

Waiting for the small-cap resurgence



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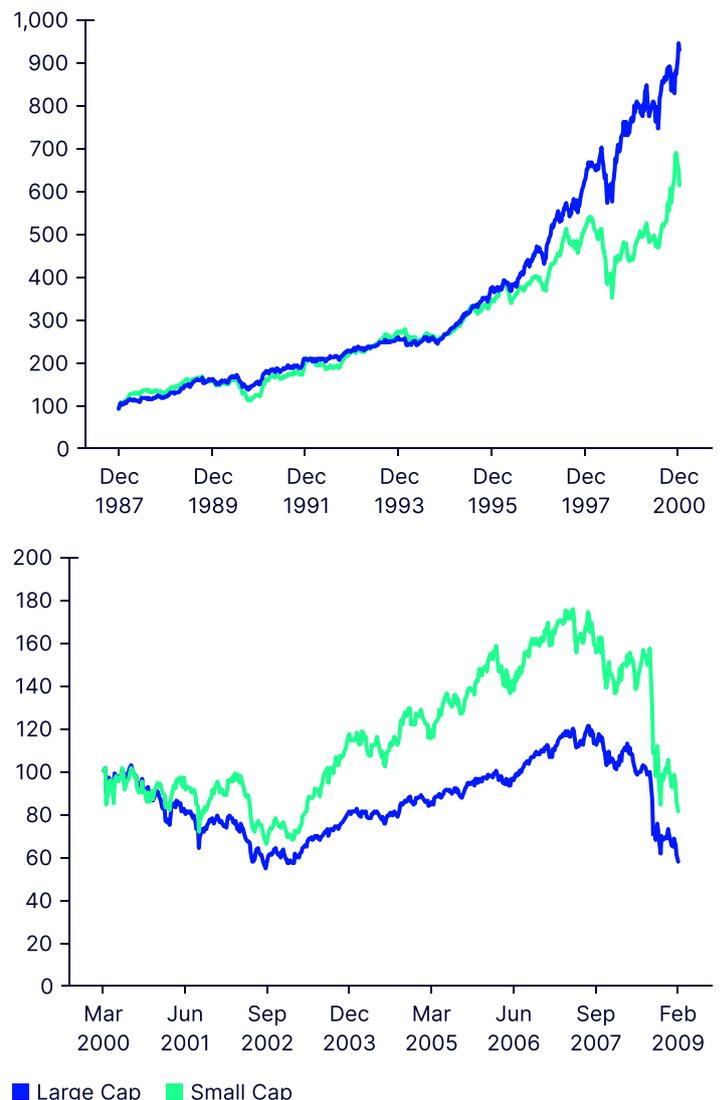
Returns for smaller capitalization stocks have lagged those of their larger counterparts since the 1980s, notwithstanding periodic outperformance in that time. But markets are cyclical and as the post-COVID bull market draws on and the mega-cap names continue to drive markets to all-time highs, we believe it is timely to revisit the prospects for smaller companies.

The rationale for investing in small-cap stocks is long established. At its core, the investment case centers on the opportunity to access exciting companies, often early in their life cycle when growth rates can be very high. The small-cap premium (or 'size effect') was first documented in 1981,¹ and demonstrated the long-term outperformance of small caps over large caps. Explanations for this premium span risk-based justification (e.g., that small caps are inherently riskier, so investors require a higher return for holding them) through to market structure and behavioural rationale. This latter argument is based on small caps being under-researched, having low investment analyst coverage, and investors often being biased towards larger, more glamorous names. It follows that small caps are all too often priced cheaply and therefore hold the potential to outperform over the long term.

Unfortunately, academic theory and market reality do not always necessarily dovetail neatly, and small caps have not delivered the returns expected of higher-growth stocks that appeared undervalued. For example, if we look at large cap and small cap US equity returns, where the

size effect was first uncovered, we can divide the period after the market crash in 1987 into four sub-periods.

