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# Small Caps

## More Than Just a Factor Premium

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**03 Executive Summary**

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**04 Size Premium:  
Dead or Just Sleeping?**

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**05 Why Small Caps?  
A Growing and Diverse Opportunity Set**

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**09 Small Caps in Global Portfolios and  
Implementation Considerations**

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# Executive Summary

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Small-cap equities have long been a subject of interest for investors seeking diversification and enhanced returns. While the “size premium” has been a central theme in this debate, the investment case for small caps extends far beyond this single factor. This paper explores the multifaceted benefits of small-cap allocations within global portfolios, examining their evolving role in the market, their unique diversification properties, and the practical considerations of implementation. We argue that while implementation challenges exist, a balanced approach that considers the holistic portfolio context can unlock the significant strategic potential of small-cap investments.

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## **Size Premium: Dead or Just Sleeping?**

- The size premium has historically been cyclical, with periods of both outperformance and underperformance.
- The investment case for small caps extends beyond the size premium, encompassing diversification and broader market access.

## **Why Small Caps? A Growing and Diverse Opportunity Set**

- The small-cap universe has grown significantly in size and economic influence, offering investors access to a much broader and more diverse opportunity set than that of large and mid caps.
- Small cap indices provide valuable sectoral and geographic diversification compared to large- and mid-cap indices, while also providing a counterbalance to the concentration risk found in the latter indices.

## **Small Caps in Global Portfolios and Implementation Considerations**

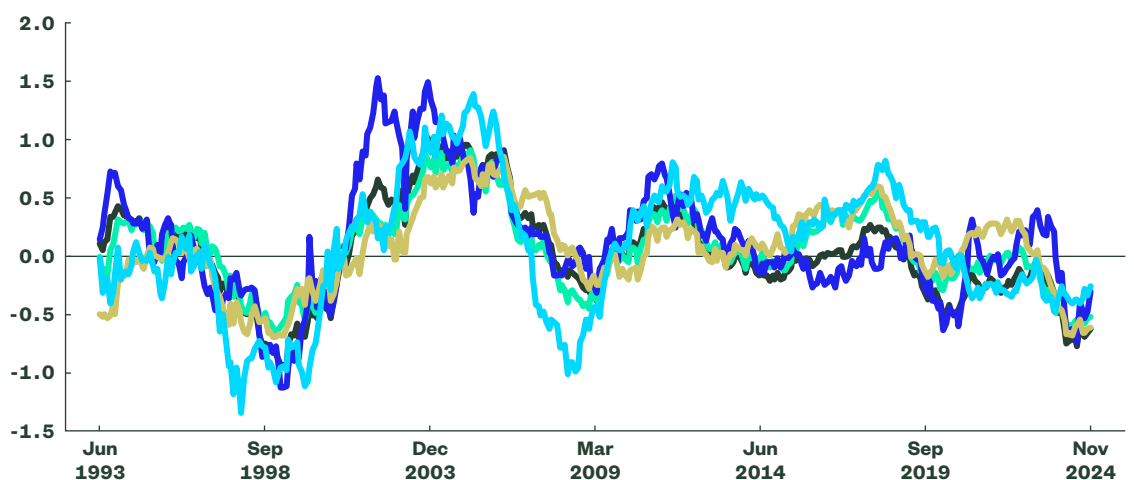
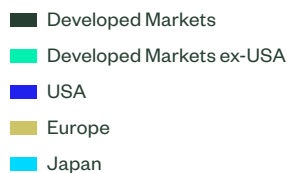
- Within a diversified portfolio, small caps can enhance portfolio characteristics while potentially reducing the frequency of severe drawdowns.
- Implementing small-cap approaches at scale requires careful consideration of implementation costs. A combined active, passive, and enhanced approach can balance alpha potential with implementation feasibility.

# Size Premium: Dead or Just Sleeping?

The concept of the size premium, originating from Banz's 1981 research<sup>1</sup> and cemented by Fama and French in 1993,<sup>2</sup> posits that small-cap stocks tend to outperform larger ones over the long term, a phenomenon not fully explained by traditional asset pricing models like the capital asset pricing model (CAPM). This insight fueled early interest in small-cap investing and led to the launch of benchmarks like the Russell 2000 in 1984. However, small-cap performance has been far from consistent, with periods of underperformance relative to large caps sparking debates about the premium's persistence in the late 1990s. Similar concerns have resurfaced recently due to the dominance of mega-cap companies in global indices.

As with other factor premia, such as value or momentum, the size premium has exhibited cyclical behavior as illustrated in Figure 1. Complicating matters further is the geographic variance in size factor performance. Different regions have seen divergent results, adding complexity to the debate.

