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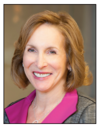
Time For Small Caps to Shine?

Given today's economic outlook, small caps could be a promising diversifier.



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With the technology-focused Magnificent Seven[1] stocks accounting for about 25% of the value of the S&P 500 Index,[2] investors are looking for any signs that market breadth will improve and make room for other sectors and styles to outperform. I think one interesting space to explore is US small-cap stocks.

While small caps are more volatile than large-cap stocks, I see several reasons investors may want to consider an allocation to US small caps in a diversified portfolio:

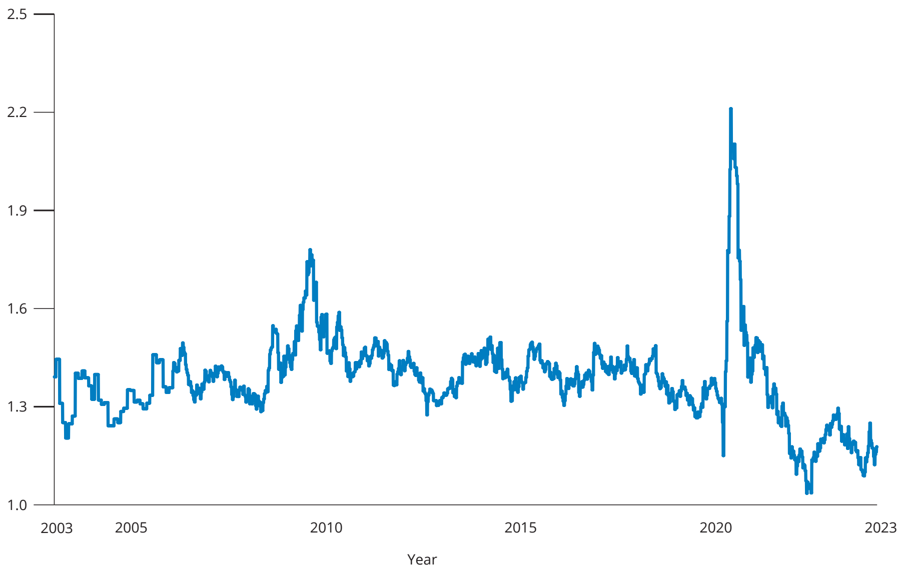
- **Economic growth expectations for the US are stronger than in Europe, the UK, and Japan, which could benefit domestically oriented small-cap stocks.** Last year, the consensus view was that a recession was on the way. But with consumer spending remaining healthy, inflation moderating, and interest-rate cuts on the horizon, the economy might actually be accelerating. Given their greater economic sensitivity, this could actually be an environment in which small caps excel.
- **Small-cap valuations look attractive relative to large caps.** Small caps have underperformed large caps over the past 11 years, yet we find that, historically, the cycle of large-cap outperformance over small caps has averaged about 10 years and then reversed. With the small-cap forward price/earnings (P/E) ratio[3] at one of its lowest levels in recent years relative to the large-cap forward P/E ratio (**FIGURE 1**), a switch to small-cap outperformance may be due if the long-term pattern holds.

Key Points

- For investors interested in diversifying away from the concentration of the Magnificent Seven stocks, small caps may be a space worth exploring.
- Growth expectations, valuations, evolving policy, and more could all be a boon for small caps.
- While there are many factors that make small caps an interesting allocation, large-cap companies could still maintain their advantage.

FIGURE 1

Small Caps Have Been Trading at Historically Low Valuations Relative to Large Caps
12-Month Forward P/E Ratio of the Russell 2000 Index Divided by the12-Month Forward P/E Ratio of the Russell 1000 Index



Data from 1/1/03-3/5/24. **Past performance does not guarantee future results**. Indices are unmanaged and not available for direct investment. **Russell 1000 Index** measures the performance of the large-cap segment of the US equity universe. **Russell 2000** Index measures the performance of the small-cap segment of the US equity universe. For illustrative purposes only. Data Source: Refinitiv Eikon DataStream, 3/24.

- **The tailwinds that have given large-cap companies an edge and boosted their profits, including low taxes and light regulation, could become headwinds.**

  Some large caps, including those in the tech space, have reaped the benefits of quasi-monopoly businesses. But these businesses are increasingly coming under scrutiny from policymakers and regulators.

- **A large pipeline of private companies could come to the public small-cap market at relatively inexpensive valuations.**

  The number of private companies entering the public small-cap market through an initial public offering has slowed in the last few years, but that could change as economic conditions improve. In addition, small-cap stocks could be acquisition targets for large-cap companies looking for “inorganic” growth. Following a sparse year for mergers and acquisitions in 2023, activity has picked up this year, which could create unique opportunities for small-cap managers.

- **The inefficiency of the small-cap market makes it potentially fertile ground for active managers.**

  Small-cap companies are less likely than large-cap companies to be covered by research analysts. And with less information available, it’s more likely that the stocks may be mispriced. There also tends to be more dispersion in the performance and valuations of small caps, which can make for a more attractive opportunity set for skilled stock pickers.

The Counterarguments

There are, of course, risks to my view. Large-cap companies have advantages that could continue to serve them well in any environment, including brand, scale, data, and the power to attract and retain talent. The ability of the most successful large-cap technology companies to consistently outperform market expectations is a trend that could continue, aided by their advances in artificial intelligence. And while interest-rate cuts are widely expected later this year, the process won’t happen overnight. In the meantime, today's higher interest rates could be a particular challenge for small caps, which tend to use more leverage and have more floating-rate debt.

Investment Implications

- **Investors may want to consider moving some large-cap exposure to small caps**. After a long stretch of underperformance, small caps could be positioned for better results going forward given their valuations and the economic outlook.
- **Small caps could offer diversification in a tech-driven market**. The mega-cap technology stock rally has left some portfolios with concentrated exposure to a small number of stocks. Small caps have different drivers than mega-cap tech stocks, which could potentially help mitigate risk if mega caps falter.
- **Active managers may have an edge in small caps**. The small-cap market generally has greater dispersion, greater idiosyncratic risk, and less analyst coverage than the large-cap market, creating the potential for better returns through active management.

To learn more about opportunities in small-cap investing, talk to your financial professional.

[1] The Magnificent Seven stocks are a group of high-performing and influential companies in the US stock market: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

[2] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[3] Price/Earnings is the ratio of a stock's price to its earnings per share.

Important Risks: Investing involves risk, including the possible loss of principal. • Small-cap securities can have greater risks and volatility than large-cap securities. • Diversification does not ensure a profit or protect against a loss in a declining market.

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