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The Third Quarter Ends With a Blast: Tech, Small Caps, and Beta | October 2010

Introduction

The US equity markets showed their strongest gains for any September on record in the 40-year history of the MSCI USA Index. Other equity markets saw similar strong gains. This paper explores these trends in more detail, using the Barra US Equity Model to validate which trends were real and how strong they actually were.

Record Gains in September 2010

Despite a tepid economic outlook and disheartening employment statistics, September 2010 was a strong month for equity markets around the world. The MSCI ACWI (All Country World Index) was up 9.4% for the month, with strong performance in both developed and emerging markets. In the US, the MSCI USA Index was up 9.3% with widespread gains in blue chips, tech stocks and small caps, the best September on record in the index's 40-year history. Exhibit 1 breaks down US equity market performance by segment. Growth outperformed value stocks and small caps outperformed large and mid caps.

Exhibit 1: Overview of US Equity Performance (September 2010)

	USA All Cap	USA Large Cap	USA Mid Cap	USA Small Cap	USA Growth	USA Value
September 2010	**9.3%**	**8.6%**	**10.6%**	**11.5%**	**10.5%**	**8.2%**
YTD*	**1.9%**	**3.5%**	**1.1%**	**10.0%**	**9.7%**	**3.6%**
QTD**	**13.8%**	**11.1%**	**10.6%**	**13.0%**	**11.9%**	**15.0%**

* Year-to-date values represent cumulative returns of the indices from December 31, 2009 to September 30, 2010.
**Quarter-to-date values are cumulative returns from June 30, 2010 to September 30, 2010.

Are the growth and small cap effects "real"? Broad market indices can have significant tilts on styles or certain industries which can dominate returns. For example, relative gains in the MSCI USA Growth Index could (and generally will over the long run) be driven by "pure" Growth[1] -- *or* it can just be that the index happens to be tilted on certain industries that have performed well. This is where factor models can help disentangle the effects. Exhibit 2 shows a decomposition of each index's return.[2]

[1] See MSCI Research Bulletin "The Shift from Value to Growth" (October 11, 2007).
[2] Only a subset of style factors are shown in Exhibit 2 -- those intuitively related to cap size, growth, and value strategies (the Size, Growth, Earnings Yield, and Value factors) and one additional factor (Volatility) which has a notable contribution to the USA Small Cap Index. The additional factors not shown are: Momentum, Size-Nonlinearity, Trading Activity, Currency Sensitivity, Leverage, Yield, Earnings Variability, and the Non-estimation Universe factors. The full decomposition appears in Appendix Table A1.

Exhibit 2: Return Attribution with the Barra US Equity Model (USE3, September 2010)[3]

	USA All Cap	USA Large Cap	USA Mid Cap	USA Small Cap	USA Growth	USA Value
Style Factors	0.0%	-0.6%	1.6%	2.3%	0.1%	0.0%
Size	0.0%	-0.4%	0.9%	1.7%	0.1%	0.0%
Growth	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Earnings Yield	0.0%	0.1%	-0.1%	-0.2%	-0.1%	0.1%
Value	0.0%	0.0%	0.0%	0.0%	-0.1%	0.1%
Volatility	0.1%	-0.6%	1.4%	3.1%	0.2%	0.0%
Industry Factors	9.6%	9.6%	9.4%	9.7%	10.5%	8.6%
Asset Selection	-0.1%	-0.1%	-0.4%	-0.1%	0.5%	-0.8%

Exhibit 2 contains some rather interesting effects. First, focusing on the USA Small Cap column, we see that there is quite a significant return coming from the USE3 Size factor (red box).[4] However, there is an even larger contribution to return from the Volatility factor; the index benefited from containing stocks with relatively higher beta to the market and higher volatility on average. Second, focusing on the USA Growth and Value columns, we see that there is negligible return from relevant factors – Growth, Value, and Earnings Yield[5] (green box). In effect, the small cap effect is present, while the growth effect is not.

What is perhaps equally interesting about Exhibit 2 is the sizable amount of return from industry factors. Return contribution from industry factors does generally tend to be larger than that from style factors (the way the model is defined, the industry factors pick up much of the market risk.) However, what is notable here is that they essentially drove the MSCI USA Growth performance relative to Value (about 190 bps).[6]

Let's look next at which sectors drove the MSCI USA Growth and Value indexes. Exhibit 3 shows the return from each sector.