Figure 1  
**Size Premia Vary  
Over Time**



Source: [Kenneth R. French — Data Library](#), State Street Global Advisors, Monthly data from July 31, 1990, to November 30, 2024. Size premia as indicated. Past performance is not a reliable indicator of future performance.

This cyclicity has led to differing investor viewpoints, with some abandoning size factor allocations and others attempting notoriously difficult factor timing.<sup>3</sup> Regardless of the size premium's current state, the broader investment case for small caps endures. While the size premium's future remains uncertain, focusing on it alone overlooks the broader and more compelling rationale for small-cap allocations — as we highlight in the next section.

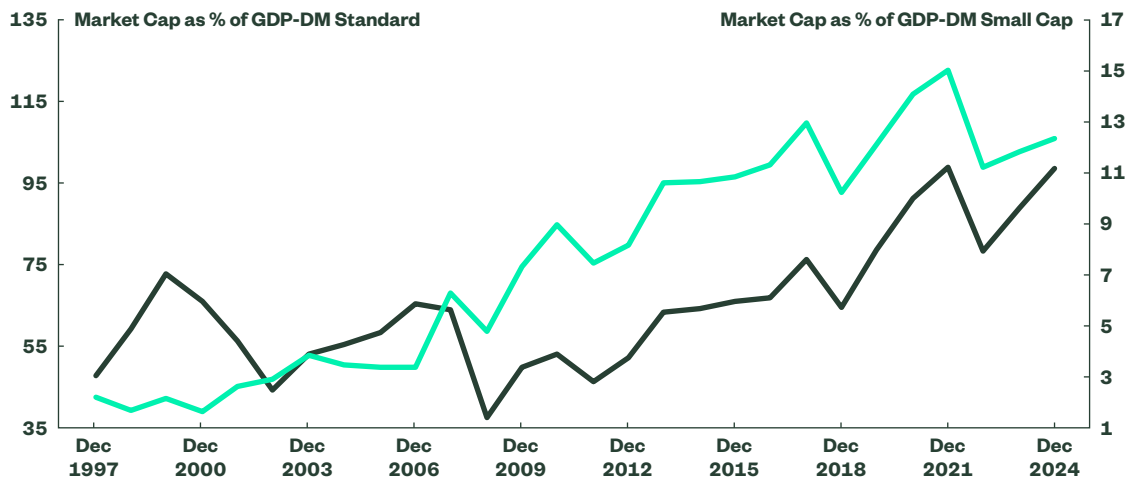
# Why Small Caps?

## A Growing and Diverse Opportunity Set

The definition of “small cap” has evolved significantly, reflecting the growth of smaller companies and the overall expansion of equity markets. For instance, as of the end of 2024, the median market capitalization of a company in the MSCI World Small Cap Index stood at \$1.2 billion, compared to just \$344 million in 1985. What qualifies as a small-cap company today might have been considered mid-sized decades ago. Over the years, the market capitalization of small caps has grown at a pace far exceeding both economic growth and that of large caps, as shown in Figure 2. This evolution underscores not only the rising scale of small caps but also their expanding role in the economy and global equity markets. Moreover, small-cap indices encompass a much broader opportunity set than standard (large- and mid-cap) indices. At the end of 2024, the MSCI World Small Cap Index contained 3,979 companies compared to just 1,395 firms in the MSCI World Index, offering investors access to a more diverse range of business models, industries, and growth trajectories.

Figure 2  
**The Growing Economic Influence of Small Caps: Market Cap as a % of GDP**

■ Market Cap as % of GDP-DM Standard  
 ■ Market Cap as % of GDP-DM Small Cap



Source: FactSet, International Monetary Fund, MSCI Indices, State Street Global Advisors. Free float-capitalization in USD. Annual Data from December 31, 1997, to December 31, 2024. Expected GDP figure was used for 2024.

