

The Russell 2000[®] Index: Small cap index of choice

Key points:

- The Russell 2000 Index has been overwhelmingly embraced as the small cap index of choice for measuring the small cap market segment and serving as the basis for the creation of small cap investment products.
- Securities lending programs, based on highly liquid products replicating the small cap indexes, such as exchange-traded funds (ETFs) or the individual stocks within the index, may offer market participants an additional lending yield.
- Some ETF issuers have used securities lending income to offset management fees, enhancing fund returns net-of-fees.

The potential long-term benefits of including small cap stocks as part of a diversified, multi-asset portfolio have been well documented by numerous academic researchers and industry practitioners. A wide body of research has shown that small cap stocks have distinct risk/return characteristics that can increase portfolio diversification and can boost potential returns over time.¹

The comprehensive and objective design of the Russell 2000 Index has made it institutional market participants' most widely used benchmark for measuring the US small cap equities market and serving as the basis for active and passive investment products. Russell pioneered the Russell 2000 in 1984 as the first index to measure the small cap market segment. In recent years, the growth of index-based investment vehicles such as exchange-traded funds (ETFs) has given market participants an efficient, cost-effective way to gain exposure to small cap stocks. Additionally, the exceptional high liquidity of ETFs that track the Russell 2000 Index has been used by some market participants to help offset management fees and potentially enhance returns through securities lending programs.

¹ Bänz, Rolf, "The Relationship Between Market Value and Return of Common Stocks," *Journal of Financial Economics*, 1981; Fama and French, "The Cross-Section of Expected Stock Returns," *Journal of Finance*, 1992; Fama and French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics*, 1993.

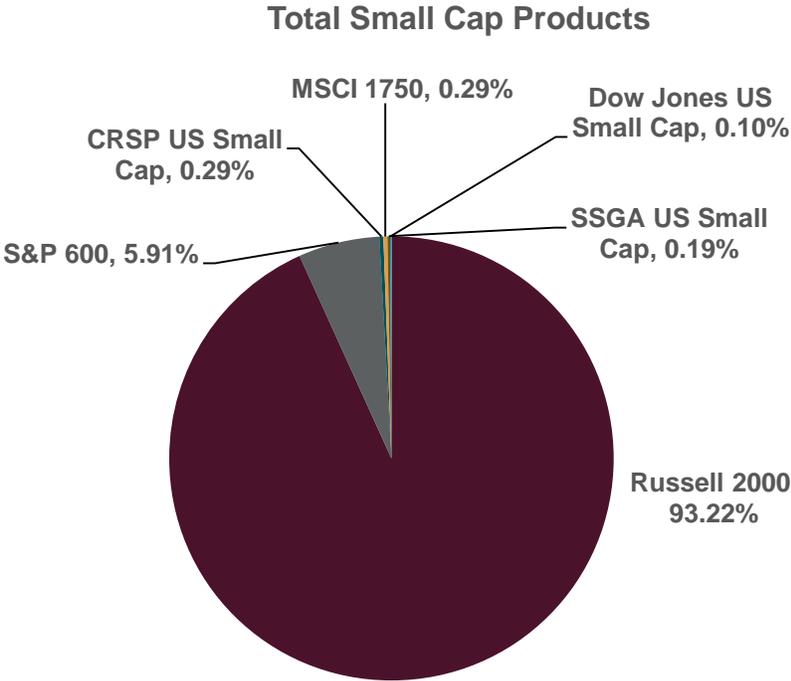
The Russell 2000 Index has been widely adopted as the small cap index of choice

Market participants have overwhelmingly embraced the Russell 2000 Index for measuring and benchmarking the small cap market segment and serving as the basis for the creation of small cap investment products. As Figure 1 shows, the Russell 2000 Index and its variants serves as the basis for approximately 93% of small cap products and is benchmark for approximately 84% of small cap assets as of December 31, 2017. One reason for this wide adoption is that the Russell 2000 is designed to offer a comprehensive and objective representation of the US small cap market.

