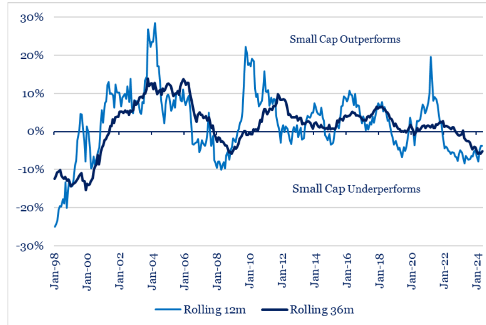
Will Small Caps Continue to Underperform? We think not.

The risk versus reward on small capitalization stocks has historically been attractive relative to their large capitalization counterparts. Small cap stocks have tended to outperform large caps over the long-term relative to the risk thus driving their premium. Often times, the premium on small caps has been justified due to their higher growth as well as the opportunity they represent to find hidden gems that could be a potential target for a merger or an acquisition. Furthermore, market inefficiencies and a lack of information make the small cap universe a fertile hunting ground for investing.

However, for the first time in multiple decades, small cap stocks have underperformed large caps in recent years as presented in Exhibit 1. One has to go back to the Global Financial Crisis (GFC) in 2008 or even the period leading up to the Telecom, Media and Technology (TMT or dot com) bubble in 2000 to find such an extended period of small cap underperformance. In our view, there are some similarities between these periods and the current market environment, which explains the recent small cap underperformance. These reasons are also precisely why we think that small cap stocks could start to outperform again.

Exhibit 1. Small versus Large Cap Performance: MSCI World ex USA



Source: Bloomberg

In general, small cap stocks tend to be more sensitive to cyclical factors and economic cycles. The cyclicality of small cap stocks are demonstrated by a higher representation of cyclical sectors such as Industrials, Materials and Real Estate in the small cap index. As shown in Exhibit 2, these three sectors are almost 44% of the small cap index while more defensive areas such as Consumer Staples, Health Care and Utilities are less than 15%. Global economic weakness during the GFC had a proportionally higher negative impact on smaller companies, thus driving small caps to lag.

Exhibit 2. Sector Exposure: May 2024

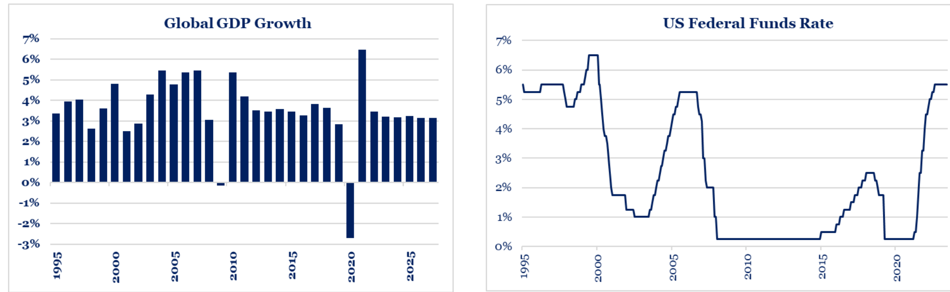
	World ex US	WxUS Small Cap
Industrials	16.7%	22.5%
Financials	21.5%	12.0%
Discretionary	10.8%	11.7%
Materials	7.6%	11.4%
Real Estate	2.0%	9.6%
Info-Tech	8.9%	9.3%
Staples	8.2%	5.9%
Health Care	11.7%	5.5%
Energy	5.8%	5.2%
Communications	3.7%	3.6%
Utilities	3.2%	3.1%

By contrast, the underperformance in small caps in the late 1990s occurred even before global growth slowed down and while the dot com bubble was still brewing. During this phase, any stock that had even a remote connection to the dot com phenomenon was getting bid higher thus leading to an increased concentration of large cap names in the index. Thus, as larger companies outperformed, they became an even bigger weight in the index which in turn pushed the markets higher and left the small caps behind. In addition, between May 1999 and May 2000, the Federal Reserve raised interest rates by

175bps thus increasing the cost of debt for smaller companies, which being out of favor could not rely on the equity markets to raise funds.

The current market environment has similarities to both of these periods of large cap outperformance. Following one of the fastest monetary tightening cycles since the 1970s, global growth has slowed down from the post pandemic recovery of 6.5% in 2021 to 3.2% in 2023. Thus, given the economic slowdown and cyclical sensitivity of small caps, it is not surprising that small caps have lagged in the current environment.

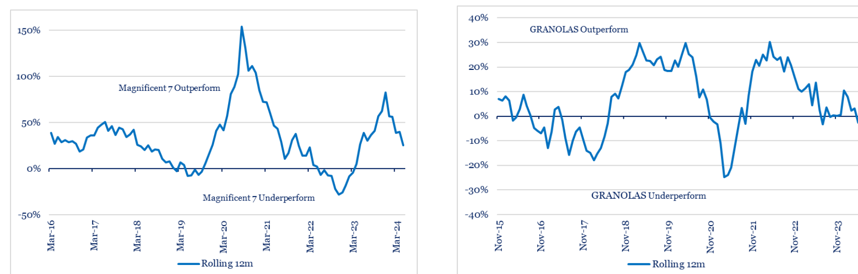
Exhibit 3. Global Macro Data



Source: IMF (Expected Growth for 2024 and thereafter); US Federal Reserve, Bloomberg

Second, similar to the dot com bubble, current demand for Artificial Intelligence has led to large cap outperformance (left chart in Exhibit 4). The Magnificent 7 in the United States, and in particular Nvidia, has driven the S&P 500 index higher with a "winner-takes-it-all" investment environment. These 7 stocks represent approximately 30% of the S&P 500 index, which is even higher than the level of concentration at the peak of the dot com bubble.

Exhibit 4. Performance of Select Stocks Relative to the Broader Markets: US and Europe



Sources: Bloomberg, Goldman Sachs, MSCI

While concentration risk is lower outside the US (MSCI World ex USA), similar to their US counterparts, the larger stocks in the index have benefitted from AI as well as an almost insatiable demand for obesity drugs (right chart in Exhibit 4). An equivalent set of stocks in Europe are known as GRANOLAS, as defined by Goldman Sachs. The largest 10 names (GlaxoSmithKline, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP and Sanofi) represent roughly 13% of the index. By contrast, the largest 10 stocks in the small cap index are only 2.7% of that index.

The recent underperformance of small caps has meant that for the first time in a long while, these stocks are trading at attractive valuations. While historically small caps have traded at a premium to large caps, currently, they are trading at a discount. The price to earnings ratio of MSCI World ex US is 14.8x versus 14.1x for MSCI World ex US Small Cap. By comparison, these small caps traded at an average 20% premium to large cap stocks over the past 10 years.

Although interest rate cuts have been delayed relative to what was expected at the beginning of 2024, the US Federal Reserve is getting closer to lowering interest rates (Exhibit 2) as inflation has cooled down in the US. Some experts are now predicting 1-2 cuts in 2024 and 4-5 cuts in 2025. Meanwhile the International Monetary Fund, in its most recent World Economic Outlook, is projecting global real GDP growth to stabilize at current levels of 3.2%.

Hence, in our view, a stable economic growth environment, along with lower interest rates in the US and attractive valuations could provide the perfect recipe for small caps to shine once again.