All The…Small Things

Blink 182 Explains Small-Caps

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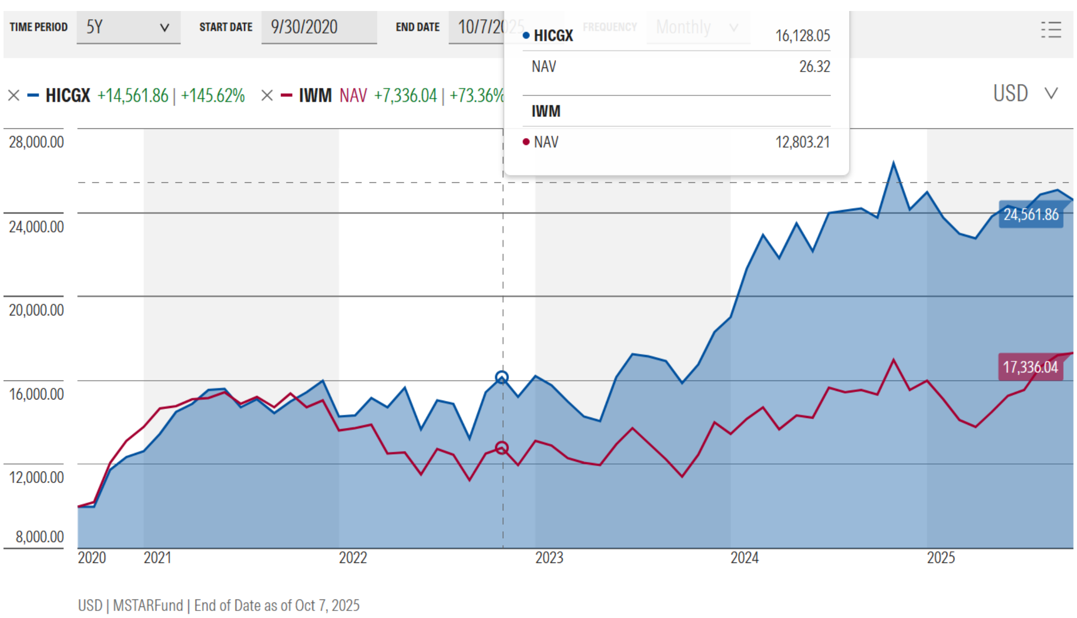
Today's essay is meant to correct the numerous misnomers going around about small-caps (stocks, that is.) Unfortunately, many of the talking heads on the media who love to spew nonsense about small-cap stocks, (Morgan Stanley CIO Recommends Selling Small-Caps) are not small-cap stock investors themselves. These folks are easy to spot, because inevitably, they go on to quote the performance of the Russell 2000, a benchmark characterized by its abnormally high number of unprofitable companies (around 40% of the companies don't make any money. Apollo on Russell 2000)However, this is generally as far as the conversation advances, leaving viewers unsatisfied and confused about why anybody would be talking about "small-caps" if they are so un-investable. Count me among the confused.

First, I am not aware of any actual money managers who are using the Russell 2000 ETF as their preferred expression of small-cap ownership. Doing so would be "client-portfolio suicide," as it has chronically underperformed the S&P 500. Relatedly, most wealth management firms who are pursuing the responsible stewardship of their clients' wealth, are implementing small-cap stock ownership in an active management model. I oftentimes hear talking heads say "it's impossible to beat the S&P 500, in any given year, 80% of active managers fail to outperform." But then they fail to take the next logical step, which is to say, "you should own good small-cap active managers, because as of 2024, 70% of small and micro-cap managers beat the Russell 2000." (Outperformance of Small Cap Managers).

Second, many of these small-cap averse Investment Chiefs are speaking out of both sides of their mouths – because many of them are starting to expand access to private equity investments to retail clients (Morgan Stanley Expands Access to Private Equity to Retail Clients). Unfortunately for private equity, these wealth managers who promote private equity, and the Retail End-Clients who in my opinion will likely suffer through the poor private equity performance in their accounts, private equity is nothing more than expensive exposure to leveraged micro-cap stocks (Richard Ennis White-Paper on Risks of Private Equity.) It is highly risky, and has underperformed the S&P 500 on a risk-adjusted basis. So, why would anybody hold views that are both not true and nonsensical about small-caps, and then turn around and buy an expensive private equity fund? There is limited upside, in my view – since the weak performance history of private equity has shown that wealth managers remain vulnerable to SEC lawsuits if "products" underperform their stated benchmarks (Merrill Lynch Sued for Recommending Underperforming Private Equity).

Third, even by applying the most basic of all basic screening criteria across the broad and vast small-cap stock universe yields huge incremental performance improvements. For instance, by simply applying a profitability criteria to small caps vis-à-vis the S&P 600 (small cap index comprised of only profitable companies) – you added over 50 percentage points of incremental return over the Russell 2000 since 2009. What I have just displayed is that some basic analysis pokes holes in the "no small caps" argument. But please don't take this as a recommendation to buy the S&P 600, I simply think the opportunity for significant alpha in this space is much higher than what this index can generate.

Finally, if you're an everyday investor trying to make sense of this market, you shouldn't be deterred by some random naysayer on the news. Small-caps provide fertile ground for uncovering opportunities that most folks have never heard of. While it may be true that the Russell 2000 is a poorly performing index, the broader small-cap universe affords the chance for a manager to do deep research, have a long-term horizon, and outperform. If we run a Morningstar search on managers with the best 5-year track records in the category, we see a fund like Hennessey Institutional Growth (HICGX)[1] which has outperformed the IWM (small cap index ETF) by over seventy percentage points over that time period. I am not advocating for that particular fund – but it should serve as good evidence that investors seeking opportunities outside of the Mega Cap Growth (Magnificent 7) don't need to simply sequester their search to broad categories of Beta (market performance).



John Bay, CFA, UCLA MBA, Chief Investment Officer/ Founder

Kaizen Wealth Strategies

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