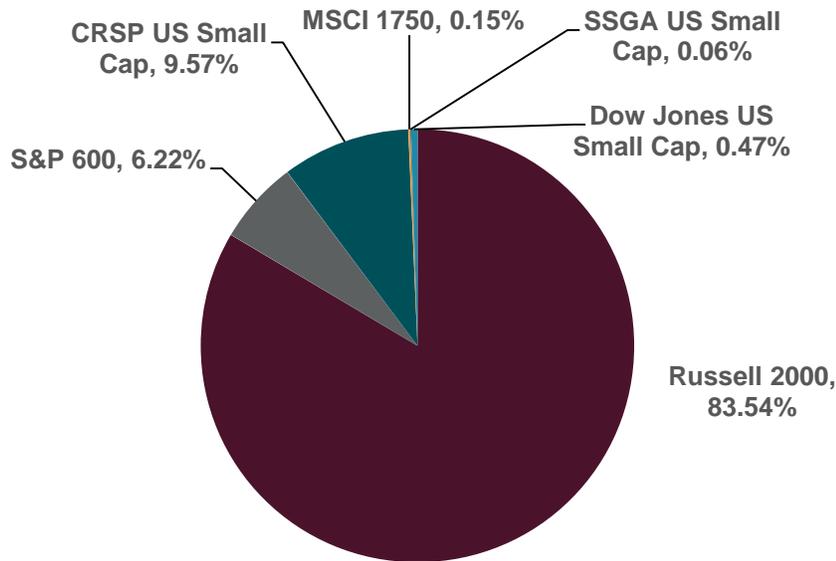
Research has shown that the Russell 2000 Index provides a pure and objective picture of the small cap segment of the US equity market, while several other small cap indexes on the market are more similar to “SMID cap” indexes, which blend small cap and mid cap stocks, based on the constituents they cover.

Figure 1. US indexes with small cap linked products and assets benchmarked

Total SC products		1,033	Total SC assets		\$1,416.3B
Russell 2000	963	93.22%	Russell 2000	\$1,183.2B	83.5%
MSCI 1750	3	0.29%	MSCI 1750	\$2.1B	0.1%
S&P 600	61	5.91%	S&P 600	\$88.0B	6.2%
CRSP US Small Cap	3	0.29%	CRSP US Small Cap	\$135.5B	9.6%
SSGA US Small Cap	2	0.19%	SSGA US Small Cap	\$0.8B	0.1%
Dow Jones US Small Cap	1	0.10%	Dow Jones US Small Cap	\$6.6B	0.5%
Total	1,033			\$1,416.3B	



Total Small Cap Assets



Sources: Morningstar Direct for ETFs and retail mutual funds, eVestment for institutional assets. Data as of December 2017, as reported on March 3, 2018. "Russell 2000" includes variants (Defensive, Dynamic, Growth, Value) and others. "MSCI 1750" includes variants (Growth). "S&P 600" includes variants (Value, Growth) and others. "CRSP SC" includes variants (Growth, Value). "SSGA US Small Cap" includes variants. Count of retail mutual funds and ETFs by product, count of institutional AUM by strategy. Percentages may not add up to 100% due to rounding.

The Russell 2000 Index enjoys a broad ecosystem that results in high liquidity

The wide adoption of the Russell 2000 has led to a broad financial-products "ecosystem" based on the index, which includes active and passive institutional funds, mutual funds, ETFs, futures and options. All combined, these developments have led to tremendous liquidity for market participants seeking to gain exposure to US small cap stocks. As shown in Figure 2, volume for US small cap exchange-traded futures and options based on the Russell 2000 Index were significant.² Notably, volume for ETFs based on the Russell 2000 was exceptionally high, with an average daily volume traded of \$4.5 billion.³

In seeking to exploit the small cap premium, it is important to control costs, which can erode potential excess returns. Index-based investment vehicles such as ETFs, futures and options can provide efficient and cost-effective ways for market participants to gain access to portfolios of small cap stocks designed to track the Russell 2000 Index. The liquidity in these markets can help reduce trading costs associated with bid/ask spreads and mitigate potential market impact of trades.

² Derivatives based on other indexes may have been traded over-the-counter.

³ FactSet, as of December 31, 2017.

