

Enhancing returns on the Russell 2000[®] Index with securities lending programs

March 2023

AUTHOR

Catherine Yoshimoto
Director, Product Management,
London Stock Exchange Group
+1 206 637 6267
catherine.yoshimoto@lsegroup.com

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 indices, such as exchange-traded funds (ETFs) or the individual stocks within the index, may offer market participants an additional lending yield.
- Some ETF issuers and institutional investors 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), have 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.

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 serve as the basis for approximately 92% of small cap products and is the benchmark for approximately 83% of small cap assets as of December 31, 2021. 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 indices on the market are more similar to "SMID cap" indices, which blend small cap and mid cap stocks, based on the constituents they cover.

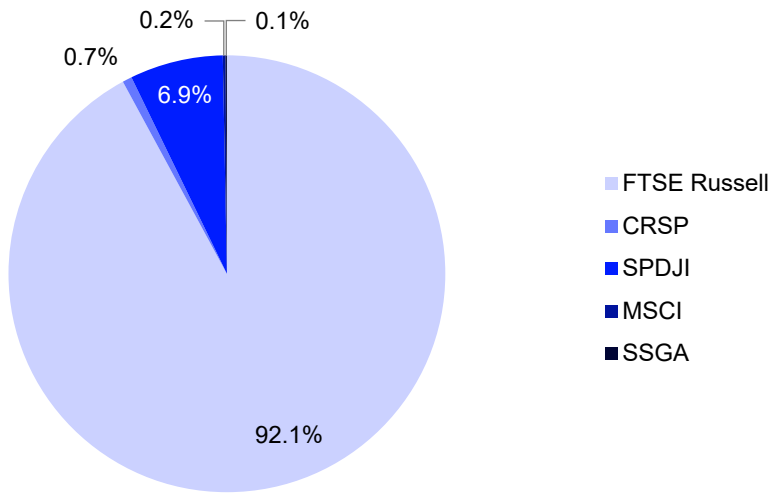
Figure 1. US indices with small cap linked products and assets benchmarked

Index provider	Total SC products	Total SC AUM (\$bn)	Percent of products	Percent of AUM
FTSE Russell	1,377	1,946.5	92.1%	82.8%
CRSP	11	228.7	0.7%	9.7%
SPDJI	103	168.2	6.9%	7.2%
MSCI	3	6.5	0.2%	0.3%
SSGA	1	0.2	0.1%	0.0%
Grand Total	1,495	2,350.1	100.0%	100.0%

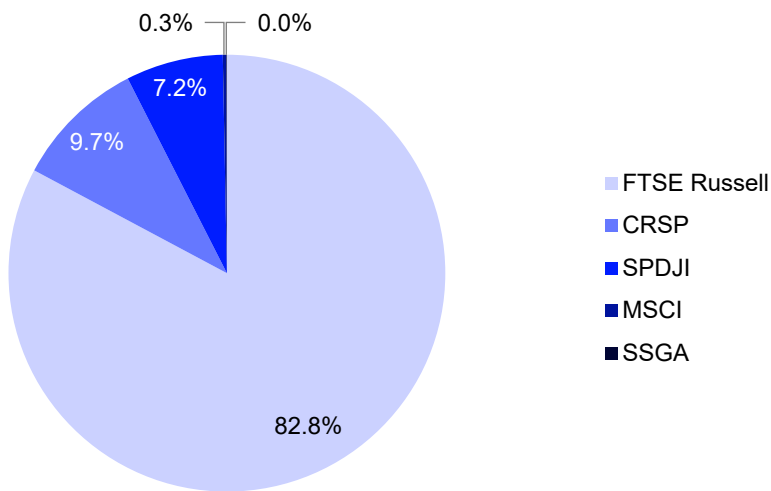
Sources: Morningstar Direct for ETFs and retail mutual funds, eVestment for institutional assets. Data as of December 2021, as reported April 2022. "Russell 2000" includes variants (Defensive, Dynamic, Growth, Value) and others. "MSCI 1750" includes variants (Growth). "S&P 600" includes variants (Value, 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.

¹ Banz, 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.

Total small cap products



Total small cap assets



Sources: Morningstar Direct for ETFs and retail mutual funds, eVestment for institutional assets. Data as of December 2021, as reported on April 3, 2022. "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, volumes 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 \$4.3 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.

