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## Out of Bounds: Style Drift in the Russell 2000 Value Index

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Jun 23, 2021

AMC and GameStop are priced squarely in the large cap growth space, and yet represented nearly 1.5% of the Russell 2000 Value Index as of May 31. On the scale of size discrepancies, this is akin to 7-foot-6-inch former NBA star Yao Ming visiting a kindergarten class. However, investors in strategies tracking the Russell 2000 Value Index may be surprised to learn the list of holdings inconsistent with the index's definition goes much deeper, an outcome of the style drift potentially occurring with most index-based approaches due to infrequent rebalancing.

### DRIFTING AWAY

Russell indices undergo an annual reconstitution event at the end of every June during which additions and deletions are made to the list of constituents in accordance with the indices' rules. For example, the Russell 2000 Value Index constituent list is amended to generally include only value companies below the 1,000th-largest stock in the Russell 3000 Index.

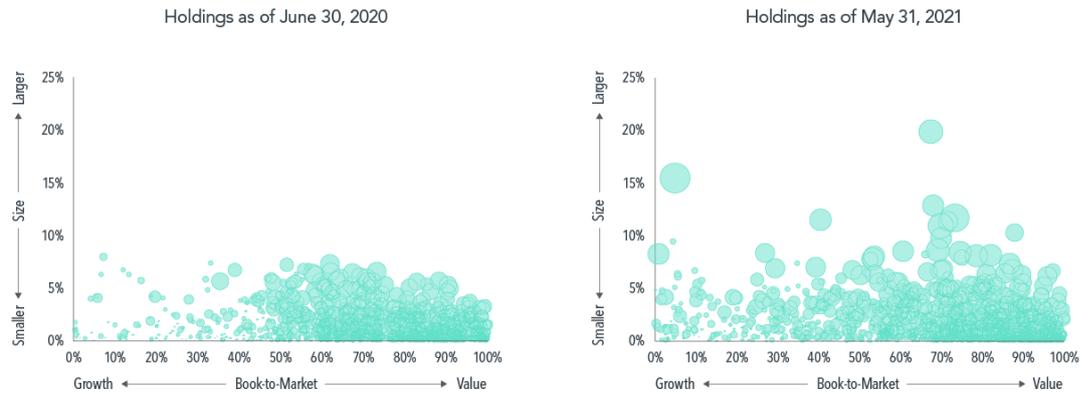
What happens in between these reconstitution events? Imagine skipping lawn mowing duty for a few months and you'll get the picture. **Exhibit 1** illustrates the Russell 2000 Value Index's holdings at the end of June 2020, following the 2020 reconstitution, compared to its holdings 11 months later, in May 2021. Each bubble represents one stock, plotted based on its percentile rank within the broader Russell 3000 Index on market capitalization (y-axis) and book-to-market ratio (x-axis). The size of the bubble indicates its weight within the index.

The left panel of the exhibit shows an emphasis on the small cap value corner following reconstitution. But by the end of the following May, many of the index's holdings have drifted both upward in market cap and toward the growth end of the spectrum. As of May 31, nearly 16% of the index's weight is accounted for by stocks among the largest 1,000, the domain of Russell's large cap indices. While GameStop is not the only growth name in the index, its tiny book-to-market ratio of 0.03 combined with its \$16.5 billion market cap give it a Yao Ming-like presence in the northwest corner of the style chart.

## Exhibit 1

### Set Adrift

Size and relative price characteristics of Russell 2000 Value Index holdings



Excludes stocks with missing or negative book equity. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes.

## MISSING THE BOAT?

Research tells us the relative performance of small cap value tends to be delivered by a small subset of the asset class<sup>1</sup> and can show up in bunches.<sup>2</sup> Both insights are relevant for style drift: infrequent rebalancing can reduce the likelihood of holding the stocks that deliver the premium as well as blunt one's exposure to the asset class at inopportune times, potentially reducing an investor's participation in strong runs for small cap value stocks.

Daily portfolio management can potentially spare investors from style drift. Of course, daily rebalancing would likely be prohibitively expensive for a strategy rigidly tracking an index. Dimensional uses a flexible daily process that seeks to balance a focus on premiums against short-term drivers of returns, costs, and other tradeoffs. This allows us to rebalance portfolios incrementally through time, keeping them focused on the targeted asset allocation and putting investors in a better position to capture what the market has to offer.

Think of it this way: which oral hygiene approach seems more effective—brushing your teeth for two minutes twice daily or for 24 hours once a year?

1. Eugene F. Fama and Kenneth R. French, "Migration," *Financial Analysts Journal* 63, no. 3 (June 2007): 48–58.

2. "An Exceptional Value Premium," *Insights* (blog), Dimensional Fund Advisors, October 5, 2020.

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