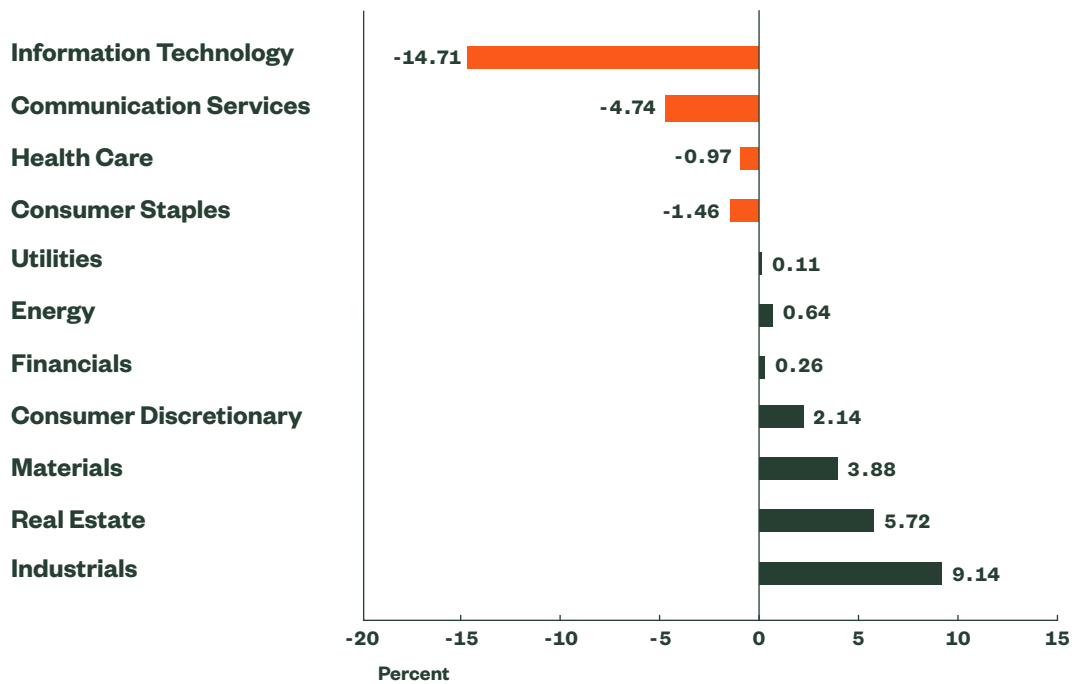
### Sectoral, Geographic, and Style Diversification

Small caps offer valuable diversification benefits beyond the realm of large multinationals. These benefits span sectors, geographies, and investment styles.

Sector Diversification

While large-cap companies often dominate sectors requiring significant capital or infrastructure, small caps frequently emerge from niche areas with lower barriers to entry. This leads to a different sector mix that offers exposure to industries often underrepresented in large-cap indices. This fundamental difference in business models, where small caps focus on specialized areas while large caps pursue economies of scale, is reflected in the sector weight differences shown in Figure 3, highlighting the diversification potential of small-cap allocations. Moreover, this differentiation extends beyond broad sectors to distinct sub-industries. For instance, while the Financials sector might have a similar representation in small-cap and large-cap indices, a deeper dive reveals a different story. The MSCI World Small Cap Index has a near 5.4% overweight in regional banks, tapping into local economies, while the MSCI World Index (large caps) is more heavily weighted in international banks with their global reach and diverse financial services. Similarly, while small caps may be underweighted in the broad Healthcare sector, they typically maintain an overweight in high growth, although riskier, biotechnology companies. This granular differentiation further enhances the portfolio diversification potential of small caps.

Figure 3  
**Small Caps Offer Sector Diversification**

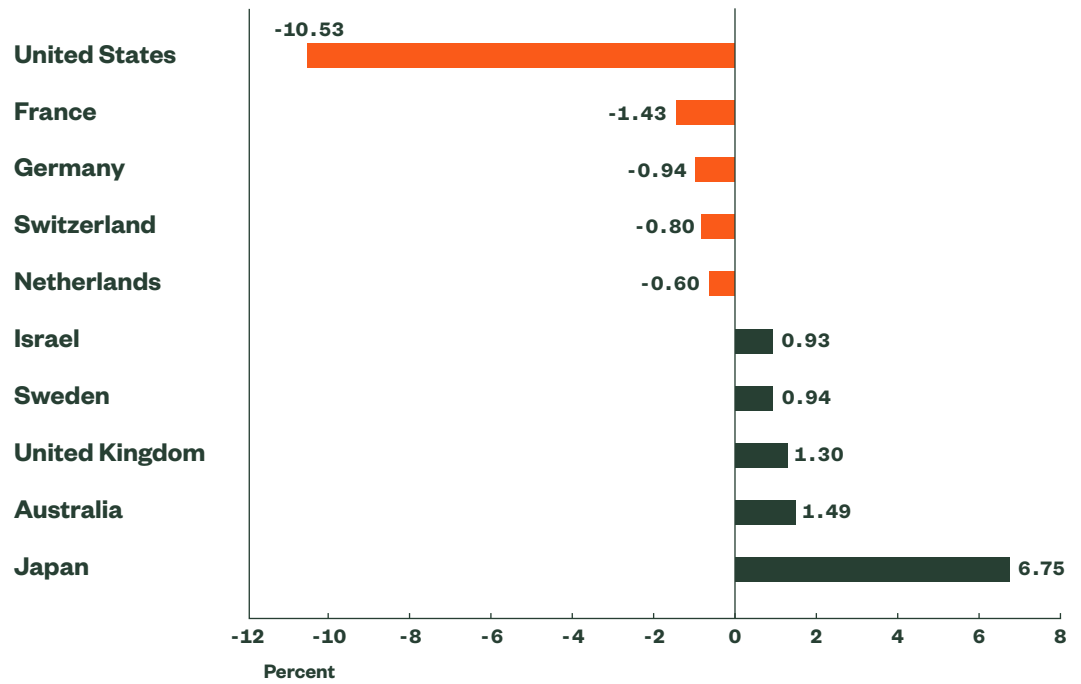


Source: FactSet, MSCI Indices, State Street Global Advisors as of December 31, 2024.

