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Setting the Stage for Small Caps in 2025

Several key themes may point to potentially brighter days ahead for small caps.

In making the case for small-cap equities in 2025, Wellington Management's small- and mid-cap (smid) portfolio managers outline several key themes to consider, such as valuations, market cycles, and economic conditions.

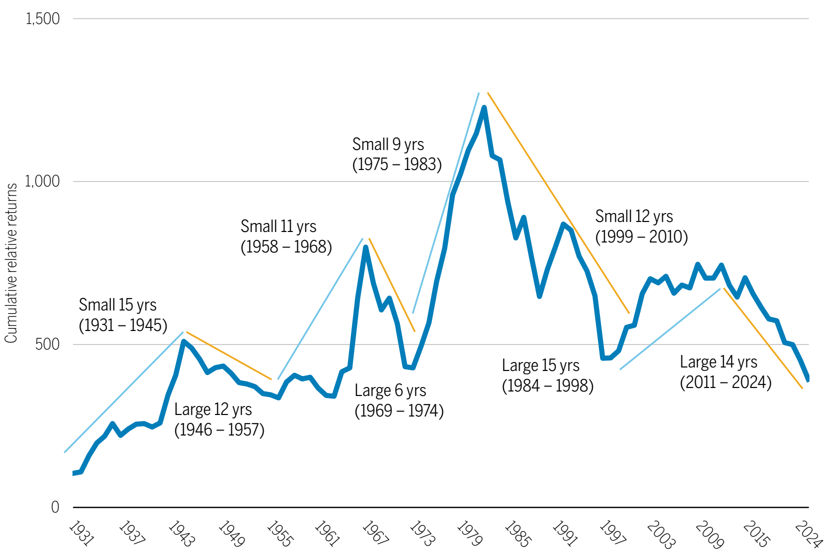
Valuations and Market Cycles

The portfolio managers believe now may be a good time to consider small-cap equities because the cycle of large-cap outperformance is arguably getting long in the tooth. Historically, large- and small-cap equities have traded cycles of outperformance lasting an average of 11 years, and we're currently 14 years into this cycle of large-cap outperformance **(FIGURE 1)**, according to small-cap core equity Portfolio Manager Peter Carpi.

Carpi points out that the large-cap cycle appears to be in its final stages, as suggested by increasing narrowness and unsustainable valuations. He also notes that the greatest gains in each cycle have historically occurred at their outset and just before their end.

Smid/mid-cap value Portfolio Manager Greg Garabedian also highlights the extended period of large-cap outperformance relative to smid- and mid-caps. He notes, "the Russell 2500 Value Index[1] and Russell Midcap Value Index[2] have been trading near record-low valuations relative to the S&P 500 Index."[3]

FIGURE 1
The Current Cycle of Large-Cap Outperformance Is Longer Than Average
Small-Cap vs. Large-Cap Leadership Cycles (1931-2024)



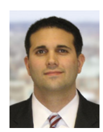
As of 12/31/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Relative strength line indexed at 100 at the start of 1931. Small caps (Russell 2000 Index)[4] vs. large caps (Russell 1000 Index)[5] for 1979 to 2024, and Small minus Big factor returns from FamaFrench database for 1931-1978. For illustrative purposes only. Data Source: Wellington Management.

Insight from sub-adviser Wellington Management


David DuBard
Equity Portfolio Manager


Peter Carpi
Equity Portfolio Manager


Ranjit Ramachandran, CFA
Equity Portfolio Manager


Greg Garabedian
Equity Portfolio Manager


Sean Kammann
Equity Portfolio Manager

Key Points

- The average cycle of outperformance for large caps relative to small caps is 11 years, and we're currently in the fourteenth year of large-cap outperformance.
- Smid- and mid-caps are currently trading near record-low valuations relative to the S&P 500 Index.
- After several years of underperformance, small caps are finally expected to see their earnings growth exceed large caps.

Within the small-cap space, the smallest, institutional-grade, publicly traded companies—micro caps—may be undervalued. Micro-cap Portfolio Manager David DuBard notes that these companies are often overlooked because they fall just below the "market cap bar of relevance," where larger-cap investors typically focus. "The micro-cap market has been out of favor as investors have shifted toward larger, more liquid stocks, making it one of the few asset classes that has become less efficiently scrutinized in recent years," he explains. He believes current market conditions may be ideal for generating alpha[6] by identifying undervalued opportunities in the micro-cap space.

> Small caps are finally expected to see their earnings growth exceed large caps' after several years of underperformance.