[3] Note that only a subset of style factors are shown here. The full decomposition appears in Appendix Table A1.
[4] The Size factor represents the return to large caps relative to small caps. The MSCI USA Small Cap Index benefited from a negative exposure to the Size factor.
[5] Earnings Yield reflects historical and forward looking earnings to price (the inverse of P/E) and for many investors is a definition of Value that links closely to the Barra Value factor definition book-to-price (the inverse of P/B).
[6] The industry contributions are close across the large, mid, and small cap segments and are a less interesting story here at least at the aggregate industry level.

Exhibit 3: Sector Return Attribution with the Barra US Equity Model (USE3, September 2010)

	USA All Cap	USA Large Cap	USA Mid Cap	USA Small Cap	USA Growth	USA Value
Industries/Sectors	9.6%	9.6%	9.4%	9.7%	10.5%	8.6%
Basic Mat'ls	0.5%	0.4%	0.7%	0.6%	0.5%	0.5%
Energy	0.9%	1.0%	0.7%	0.5%	0.7%	1.1%
Cnsmr (non-cyclical)	0.7%	0.9%	0.3%	0.2%	0.7%	0.8%
Cnsmr (cyclical)	0.9%	0.7%	1.2%	1.4%	1.3%	0.4%
Cnsmr Services	0.5%	0.4%	0.6%	0.5%	0.5%	0.4%
Industrials	0.5%	0.5%	0.6%	0.7%	0.5%	0.6%
Utility	0.2%	0.2%	0.3%	0.2%	0.0%	0.4%
Transport	0.2%	0.2%	0.1%	0.3%	0.3%	0.1%
Health Care	1.2%	1.2%	1.0%	1.1%	1.1%	1.2%
Technology	2.2%	2.3%	1.9%	2.2%	3.6%	0.8%
Telecommunications	0.3%	0.4%	0.2%	0.1%	0.1%	0.5%
Commercial Services	0.3%	0.2%	0.6%	0.7%	0.6%	0.1%
Financial	1.2%	1.1%	1.1%	1.3%	0.5%	1.8%

Technology was clearly the biggest contributor to all the indices in Exhibit 3, but particularly so for the MSCI USA Growth Index. Another big industry bet contained in the Growth index (relative to Value) was a tilt towards Consumer Cyclicals. Meanwhile Financials interestingly was a strong tilt taken by all the indices *except* MSCI Growth that did pan out well. Lastly, Health Care was one sector that contributed across the board to all indices; for Growth versus Value it made little difference.

Conclusion

September 2010 was a record month, deserving of some commentary. Despite continued fears over the macroeconomy and a lot of noise over gold and other safe harbor assets, equities soared. Our objective was to explore in a bit more detail what was behind the big trends of the month, highlighting several main observations:

- The Growth story was really a Technology story (and Consumer Cyclicals to a lesser extent)
- The Small Cap story was partially a real small cap effect, but in fact had an important Volatility story behind it (i.e., small caps benefited from being high beta and high volatility)
- Certain sectors, like Health Care and Financial, benefited indexes across the board

Appendix

Exhibit A1:

Full Decomposition of Style Factors with the Barra US Equity Model (USE3, September 2010)

	USA All Cap	USA Large Cap	USA Mid Cap	USA Small Cap	USA Growth	USA Value
Style Factors	0.0%	-0.6%	1.6%	2.3%	0.1%	0.0%
Size	0.0%	-0.4%	0.9%	1.7%	0.1%	0.0%
Growth	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Earnings Yield	0.0%	0.1%	-0.1%	-0.2%	-0.1%	0.1%
Value	0.0%	0.0%	0.0%	0.0%	-0.1%	0.1%
Volatility	0.1%	-0.6%	1.4%	3.1%	0.2%	0.0%
Momentum	0.0%	0.1%	-0.1%	-0.1%	-0.1%	0.1%
Size Non-linearity [7]	-0.1%	0.2%	-0.1%	-1.8%	-0.1%	-0.1%
Trading Activity	0.0%	0.0%	-0.1%	0.1%	0.0%	0.0%
Earnings Variation	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Leverage	0.0%	0.1%	-0.2%	-0.2%	0.1%	-0.1%
Currency Sensitivity	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Non-Est. Universe	-0.1%	0.0%	-0.1%	-0.3%	-0.1%	-0.1%

[7] Note that the Size Non-linearity factor contributed a return of -1.8% to the MSCI USA Small Cap Index, while there was a positive contribution of 1.7% from the Size factor. The USA Small Cap Index had a negative exposure to both factors (as it always does); thus the Size factor earned a negative return while the Size Non-linearity factor earned a positive return. Intuitively, this suggests there are important non-linear effects across the range of cap sizes. Large caps (as represented by the MSCI USA Large Cap) underperformed small caps as a whole; however, extreme large cap firms ("mega-caps") performed relatively well, particularly relative to small and micro caps.

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