The long-term advantages of a modest allocation to small-caps are often overlooked, including diversification and a potential boost to returns. (UBS)

Can small-caps add value to my portfolio?

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

Small-caps would benefit even more in an upside outcome of strong US GDP 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 2.9% for 2024 as of 31 May, versus a near 12% gain for the S&P 500 index.
- Over the past five years, US small-caps have advanced around 37%, lagging a near 84% gain in the S&P 500.
- The S&P 600 small-cap index trades at a discount of roughly 30%to the large-cap index, based on forward price-to-earnings.

But the outlook for smaller companies looks brighter for 2024.

- We believe valuations are attractive for small-caps after a long period of underperformance, both in the US and the Eurozone.
- Small-caps are more reliant on floating-rate loans, so they stand to gain more from rate reductions from the Fed and the European Central Bank later this year.
- We think the earnings-per-share growth for small-cap companies could 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 as the Fed gradually cuts rates later this year, in our view.
- In addition, we believe US and European small-caps would be among the main outperformers in a more positive scenario of robust US GDP growth, falling US inflation, and swifter-than-expected rate cuts.

Did you know?

- Nearly half of the debt held by Russell 2000 companies is floating rate, versus around a tenth for large-cap companies, so Fed rate cuts can reduce interest expenses for small-cap companies.
- Earnings performance for small-caps is highly correlated to large-caps—with larger swings on the upside and downside.
- The total market cap of the Russell 2000 index is around USD 2.59tr—smaller than Microsoft or Apple.

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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