Geographic Diversification

This diversification extends geographically as well. Small-cap indices often have different country weights compared to standard equity indices. Most notably, small caps have a significantly lower allocation to the United States, as illustrated by the weight differences between the MSCI World Small Cap and the MSCI World Index. This provides investors with access to a wider range of economic environments and growth drivers, reducing the impact of any single market.

Figure 4  
**Small Caps Have Less US Concentration**



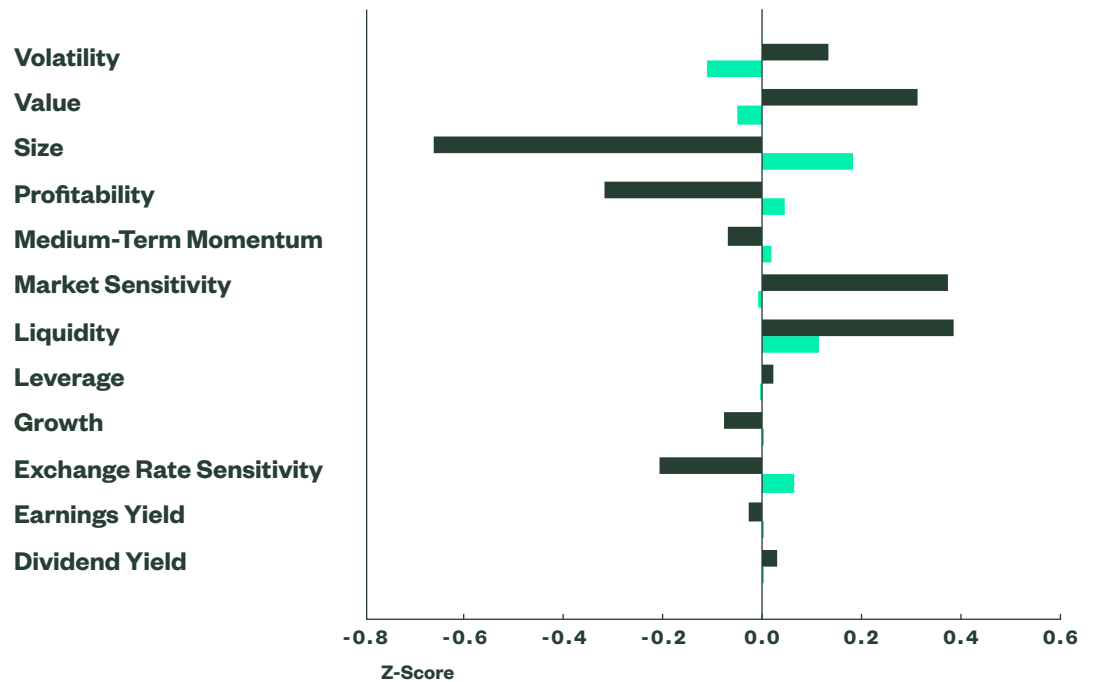
Source: FactSet, MSCI Indices, as of December 31, 2024. Chart shows top 5 and bottom 5 active country weights between MSCI World Small Cap Index and MSCI World Index. A negative figure suggest small cap underweight and vice-versa.

Style Factor  
 Diversification

On the style front, our study of factor exposures suggests that the small-cap index offers a complementary style factor exposure to large caps, as shown in Figure 5. Small caps offer a stronger Value tilt, providing a counterbalance to the Growth bias often seen in large-cap indices. However, they also exhibit lower Profitability and higher Volatility, reflecting their earlier stage of development. This nuanced factor profile further enhances their diversification benefits by providing exposure to complementary investment styles.

