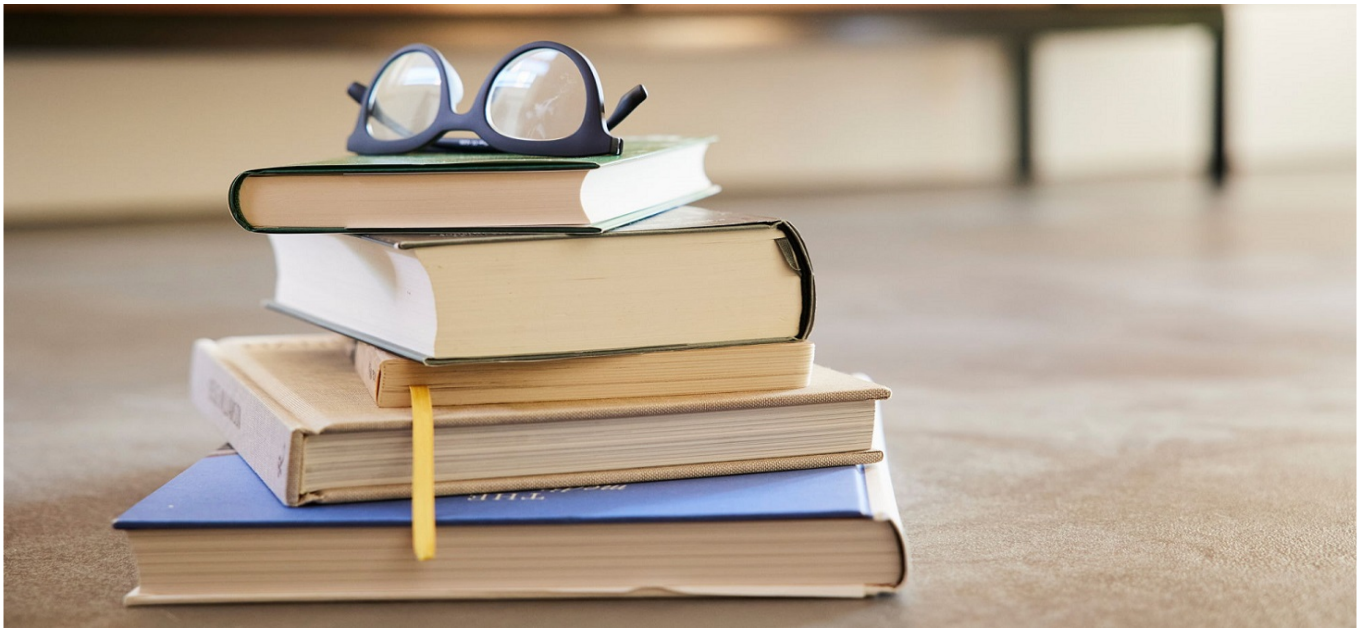

CIO continues to hold a constructive view on technology, they see small- and mid-cap stocks as one way for investors to diversify beyond the sector. (UBS)

Consider small- and mid-cap stocks for diversification

26 March 2024, 3:02 pm CET, written by UBS Editorial Team

With generative artificial intelligence (AI) continuing to power the equity rally, smaller companies have underperformed their large-cap peers.

Year-to-date, the S&P 500's 9.4% jump has overshadowed the Russell 2000's 2.3% rise. The former's gains of 36% since the start of 2023 are also double those of the latter.

However, while we believe the excitement over AI is rational, we also see attractive value in small- and mid-sized companies. With rising risk of overconcentration, we believe adding small- and mid-cap companies to a portfolio can boost returns and improve diversification over the long term.

Investing in smaller companies can add exposure to other structural growth trends. There is no debate that AI has considerable potential to transform industries. But there are other structural growth themes that will continue to drive the performance of related companies, in our view, including energy transition, healthcare disruption, and water scarcity. Many smaller companies are active in these high-growth sectors.

Supportive inflections are emerging in the macroeconomic backdrop. The latest FOMC meeting showed that the US central bank remains set to cut interest rates this year, with the median "dot" of policymakers' assumptions still pointing to three cuts. Since nearly half of the debt held by Russell 2000 companies is floating rate, versus around a tenth for large-cap companies, Federal Reserve rate cuts can swiftly reduce interest expenses for small cap companies.

Valuations are appealing. With large earnings growth potential, the global tech sector is trading at a roughly 37% premium to its long-term average valuation after a strong run in AI-related stocks. Meanwhile, the forward price-to-earnings ratio for the S&P SmallCap 600 index is lower than its 10-year average and a 35% discount to the large-cap

S&P 500 valuation. With access to capital continuing to improve, we think the balance sheet and profitability outlook for smaller companies should benefit.

So, while we continue to hold a constructive view on technology, we see small- and mid-cap stocks as one way for investors to diversify beyond the sector.

We think many of the headwinds contributing to the underperformance of smaller companies should begin to abate, and believe that appropriate exposure to this segment offers advantages in a diversified portfolio.

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