself, I'd expect an index with smaller stocks to beat one that contains more big firms.

Still, there's no agreement on what counts as small, so it's hard to know. When Chicago Prof. Eugene Fama and Dartmouth Prof. Kenneth French modeled the big market anomalies of cheapness and size in 1992, their definition of smaller companies in total made up only 8% of market value. CRSP, with its academic heritage, chose a similar but broader approach of 15% of market value when they created a smaller-companies index for Vanguard, although they excluded the very smallest.

The norm from other index providers is to count stocks from the biggest down and define those after a certain number as small.

Even with this simple approach, there's no agreement on where the cutoff should be. FTSE Russell, whose Russell 2000 is the best-known smaller-companies index, counts the 1,000 biggest firms as large, with the next 2,000 being small. S&P counts 500 as large, then another 400 as "midcap," before getting to small. MSCI's U.S. small index, used by Vanguard until it started using CRSP in 2012, defines the top 750 firms as large, then

includes the next 1,750. (MSCI's main global indexes use a complex version of market value percentages.)

Anyone trying to put into practice the idea that smaller companies outperform has no good basis on which to pick between these different methods. As with so much of academic finance, what looks like a branch of science turns into art when applied.

The original version of the small-company effect is also questionable, at best. Rolf Banz first published a paper showing smaller stocks beat big ones in March 1981 based on his work while studying at Chicago. Since then, data from French shows smaller companies have just about matched the performance of bigger stock, as long periods of underperformance offset long periods of outperformance.

Some investors have since tried to resurrect the smaller-companies effect by focusing on profitable businesses or by stripping out what Cliff Asness, founder of AQR Capital Management and a former student of Fama, calls "junk," the most speculative companies.

Small stocks also have a link to the economic cycle, tending to outperform in recovery phases and underperform as the cycle nears its end—although the connection is far from perfect. Smaller businesses offer an alternative to expensive Big Tech, too, and at the very least ought to provide a different bet. The risk is that investors trying to diversify end up buying yet more big stocks when they pick up a small-company index, as Vanguard itself points out.

"You should stick with one index family," advises Bill Coleman, head of Vanguard's ETF capital markets desk. "If you're pairing the S&P 500 with CRSP small cap, there will be some overlap." The deep lesson is not to choose ETFs based on their name or marketing material. Plenty of ETFs have surprising holdings, such as tractor-maker Deere in the ARK space-exploration fund, or oil stocks in environmental, social and governance funds.

Sometimes there aren't enough stocks to fill the fund, and other times someone had to make an arbitrary decision about where to set a rule—decisions that, at least in the case of smaller stocks, now look odd.

Write to James Mackintosh at james.mackintosh@wsj.com

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