Figure 5  
**Small Caps Offer Complementary Factor Exposure**

■ MSCI World Small Cap  
 ■ MSCI World



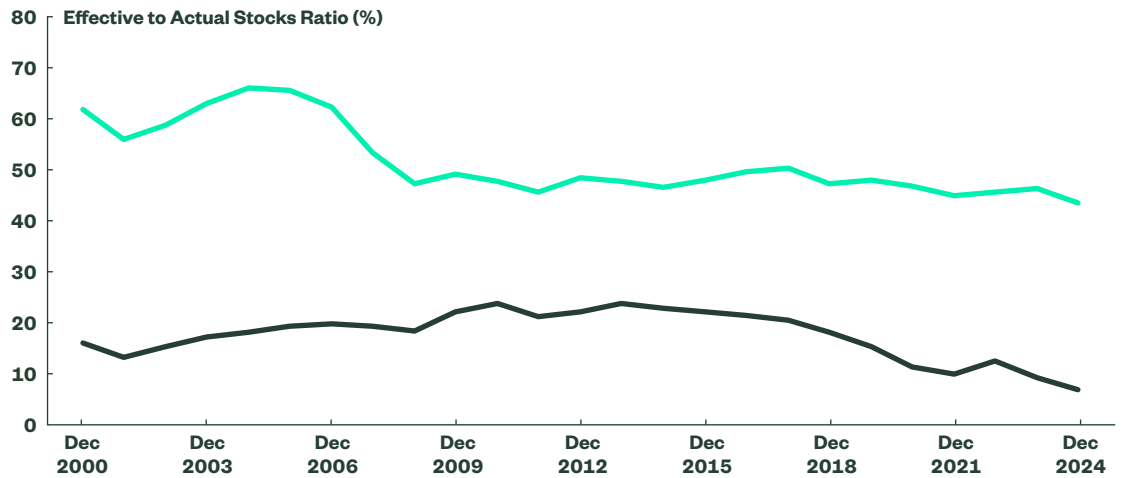
Source: FactSet, Axioma World-Wide Fundamental Equity Risk Model Medium-Horizon, as of December 31, 2024. Style factor exposures against cash (USD) are shown.

## Lower Concentration Risk

Small-cap indices currently exhibit lower concentration than currently seen in standard indices. With a greater number of constituents and the graduation of larger stocks to mid-cap status, small caps naturally offer a counterbalance to the increasing concentration seen in large-cap indices. This reduces portfolio sensitivity to the performance of a small number of companies.

Figure 6  
**Small Caps Can Counterbalance Concentration Risk**

■ MSCI World Index  
 ■ MSCI World Small Cap



Source: FactSet, MSCI Indices, State Street Global Advisors, as of December 31, 2024. Effective to Actual Stocks Ratio is calculated by dividing the effective number of stocks — inverse of Herfindahl-Hirschman Index (HHI) — by the actual number of stocks in the index. A higher ratio indicates better diversification, with a few companies dominating.

The unique sectoral and geographic exposures of small caps have meaningful implications for returns across different phases of the business cycle. Additionally, their low concentration risk makes them a valuable complement to large caps. For investors wary of mega-cap dominance in traditional standard indices, small caps provide both a hedge against concentration risk, and enhanced diversification. These attributes position small caps as a compelling portfolio diversifier, as we will explore further.



# Small Caps in Global Portfolios and Implementation Considerations

The diverse opportunity set of small-cap stocks suggest that investors should consider allocations aligned with their representation in broad market indices, such as the MSCI Global Investable Market Index (GIMI) as a baseline. However, investors' actual small-cap allocations often fall short, with concerns over higher volatility, lower liquidity, and implementation complexities frequently cited as deterrents. While these challenges are valid, closer examination reveals a stronger case for including small caps in global portfolios than conventional wisdom suggests.

## Allocation to Small Caps Can Enhance Portfolio Characteristics

Concerns about higher volatility and potential drawdowns of small caps are reasonable when assessed in isolation. However, within a diversified portfolio, these risks are significantly mitigated, and small caps offer compelling advantages instead. Historical data shows that portfolios including small caps have delivered marginally higher risk-adjusted returns without materially increasing overall volatility or exacerbating maximum drawdowns during market crises (Figure 7). Importantly, adding small caps has reduced the frequency of severe portfolio drawdowns (>20%), highlighting their diversification benefits.

Figure 7  
Adding Small Caps Enhanced Portfolio Characteristics (Jan 2001 to December 2024)

