Why You Should Be Investing in the Russell 2000

The Russell 2000 index gives investors exposure to small-cap stocks.

By Ellen Chang, Contributor Jan. 14, 2019

INVESTORS OFTEN overlook the Russell 2000 Index, but it can be a good way to add diversity to a portfolio.

The Russell 2000, commonly referred to as RUT, is a benchmark index that tracks about 2,000 small-cap companies. Experts say some investors pass over this index, since its stocks are often more volatile. But there can be rewards with small caps.

"Small stocks should be included in any well-diversified portfolio," says Justin Halverson, co-founder of Great Waters Financial, a Minneapolis-based financial planning firm. "The stocks of small companies inside and outside of the U.S. have generally performed better than the stocks of large companies over time."

What Is the Russell 2000?

The Russell 2000, established in 1984, is comprised of small-cap companies that range in market capitalization between $300 million and $2 billion. Stocks in the Russell 2000 are determined annually by the FTSE Russell, which divides the top 3,000 stocks in the U.S. market into the Russell 1000, a basket of the 1,000 largest stocks and the Russell 2000, the 2,000 smallest stocks.

“The Russell 1000 covers approximately 90 percent of the U.S. market by total value, while the Russell 2000 covers the next 10 percent,” Halverson says.

More diversified than the S&P 500, the top 10 holdings in the Russell 2000 represent only 3 percent of the entire index compared to the S&P 500, in which the top 10 holdings account for more than 20 percent.

Since small-cap stocks are primarily U.S.-based companies, the exposure to global growth and geopolitical issues like trade disputes is more limited, says Stephanie Lewicky, senior manager of futures and forex at TD Ameritrade.

“Small-cap stocks should not be as threatened by something like the U.S. and China trade tariffs as many S&P 500 and Nasdaq 100 companies are,” she says.

Advantages of Small Caps

One advantage of small-cap stocks is these companies can outperform large-cap stocks. Recent data published in the "Stocks, Bonds, Bills, Inflation (SBBI) Yearbook" show that small-cap stocks returned 12.1 percent annually between 1926 and 2017 compared with large-cap stocks, which returned 10.2 percent annually during the same period.

Halverson says one reason why these companies have generally performed better than large-cap stocks could be that investors demand a higher return for investing in small stocks.

“For example, would you demand more interest to lend your money to a local burger restaurant or McDonald’s (ticker: MCD)?” he says.

Small companies often have more upside than larger companies because of the potential to grow easily.

“It’s harder for McDonald’s to double in size than a local burger restaurant,” Halverson says.

Small-cap companies have the ability to double or triple in size, says Bryan Bibbo, a financial advisor at The JL Smith Group in Avon, Ohio.

“Most large-cap companies were once small-cap companies, but have grown over the years to have a higher market capitalization,” he says. “Everyone wants to go back in time to buy Apple (APPL), Amazon (AMZN) or Microsoft (MSFT) before they were household names.”

Why Small Cap Stocks Are Overlooked

Small-cap stocks are often overlooked as an investment because fewer stock analysts and financial journalists cover this area.

The financial media focuses on the large-cap world, reporting the performance of the overall stock market by quoting the S&P 500 index and the Dow Jones Industrial Average, experts say.

One reason investors focus less on small-cap companies is because these businesses are not as well known as large companies, Halverson says.

The relative small size of the companies means most are not household names, says John Iammarino, president of Securus Financial, a San Diego-based financial planning firm.

“The index includes many companies that have the possibility to be tomorrow’s large-cap stocks,” he says. “Research from Ibbotson Associates has demonstrated that small-cap stocks have outperformed large-cap stocks by about 2 percent annually over the long term. This small difference really adds up over time.”

Risks of Adding Russell 2000 Funds

Large caps have greater access to capital than small caps and are more value oriented. But smaller companies have a higher growth orientation.

For risk-averse investors, value stocks tend to have a larger margin of safety than growth stocks, experts say.

“There appears to be more risk in the small stock universe than in the larger stock universe,” says Robert Johnson, a finance professor at Creighton University in Nebraska.

That said, small caps outperform large caps during periods of falling interest rates.

Between 1966 and 2016, small caps returned 28.4 percent and large caps returned 14.4 percent annually, Johnson says. When interest rates rise, small caps returned 5.2 percent and large caps returned 5.7 percent.

“If investors think rates will rise, they shouldn't expect small caps to outperform,” he says. “The reason is that when rates are falling small caps have an easier time accessing capital.”

Even though small-cap stocks can be more volatile than large-cap stocks, portfolios are “generally better off with small stocks than without them,” Halverson says.