Economic Conditions and Growth Prospects

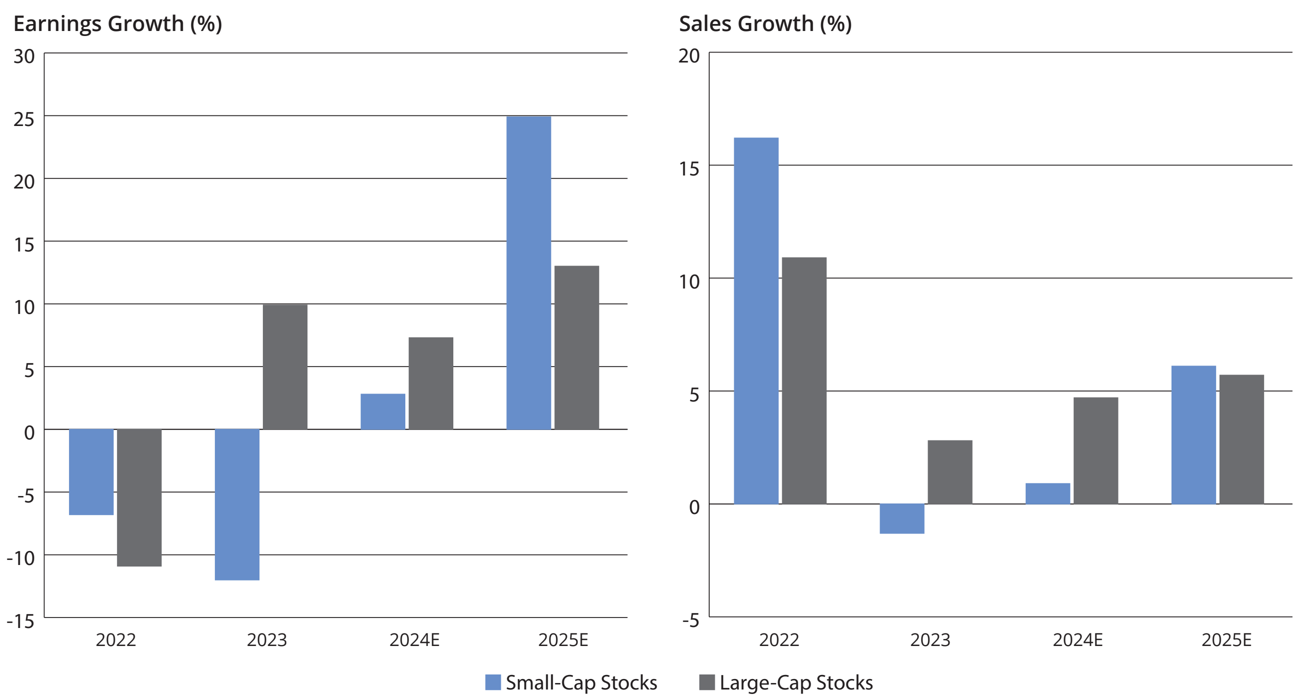
There are reasons for optimism in small caps from an earnings perspective, as well. "Small caps are finally expected to see their earnings growth exceed large caps' after several years of underperformance," says small-cap growth Portfolio Manager Ranjit Ramachandran. What's more, after trailing the S&P 500 Index in earnings and sales growth for the last two years, earnings growth is expected to accelerate for small caps as a group **(FIGURE 2)**. Relative valuations are also close to multiyear lows.

Small-cap value Portfolio Manager Sean Kammann outlines further reasons to believe in small-cap performance in 2025. He points to trends such as deglobalization, increasing confidence in small businesses, and the recent lift in employment as indicators of an accelerating economy. "Small-cap value companies are collectively more short cycle; this acceleration points to a favorable fundamental backdrop for small-cap value companies," he says. He also notes that historically, the small-cap value area of the market has outperformed over almost any medium- to long-term holding period.

FIGURE 2

Small Cap Earnings Growth Expectations Look Attractive This Year

Small- and Large-Cap Earnings and Sales Growth Expectations (2022-2025 Estimates)



As of 12/31/24. Based on Wellington's "capitalized losses" earnings model using historical constituents. For illustrative purposes only. Large-cap stocks are represented by the S&P 500 Index. Small-cap stocks are represented by the Russell 2000 Index.[4] Data Sources: Furey Research Partners and FactSet.

Sector Diversification and Mergers & Acquisitions (M&A) Activity

Garabedian says, “smid- and mid-cap value typically offer more diverse sector exposures than large caps, where more than 40% of the S&P 500 Index weighting comes from IT and communication services.” He believes a broadening of economic growth and/or slowing of Artifical Intelligence capex[7] activity could relatively benefit more diversified smid-cap exposures in areas such as financials and industrials.

In addition, Ramachandran and Garabedian point to a more accommodative regulatory stance in Washington, which could continue to accelerate the level of deal activity in markets. “Smid caps generally see the biggest relative benefit from an increasing M&A environment given the higher likelihood of being targeted for acquisitions,” Garabedian explains. Ramachandran notes, “Historically, lower taxes, deregulation, and lower interest rates have provided a positive backdrop for more domestically focused small-cap companies.”

Conclusion

Wellington’s small/smid portfolio managers see a range of factors that make their respective investment spaces appealing in 2025. Their insights on undervaluation, market cycles, economic conditions, and sector diversification provide a comprehensive view of the potential opportunity in the small-cap space.

To learn more about the opportunity in small-cap stocks, please talk to your financial professional.

[1] Russell 2500 Value Index is an unmanaged index measuring the performance of those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values.

[2] Russell Midcap Value Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

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

[4] Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe.

[5] Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

[6] Alpha is the measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio and comparing it to some benchmark. The alpha is the excess return of the portfolio over the benchmark.

[7] Capex (capital expenditures) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. Capital expenditures are often used to undertake new projects or investments by a company.