Figure 2. 2017 US small cap ETF, exchange traded futures and exchange traded options volume

	ETF avg. daily volume (\$M)	Futures total volume	Options total volume
Russell 2000	4,471.6	39,987,557	16,922,912
MSCI 1750	–	–	–
S&P 600	3.9	–	–
CRSP US SC	159.9	–	–
SSGA SC	1.6	–	–
Dow Jones SC	30.7	–	–

Sources: FactSet, Intercontinental Exchange, CME Group, FIA, Cboe, as of December 31, 2017.

Securities lending programs can help support the small cap market

It is not commonly known that 60% of all US-listed ETFs can and often do lend out the securities within their portfolios.⁴ Issuers say that the practice helps offset costs and improve fund performance. We detail below that securities lending in the small cap market in particular has played a significant supportive role. But first, we present a brief overview of securities lending.

In a securities lending (sec lending) transaction, the owner of a security (lender) typically hires a lending agent that would act on their behalf and negotiate terms of the loans with the borrowers. The owner of the security temporarily transfers the title and associated rights of a security to another party (borrower) in exchange for collateral, which is generally cash or liquid securities. That cash collateral can then be reinvested to generate income as a part of the lending transaction.

This practice has been widely adopted among large institutional market participants. For example, the California Public Employees' Retirement System (CalPERS) had securities on loan with a fair value of approximately \$4.8 billion as of June 30, 2017, and earned approximately \$768,000 in securities lending income for the 2016–2017 fiscal year.⁵

Securities lending has been shown to benefit financial markets by providing increased liquidity and to benefit market participants by providing a way to offset management fees and potentially enhance returns. According to a report from the Federal Reserve Bank of New York, "The markets for repos and sec lending are crucial for the trading of fixed-income securities and equities."⁶

Securities lending is not without risks, however, so market participants need to have a clear understanding of the risk management practices and fiduciary commitments of the firm managing the securities lending program. Potential risks such as counterparty risk and reinvestment risk can be mitigated through a strong risk management framework that includes ongoing credit reviews, conservative investment guidelines, daily mark-to-market of collateral and strong operational controls.⁷

⁴ Lisa Crigger, "Is Securities Lending Good for ETF Investors?" *ETF.Com*, February 26, 2018.

⁵ Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2017, California Public Employees' Retirement System (CalPERS), November 2017.

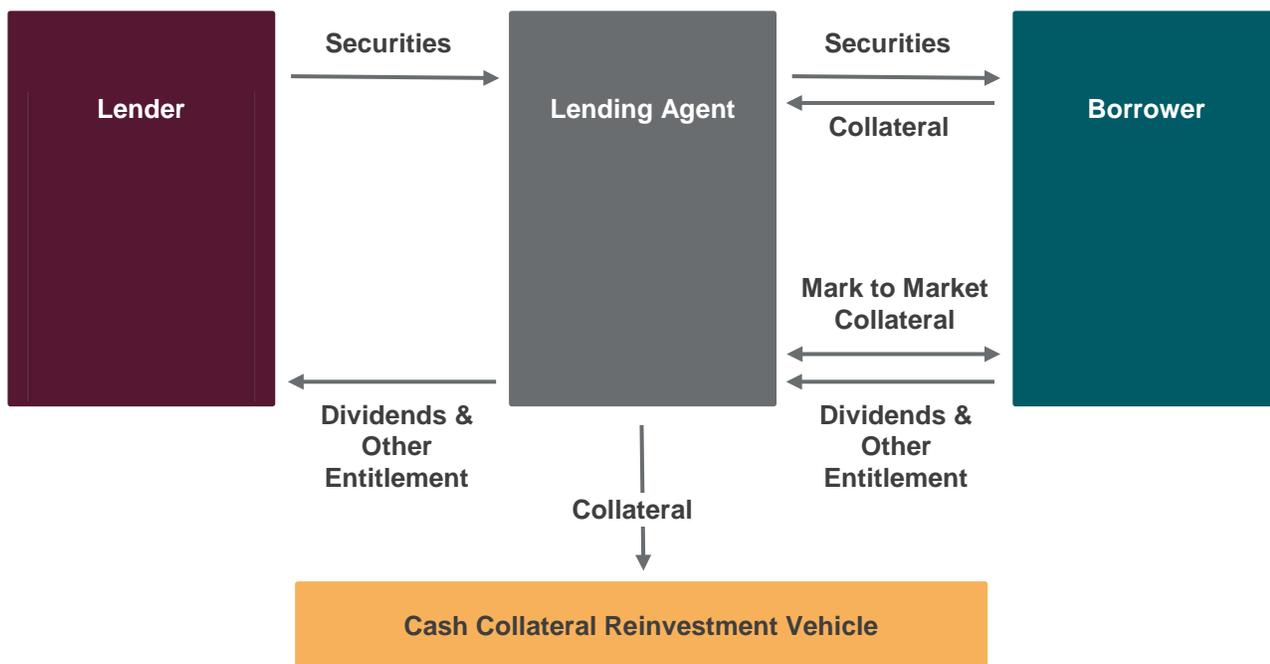
⁶ Adrian, Begalle, Copeland and Martin, "Repo and Securities Lending," *Federal Reserve Bank of New York Staff Reports*, 2012.

