Small-cap stocks would likely be the biggest outperformers in a Goldilocks scenario of robust US growth, falling US inflation, and preemptive US rate cuts. (UBS)

Can small-caps add value to my portfolio?

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Small-cap stocks have recently lagged the broader equity rally. But after a prolonged period of underperformance, we now believe small-caps are attractively valued. This part of the market also stands to gain more from Fed rate cuts in 2024, since smaller companies are more reliant on floating-rate debt than larger peers.

Small-caps would benefit even more in the event of a "Goldilocks" outcome of strong US growth, falling inflation, and swifter-than-expected rate reductions.

Small-cap stocks have lagged in recent years.

- The Russell 2000 index, a benchmark for US small-cap stocks, is up 0.4% so far in 2024 at the time of writing on 18 March, versus an 8.3% gain for the S&P 500 large-cap index.
- Over the past five years, US small-caps have advanced around 35%, lagging a roughly 82% gain in the S&P 500.
- In 2023, large-cap tech stocks led the way, with the FANG+ index gaining 96% compared to a return of 16.9% for the Russell 2000.

But the outlook for smaller companies looks brighter for 2024.

- Valuations are attractive for small-caps after a long period of underperformance, both in the US and Eurozone.
- Small-caps are more reliant on floating-rate loans and so stand to gain more from rate reductions from the Fed and the ECB.

- The earnings per share growth for small-cap companies looks set to outpace the broader index this year in the US.

So a modest allocation to this part of the equity market can add value to portfolios, in our view.

- While small-caps are generally more cyclical, the segment should perform well in our base case of a soft landing for the US economy, in our view.
- In addition, we 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.

Did you know?

- 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.
- 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 total value of the Russell 2000 index is just around USD 3tr and accounts for only 6% of the total US equity market capitalization.

Investment view

The long-term advantages of a modest allocation to small-caps are often overlooked, including diversification and a potential boost to returns. In addition, on a tactical basis, small-caps appear well positioned to outperform as central banks cut rates.

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