Small-cap companies should benefit from a Fed pivot more than their larger peers. (UBS)

Add small companies to your portfolios amid Fed's pivot

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Mega-cap technology stocks have been the driving force behind the equity uptrend over the past year, as well as the recent rally that pushed the S&P 500 to all-time highs. Year-to-date, the FANG+ index, which tracks America's top 10 mega cap tech firms, is up 5.6%, while the Russell 2000, the main US index for small-cap businesses, is down 2.4%. In 2023, the returns were 96% and 17%, respectively.

There is a good reason that small-caps will never likely be a big portion of investors' portfolios, with the total value of the Russell 2000 index at just around USD 3tr and accounting for only 6% of the total US equity market capitalization. Small-cap companies may also have weaker balance sheets, be more sensitive to the economic cycle, and have less readily-traded (less liquid) shares.

However, adding small- and mid-cap companies to a portfolio can boost returns and improve diversification over the long term. In addition, now looks like an especially good time to add exposure, in our view:

Small-cap companies should benefit from a Fed pivot more than their larger peers. The next major focus for markets will be the Federal Reserve's first policy meeting of the year this week. We think the central bank is likely to open the door to possible rate cuts, with recent economic data pointing to moderating inflation and a gradually cooling labor market. Since nearly half of the debt held by Russell 2000 companies is floating rate, versus around a tenth for large-cap companies, Fed rate cuts can quickly start to reduce interest expenses for small-cap companies. The same applies to Eurozone small- and mid-caps, which are more than twice as reliant on floating-rate debt compared to larger companies. In our base case, we see 100 basis points (bps) of rate cuts by the Fed this year and 75bps from the European Central Bank.

Accelerating earnings growth and relative valuations are likely to be supportive. Swings in earnings are typically more pronounced for small-caps compared to large-caps. At present, this is a positive for more modestly-sized companies.

We think low-double-digit earnings growth is likely for the S&P 600 small-cap index this year, based on our 8% growth forecast for the S&P 500. This marks a substantial improvement from the roughly 10% decline in S&P 600 profits in 2023.

In terms of valuations, the Russell 2000 is trading at a roughly 55% discount to the Russell 1000 versus a 10-year average discount of 32%, while the forward price-to-earnings ratio for the S&P 600 is also lower than its 10-year average. In the Eurozone, the relative valuations of small- and mid-caps are even lower than at the trough during the global financial crisis, suggesting the biggest discount since the tech bubble in the late 1990s and early 2000s.

Small-caps provide the opportunity for alpha, along with some diversification benefits. There can be bigger payoffs to stock selection in smaller-cap indexes compared to large-caps due to a higher dispersion in performance. Since most companies are less followed by the analyst community, there can be greater inefficiencies that can be exploited. As a result, there is greater scope for active managers to achieve above-market returns (alpha) in this part of the equity market.

In addition, the correlation of US small- and mid-caps to the MSCI World index is around 0.52, while European small-and mid-caps have a 0.57 correlation to the MSCI World Index. Smaller stocks moves less in lockstep with developed market equities, given a correlation of around 0.6 for large-caps in both regions to MSCI World. While modest, we think the difference is meaningful from a portfolio diversification standpoint.

So, while small-caps do see more cyclical swings, we think scaling exposure appropriately to this segment offers advantages in a diversified portfolio over the long term. We also believe US and European small-caps, along with Swiss mid-caps, would be among the main outperformers in a Goldilocks scenario of robust US growth, falling US inflation, and preemptive US rate cuts.

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