Figure 1: US large cap vs small cap returns (Dec 1987–Mar 2000) & (Mar 2000–Feb 2009)



Source: State Street Investment Management, Factset, Russell. As at August, 22 2025. Large Caps are represented by the total return to the Russell 1000 Index. Small Caps are represented by the total return to the Russell 2000 Index, rebased to 100 at the beginning of each period. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The first period was the long bull market from 1987 to late 1999 (Figure 1a). Large-cap names significantly outperformed over that period, especially in the final throes of the “TMT bubble” towards the end of 1999. However, in the deflation of that bubble those large-cap stocks underperformed and continued to be weaker than small caps until the Global Financial Crisis (GFC) and ensuing bear market of 2008 and 2009. In the GFC-induced market crash, risk worries decimated smaller names as investors gravitated towards the larger more well-known names rather than riskier small caps.

As equity markets recovered after the GFC, there were periods of small-cap outperformance, followed by larger caps catching up, with no clear winner up until 2020. In the initial stages of the COVID pandemic and the perception of an existential threat to many smaller companies, the small-cap index underperformed significantly — something it is prone to do in times of panic (Figure 2a).

However, markets began to quickly recover as panic turned to rampant enthusiasm as governments globally took steps to keep companies, markets, and their populations afloat. And amid the euphoria around the discovery of the effectiveness of the first COVID vaccines, small caps significantly rallied even above the impressive large-cap boom. (Figure 2b)

As we moved into the more recent era of AI euphoria, hyperscalers, and a winner-takes-all mentality, the small-cap index has been left in the wake of the large-cap index advance powered by the Magnificent Seven group of stocks.

While smaller names have struggled over this nearly 40-year period to match the gains of their larger counterparts, there have been pockets of encouragement. This is especially the case when looking outside of the US equity market. So far this year, small-cap indices in Europe, Japan, Pacific, and Emerging Markets have outperformed the MSCI World (large cap) Index, despite the heavy weighting of outperforming mega-cap US names in the broad market index. Relative underperformance has been concentrated in US names. (Figure 3).

Figure 2a: US large cap vs small cap returns (Feb 2009–Mar 2020)

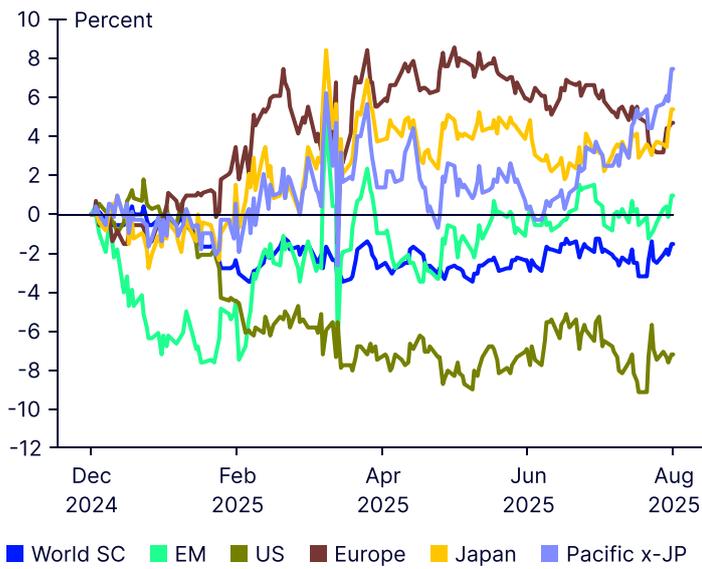


Figure 2b: US large cap vs small cap returns (Mar 2020–Aug 2025)



Source: State Street Investment Management, Factset, Russell. As at August,22 2025. Large Caps are represented by the total return to the Russell 1000 Index. Small Caps are represented by the total return to the Russell 2000 Index, rebased to 100 at the beginning of each period. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