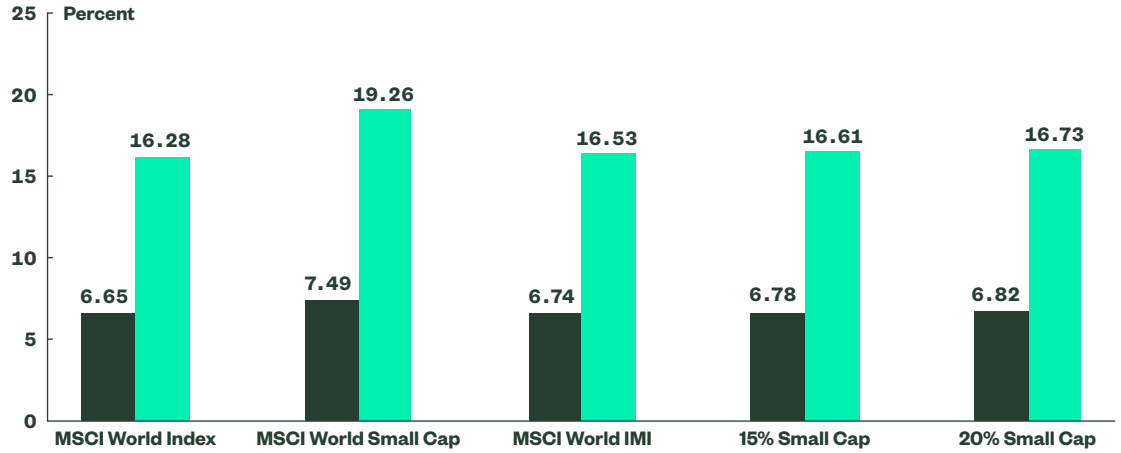
	Developed Markets (%)	Developed Markets Small Caps (%)	10% SC Allocation (\$)	15% SC Allocation (%)	20% SC Allocation (%)
<b>Historical Performance</b>					
Annualized Return	7.20	8.80	7.40	7.40	7.50
Annualized Risk	15.60	18.20	15.80	15.80	15.90
Return/Risk	0.46	0.48	0.47	0.47	0.47
<b>Historical Scenarios</b>					
COVID Crash (2020)	-22.40	-26.40	-22.80	-23.00	-23.30
Global Financial Crisis (2008-09)	-39.90	-45.90	-40.50	-40.80	-41.10
Dot Com Crash (2000-03)	-39.40	-46.50	-40.10	-40.40	-40.80
<b>Historical Downside Performance</b>					
Max Drawdown	-53.70	-56.20	-53.90	-54.00	-54.10
Frequency of Drawdown > 20%	19.50	12.20	17.40	16.00	15.70

Source: FactSet, MSCI Indices from January 31, 2001 to December 31, 2024. Combinations shows historical blends of Developed Markets (MSCI World Index) and DM Small Caps (MSCI World Small Cap Index) indices assuming monthly rebalancing. 10% SC Allocation implies 10% DM SC World and 90% World Index and so on thereafter. Frequency of Drawdown calculation uses overlapping monthly rolling periods. By construction small cap allocation in MSCI World IMI index can vary from 10% to 20% and it averaged 12.51% since its inception in the year 2007 until December 31, 2024. Index returns are unmanaged and do not reflect management fees. Past performance does not guarantee future performance.

Forward-looking<sup>4</sup> analysis further reinforces this conclusion. Small Caps are likely to marginally improve overall portfolio returns without comprising risk efficiency (see Figure 8).

Figure 8  
**Forward Looking Analysis Suggests Adding Small Caps Can Help Improve Returns**

■ Annualized Return  
 ■ Annualized Risk

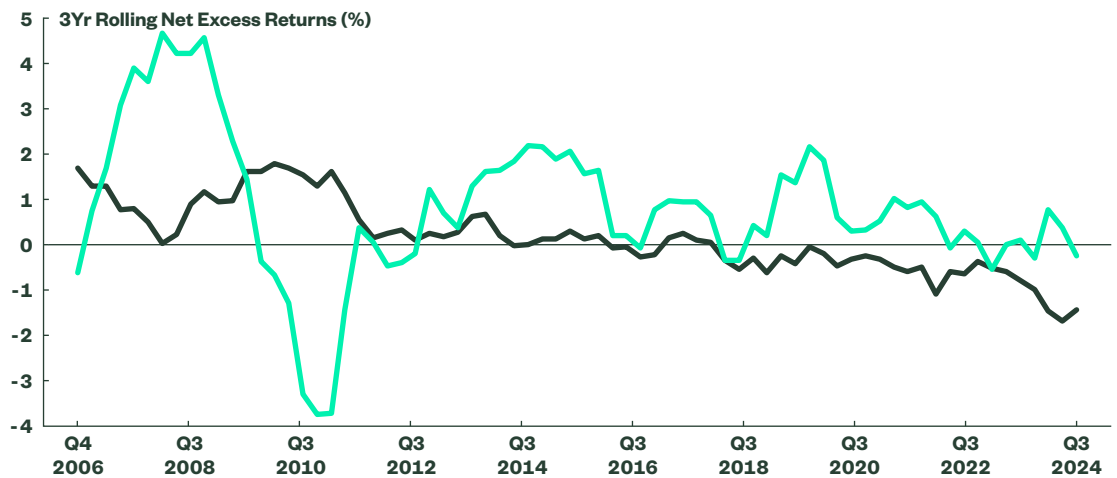


Source: State Street Global Advisors, as of December 31, 2024. Our estimates are based on LTAC Q4 2024 and assume a size premium of 50bps for US small cap and 75bps for DM ex US small cap. 15% SC Allocation implies 15% DM SC World and 85% World Index and so on thereafter. Notably, MSCI World IMI had 10.3% allocation to small caps as of December 31, 2024.