Figure 2. 2022 Russell 2000 ETF, exchange traded futures and exchange traded options volume

	ETF avg. daily volume (\$M)	Futures total volume	Options total volume
Russell 2000	4,300	93,403,888	12,760,511

Sources: Refinitiv, CME Group, Cboe. ETF average daily volume is the 20-day average as of December 31, 2022.

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 \$36.5 billion as of June 30, 2022, and earned over \$13.5 million in securities lending income for the 2021–2022 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

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

³ LSEG Data & Analytics.

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

⁵ 2021-22 Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2022, California Public Employees' Retirement System (CalPERS).

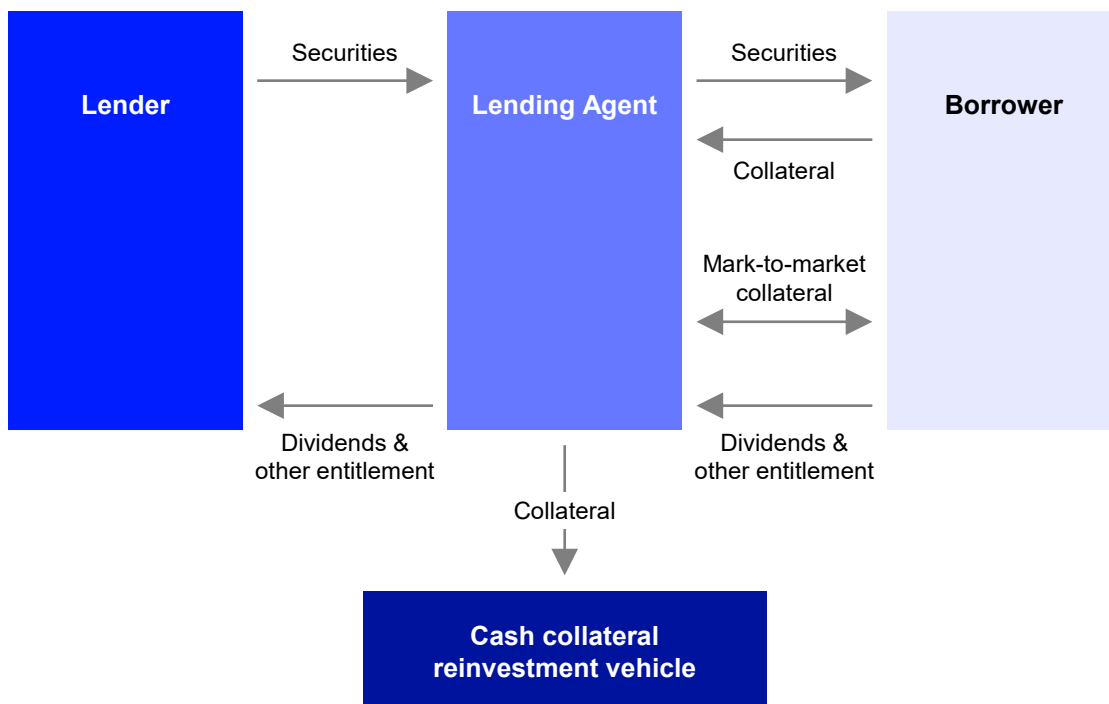
⁶ Adrian, Begalle, Copeland and Martin, "Repo and Securities Lending," *Federal Reserve Bank of New York Staff Reports*, 2012.

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

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



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

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

Research firm IHS Markit estimated that the equity value on loan in securities lending programs reached approximately \$1.3 trillion at the end of June 2022.⁸ According to the same source, 2022 also saw the highest overall securities finance revenues (\$12.5 billion) since 2008, while the iShares Russell 2000 ETF (IWM) generated the second-highest revenues of all US equity ETFs.⁹

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 offset management fees partially or wholly 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.

⁸ Securities Finance June Snapshot 2022, S&P Global Market Intelligence.

⁹ Securities Finance H2 2022 review, S&P Global Market Intelligence.

ABOUT FTSE RUSSELL

FTSE Russell is a leading global provider of index and benchmark solutions, spanning diverse asset classes and investment objectives. As a trusted investment partner, we help investors make better-informed investment decisions, manage risk, and seize opportunities.

Market participants look to us for our expertise in developing and managing global index solutions across asset classes. Asset owners, asset managers, ETF providers, and investment banks choose FTSE Russell solutions to benchmark their investment performance and create investment funds, ETFs, structured products, and index-based derivatives. Our clients use our solutions for asset allocation, investment strategy analysis, and risk management, and value us for our robust governance process and operational integrity.

