Overweight US Small-Cap Equities vs US Equities

Recommended Since April 30, 2022

INVESTMENT THESIS: We expect small-cap equities will outperform their mid- to large-cap counterparts in the United States, given their valuation discount and strong profitability. We like the relative diversifying benefit from their sector exposures. Small-cap equities have historically tended to perform best in the recovery stage of business cycles, and investors could see significant benefit when fundamentals rebound.

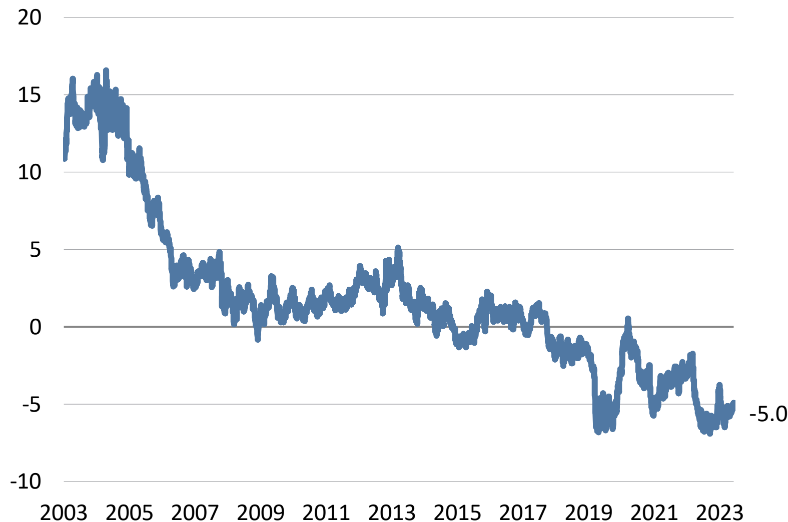
- **KEY SUPPORT #1:** US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades at a 43% discount to the MSCI US Index's 21.3 normalized price-to-cash earnings multiple, the widest discount on record based on history back to 2003. Investors have also assigned higher multiples to expected earnings for large-cap stocks relative to small caps. The price-to–forward earnings multiple for the MSCI US Index is 21x, 1.4 times higher than that for small-cap stocks. This is 54% higher than the median of 0.9 that has been observed over the past 20 years.

- **KEY SUPPORT #2:** Recent US government initiatives, such as the Infrastructure Act, the CHIPs Act, and the Inflation Reduction Act, could provide incentives for some reshoring of supply chains that would benefit certain sectors overweight in small-cap stock indexes. In the case of the Infrastructure Act, a substantial amount of funding is still yet to be awarded. The industrials and materials sectors, which could see direct benefit from this impending spending, have higher relative weights in the S&P 600® Index compared to the MSCI US Index.

- **KEY RISKS:** Small-cap companies have lower margins and tend to be more cyclical than larger-cap stocks, and thus are more vulnerable to an economic slowdown. Moreover, the recent boom in mega-cap tech stocks saw small caps lag substantially, and a continuation of that rally could further widen the performance gap.

5-YR EXCESS RETURN S&P 600® VS MSCI USA

December 31, 2003 – May 31, 2024 • Rolling 5-Yr Relative AACR (%)



RELATIVE NORMALIZED P/E RATIO: S&P 600® VS MSCI USA

December 31, 2003 – May 31, 2024

Sources: FactSet Research Systems, MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Excess return data are daily. The cyclically adjusted price-to–cash earnings (CAPCE) ratio is calculated by dividing the inflation-adjusted index price by trailing ten-year average inflation–adjusted cash earnings. Cash earnings are defined as net income from continuing operations plus depreciation and amortization expense. MSCI does not publish cash earnings for banks and insurance companies and therefore excludes these two industry groups from index-level cash earnings. S&P does not calculate a cash earnings metric; cash flow is used as a proxy.