⁷ "Securities Lending Best Practices," Securities Finance Trust Company, 2012.

The basic process for sec lending is illustrated in Figure 3:

- Lending agent and borrower negotiate loan terms, including collateral amount, length of the loan and rebate rate. Collateral value is typically 102% of the value of the loaned security if in the same currency or 105% if in a different currency. The lender generally has the right to recall the security at any time.
- Title of the security is transferred to the borrower and collateral is delivered to the lender. The borrower receives dividends and interest during the life of the loan and is required to make payments back to the lender since the lender retains an economic interest in the security. Proxy voting rights transfer from the lender to the borrower.
- The lender reinvests the cash collateral to generate income during the term of the loan.
- Values of the loaned security and collateral are marked to market daily to bring the collateral back to the negotiated percentage of the borrowed security's current value.
- At the end of the loan, the borrower and lender return the securities and collateral.

Figure 3. How securities lending works



Small cap securities lending programs can potentially enhance after-fee fund performance

Research firm Markit Securities Finance estimated that the equity value on loan in securities lending programs reached approximately \$1.1 trillion at the end of February 2018.⁸ Markit indicated that about 56% of the ETF lending pool was at a fee of greater than 150 basis points and that the average total return to lendable securities based on the Russell 2000 was approximately 16 basis points, also at the end of February 2018.⁹

⁸ Correspondence with Markit Securities Finance, March 2018.

⁹ Correspondence with Markit Securities Finance, March 2018.

Investing in a separate account that holds and lends an ETF based on the Russell 2000 Index can provide market participants exposure to small cap stocks with the benefits of index-based investments—such as potentially lower costs, transparency and high liquidity—along with the potential for return enhancement. This type of “long and lend” opportunity exists in the market because investment managers often seek to hedge their small cap beta exposure. It is much easier to short a single highly liquid ETF which contains a basket of 2,000 constituents rather than all 2,000 individual constituents of the Russell 2000 Index. Several ETF issuers have been using securities lending income to partially or wholly offset management fees to the ETF investor.

Market participants could also take advantage of this market dynamic synthetically through futures or swaps; however, using an ETF “long and lend” strategy lets market participants take advantage of this through a physical basket of the underlying constituents, with potentially lower expenses and without some of the risks that may be associated with synthetic alternatives. Market participants using this type of strategy can capitalize on securities lending yields to potentially offset management fees and generate potential excess returns.

Conclusion

The potential benefits of including exposure to small cap stocks in a multi-asset-class portfolio have been well documented. FTSE Russell has been a pioneer in researching the small cap market segment, and institutional market participants have widely adopted the Russell 2000 Index as the small cap benchmark of choice because of its comprehensive and objective design. This wide adoption has led to high liquidity for ETFs, futures and options based on the Russell 2000. The highly liquid nature of this “ecosystem” presents additional opportunities for market participants to help offset management costs and potentially enhance returns through securities lending programs.

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