For over 35 years we have been at the forefront of driving change for the investor, always innovating to shape the next generation of benchmarks and investment solutions that open up new opportunities for the global investment community.

CONTACT US

To learn more, visit seq.com/ftse-russell; email info@ftserussell.com; or call your regional Client Service team office:

EMEA +44 (0) 20 7866 1810

Asia-Pacific

North America +1 877 503 6437

Hong Kong +852 2164 3333

Tokyo +81 3 6441 1430

Sydney +61 (0) 2 7228 5659

Disclaimer

© 2023 London Stock Exchange Group plc and its applicable group undertakings ("LSEG"). LSEG includes (1) FTSE International Limited ("FTSE"), (2) Frank Russell Company ("Russell"), (3) FTSE Global Debt Capital Markets Inc. and FTSE Global Debt Capital Markets Limited (together, "FTSE Canada"), (4) FTSE Fixed Income Europe Limited ("FTSE FI Europe"), (5) FTSE Fixed Income LLC ("FTSE FI"), (6) The Yield Book Inc ("YB") and (7) Beyond Ratings S.A.S. ("BR"). All rights reserved.

FTSE Russell® is a trading name of FTSE, Russell, FTSE Canada, FTSE FI, FTSE FI Europe, YB and BR. "FTSE®", "Russell®", "FTSE Russell®", "FTSE4Good®", "ICB®", "The Yield Book®", "Beyond Ratings®" and all other trademarks and service marks used herein (whether registered or unregistered) are trademarks and/or service marks owned or licensed by the applicable member of LSEG or their respective licensors and are owned, or used under license, by FTSE, Russell, FTSE Canada, FTSE FI, FTSE FI Europe, YB or BR. FTSE International Limited is authorized and regulated by the Financial Conduct Authority as a benchmark administrator.

All information is provided for information purposes only. All information and data contained in this publication is obtained by LSEG, from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, such information and data is provided "as is" without warranty of any kind. No member of LSEG nor their respective directors, officers, employees, partners or licensors make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to the accuracy, timeliness, completeness, merchantability of any information or of results to be obtained from the use of FTSE Russell products, including but not limited to indexes, data and analytics, or the fitness or suitability of the FTSE Russell products for any particular purpose to which they might be put. Any representation of historical data accessible through FTSE Russell products is provided for information purposes only and is not a reliable indicator of future performance.

No responsibility or liability can be accepted by any member of LSEG nor their respective directors, officers, employees, partners or licensors for (a) any loss or damage in whole or in part caused by, resulting from, or relating to any error (negligent or otherwise) or other circumstance involved in procuring, collecting, compiling, interpreting, analyzing, editing, transcribing, transmitting, communicating, or delivering any such information or data or from use of this document or links to this document or (b) any direct, indirect, special, consequential or incidental damages whatsoever, even if any member of LSEG is advised in advance of the possibility of such damages, resulting from the use of, or inability to use, such information.

No member of LSEG nor their respective directors, officers, employees, partners or licensors provide investment advice and nothing in this document should be taken as constituting financial or investment advice. No member of LSEG nor their respective directors, officers, employees, partners or licensors make any representation regarding the advisability of investing in any asset or whether such investment creates any legal or compliance risks for the investor. A decision to invest in any such asset should not be made in reliance on any information herein. Indexes cannot be invested in directly. Inclusion of an asset in an index is not a recommendation to buy, sell or hold that asset nor confirmation that any particular investor may lawfully buy, sell or hold the asset or an index containing the asset. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

The information contained in this report should not be considered "research" as defined in recital 28 of the Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council ("MiFID II") and is provided for no fee.

Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only. Index returns shown may not represent the results of the actual trading of investable assets. Certain returns shown may reflect back-tested performance. All performance presented prior to the index inception date is back-tested performance.

Back-tested performance is not actual performance, but is hypothetical. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. However, back-tested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month to month based on revisions to the underlying economic data used in the calculation of the index.

This document may contain forward-looking assessments. These are based upon a number of assumptions concerning future conditions that ultimately may prove to be inaccurate. Such forward-looking assessments are subject to risks and uncertainties and may be affected by various factors that may cause actual results to differ materially. No member of LSEG nor their licensors assume any duty to and do not undertake to update forward-looking assessments.

No part of this information may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the applicable member of LSEG. Use and distribution of LSEG data requires a license from FTSE, Russell, FTSE Canada, FTSE FI, FTSE FI Europe, YB, BR and/or their respective licensors.



**FTSE
RUSSELL**
An LSEG Business