The alignment between historical performance and forward-looking estimates strengthens confidence in the critical role small caps can play in enhancing portfolio resilience during turbulent market phases while also driving incremental returns during growth periods. Another layer of value can be added by active small-cap strategies, which have historically delivered net-of-fee alpha in the median. The historical record demonstrates that small caps provide higher and more reliable alpha than their large-cap counterparts, making them an attractive proposition for active management.

Figure 9  
**Median Small-Cap Managers Have Delivered Alpha Historically**

■ Developed Markets Large Cap  
 ■ Developed Markets Small Cap



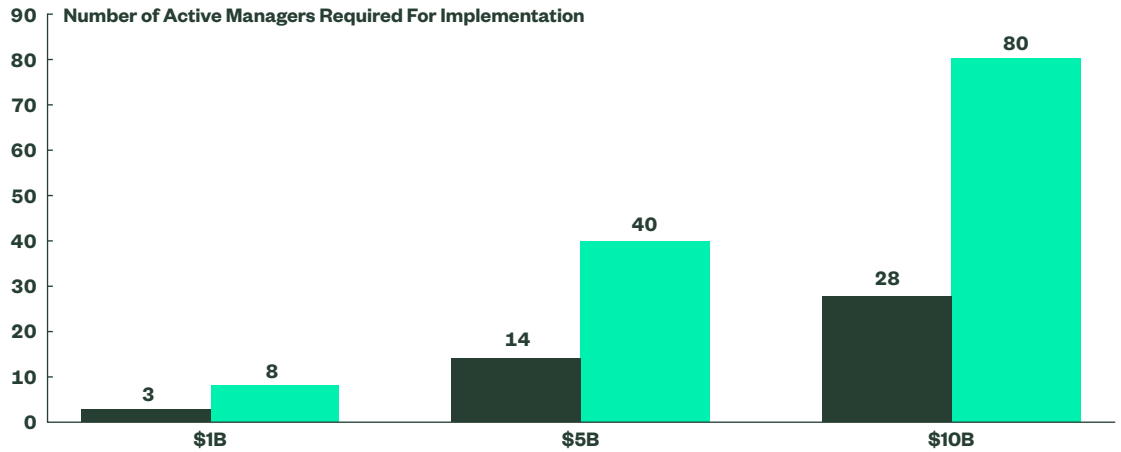
Source: eVestment, as of September 30, 2024. Returns data considered are 3-yr rolling annualized net excess return against respective manager preferred benchmark.

## Implementation Considerations

Despite their clear benefits, implementing small-cap allocations at scale presents unique challenges. Active implementation, which inherently requires thoughtful manager selection and governance, can be particularly demanding in the small-cap space due to the generally lower capacity of many active small cap managers. For example, implementing a \$1 billion US small-cap allocation typically necessitates at least three managers, rising to eight for global strategies, assuming a 25% cap on any single fund's assets.

Figure 10  
**Small-Cap Implementation at Scale Necessitates Balance Between Alpha and Feasibility**

■ US  
 ■ World



Source: eVestment, State Street Global Advisors using AUM information, as of September 30, 2024. The calculation assumes a maximum of 25% allocation to any single manager to minimize style drift and preserve each manager's competitive edge. Further, the number of managers calculation is derived using the 75th percentile fund AUM. 75% of managers have AUM at or below this level.

These complexities grow with allocation size, making implementations of \$5 billion or higher using active small-cap strategies alone prone to over-diversification.<sup>5</sup> This highlights the need for a mix of active, passive, and enhanced strategies to balance alpha potential with practical implementation.

Liquidity concerns are another key consideration. While small-cap stocks, viewed in isolation, can pose liquidity challenges due to relative illiquidity, these challenges are often alleviated by the low concentration of small-cap indices. Within the context of a broader portfolio, these challenges are usually manageable. For instance, in our simulations, trade execution times for small-cap portfolios were similar to those of large-cap portfolios at lower portfolio sizes, with gaps only emerging at higher allocation levels. Even then, execution times for portfolios with small-cap allocations remained comparable to those of large-cap portfolios, even as portfolio size and small-cap allocations increased as shown in the table in Figure 11.