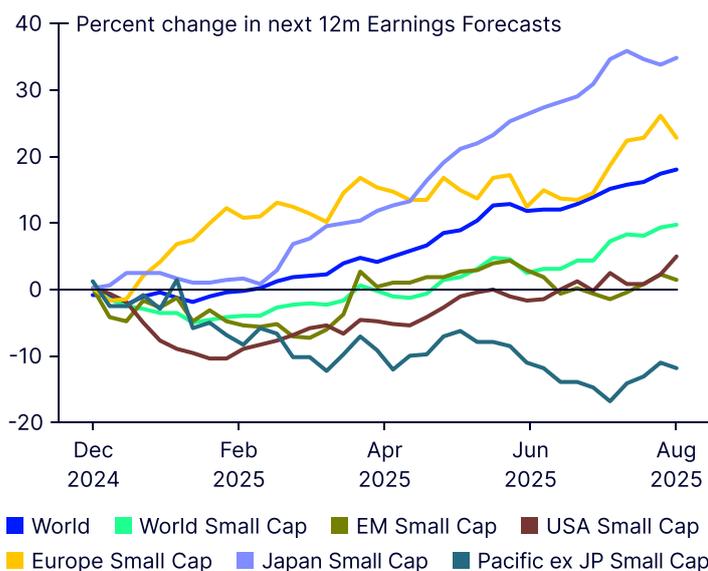
Figure 3: Relative performance of regional small-cap indices to MSCI World Index



Source: State Street Investment Management, Factset, MSCI. As at August,22 2025. Regional MSCI Small-Cap Index relative to MSCI World Returns. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

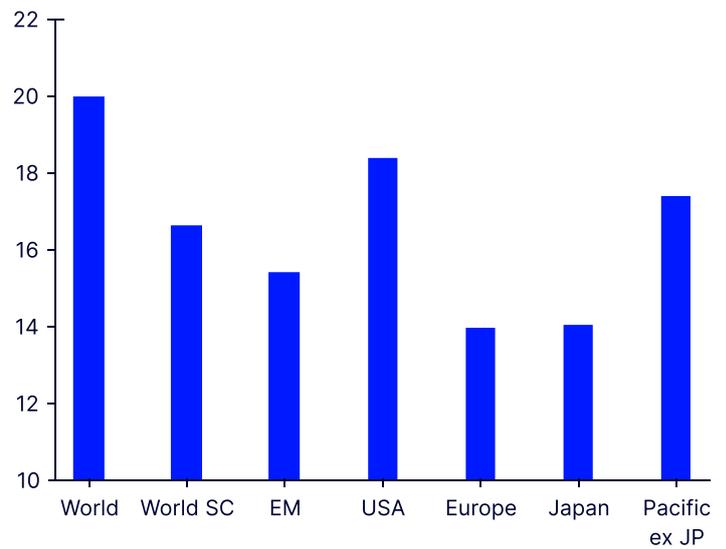
Over the longer term, outperformance from the mega-cap names has been tied to earnings; but more recently, small-cap earnings forecasts have mostly kept in touch with large caps globally. Signs of an uptick, most notably in Europe and Japan, suggest the significant valuation discount for the smaller end of the spectrum may no longer be warranted.

Figure 4: Rolling percent change in 12-month forward earnings forecasts



Source: State Street Investment Management, Factset, MSCI. As at August,22 2025.

Figure 5: 12-month forward price-to-earnings ratios



Source: State Street Investment Management, Factset, MSCI. As at July,31 2025.

The bottom line

We don't really subscribe to the theory that the small-cap premium is dead or was never alive to start with. But we do recognize that smaller names have not delivered in aggregate in terms of earnings and returns over the long term. The valuation discount that small caps hold offers some optionality however, and even a stabilization of relative earnings and reduction in risk premia, or a lowering of interest rates, may signal a long-awaited sustained rally in small-cap names.

Even as we wait for that rally, as active investors we believe we can find hidden gems within the small-cap universe. Inefficiency caused by lower information availability, low analyst coverage, weaker liquidity, and higher trading costs allows an active systematic approach to pick off those higher quality names with positive sentiment that can be found at a reasonable price (taking account of trading costs). This allows us to build attractive portfolios while we wait for the broader market to pick up.

Endnote

1 "The relationship between return and market value of common stocks" Rolf W. Banz. Journal of Financial Economics: Vol.9 Issue 1, March 1981.

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