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 historically large valuation discount. While profit growth has disappointed in recent years and hurt performance, recent results have been positive, and expectations are elevated for 2026. Downside risk exists for small-cap equities should growth slow. However, as recent performance suggests, there could also be more upside for small companies from expected Fed cuts and for sectors like industrials if efforts to boost US manufacturing bear fruit.

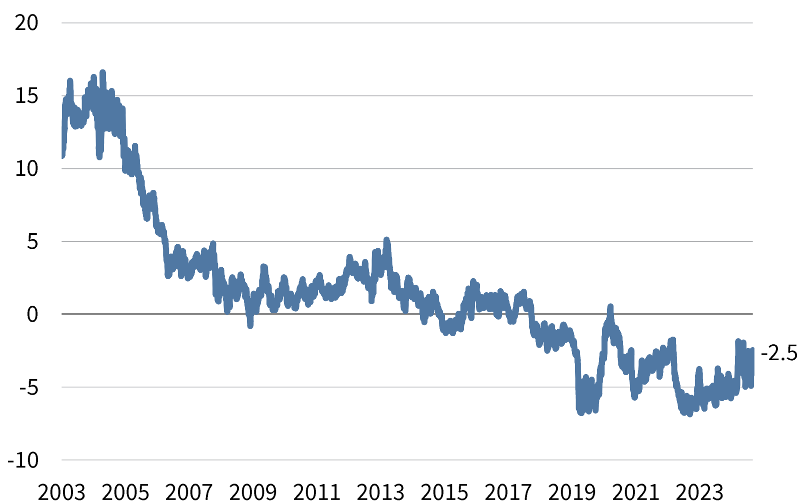
- **KEY SUPPORT #1:** US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades at a 51% discount to the MSCI US Index using normalized price-to-cash earnings multiples, close to a historical low dating back to 2004. Forward price-to-earnings ratios are also lower for small caps. The 16.5x S&P 600® forward P/E is almost 30% lower than that of large-cap stocks, whereas historically they have traded at close to a 11% premium.

- **KEY SUPPORT #2:** Small-cap earnings disappointed in recent years but this has set a low bar for comparison. As tariff tensions eased the S&P 600® Index easily surpassed expectations with earnings growth of around 13% in the second quarter. Looking ahead to 2026, forecasts are elevated—around 18%—higher than for large caps and also less reliant on a small cluster on companies to meet this bar. Tariffs create concerns around margins for small-cap companies in certain sectors, but expected Fed rate cuts should prove an important offset.

- **KEY RISKS:** Small-cap companies have lower margins, higher debt levels, and tend to be more cyclical than larger-cap stocks, making them more vulnerable to an economic slowdown. Ongoing demand for mega-cap tech stocks could weigh on relative small-cap performance. Recession concerns or geopolitics could create a flight to higher quality, defensive large-cap stocks at the expense of small-cap peers, perpetuating the current valuation discount.

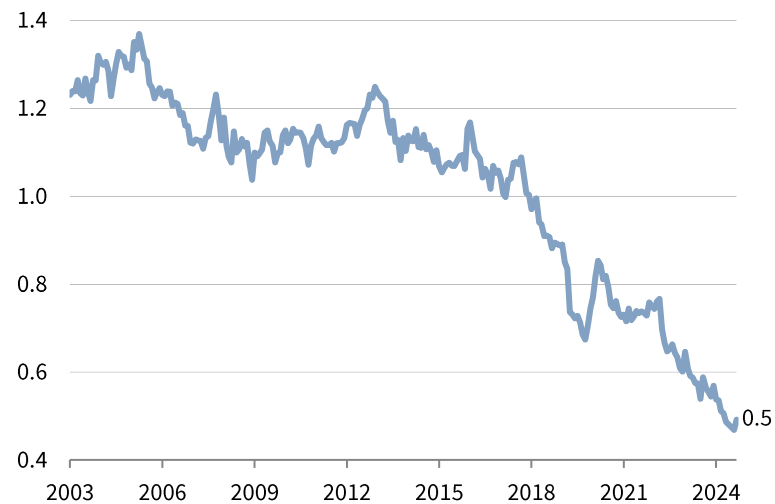
5-YR EXCESS RETURN S&P 600® VS MSCI USA

December 31, 2003 – August 31, 2025 • Rolling 5-Yr Relative AACR (%)



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

December 31, 2003 – August 31, 2025



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.