Figure 11  
**Portfolio Context Matters: Managing Small Cap Liquidity for Varying Investor Needs**

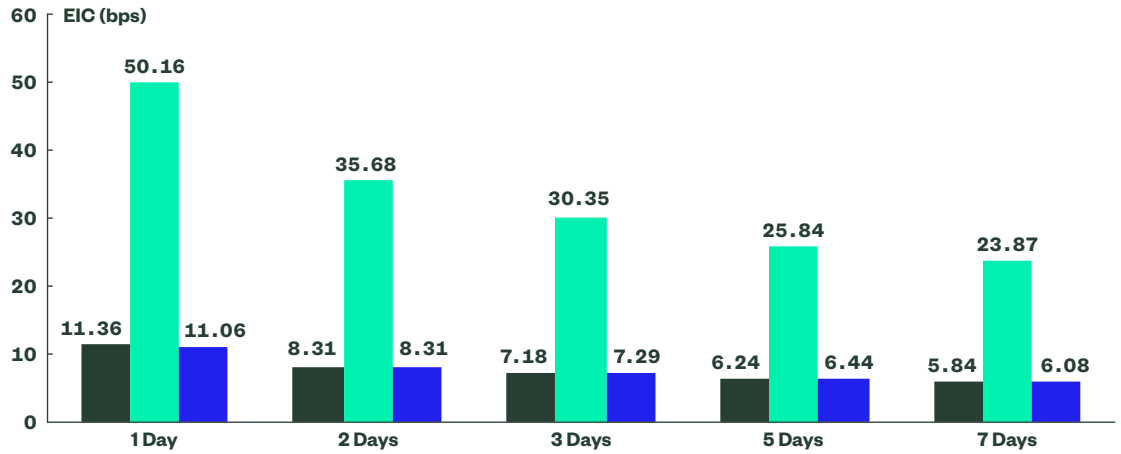
Days to trade 95%	Developed Markets	Developed Markets Small Cap	10% SC Allocation	15% SC Allocation	20% SC Allocation
\$1B	0.04	0.34	0.03	0.03	0.04
\$10B	0.38	3.37	0.34	0.34	0.38
\$50B	1.89	16.87	1.70	1.70	1.91

Source: ITG Cost Curve Model, State Street Global Advisors. Analysis as of February 19, 2025. 10% SC Allocation implies 10% MSCI World Small Cap Index and 90% MSCI World Index and so on thereafter. These estimates assume a 95% trade and maximum trading limit at 20% of median daily volume over 21 trading days. Number of days are rounded to the nearest decimal. There is no representation or warranty as to the current accuracy, reliability, or completeness of this information.

Expected implementation costs (EIC) presented a similarly nuanced picture. While small-cap portfolios consistently showed higher costs, particularly with faster execution times, the differential was less dramatic when viewed through a holistic portfolio lens (Figure 12).

Figure 12  
**Small-Cap  
 Implementation Costs  
 Are Manageable Within  
 a Diversified Portfolio**

■ MSCI World  
 ■ MSCI World Small Cap  
 ■ 85% MSCI World + 15% MSCI World Small Cap



Source: Citi BECS, State Street Global Advisors, as of December 17, 2024. EIC is the expected trading cost to execute the entire trade in a given time. EIC varies as the trading window changes. Analysis is based on selling a USD 10 Billion portfolio without any trading limit. There is no representation or warranty as to the current accuracy, reliability, or completeness of this information.

The strategic implications of small-cap allocations are significant, requiring asset owners to balance their compelling diversification and alpha potential with practical implementation challenges. While relying solely on active strategies can maximize alpha capture, it also introduces considerable governance and liquidity demands, exacerbated by concentrated positions and more frequent trading. Conversely, passive strategies offer scalability and lower costs but sacrifice potential alpha.

A balanced approach, utilizing a combination of active, passive, and enhanced index strategies, often proves pragmatic. This approach mitigates governance and liquidity burdens while still enabling investors to capture the diversification and alpha benefits of small caps. Enhanced strategies bridge the gap between active and passive, offering some alpha potential while maintaining greater scalability than pure active. By considering the holistic costs of implementation and aligning small-cap allocations with governance capacity, asset allocators can unlock the strategic potential of small caps in global portfolios.

## The Bottom Line

The strategic value of small-cap allocations within diversified portfolios is undeniable. Beyond the cyclical size premium, small caps offer compelling diversification benefits, access to a broader universe of companies, and opportunities for alpha generation through active management. While implementation complexities require careful consideration, they should not deter investors from accessing this crucial asset class. By adopting a balanced approach that considers the holistic portfolio context and leverages a mix of active, passive, and enhanced strategies, investors can effectively manage these challenges and unlock the full strategic potential of small-cap investments, enhancing long-term portfolio outcomes.

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<sup>†</sup> This figure is presented as of December 31, 2024 and includes ETF AUM of \$1,577.74 billion USD of which approximately \$82.19 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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