

## A DIVERSIFYING OPPORTUNITY: THE CASE FOR SMALL CAP INVESTING

In the evolving landscape of investment opportunities, small-cap equities stand out for their potential to enhance and diversify portfolios. As global economic and supply chain dynamics shift, smaller companies offer investors unique growth prospects and greater prospects for diversification than during previous market cycles.

Smaller companies (small caps) are a segment of the global financial market comprising firms with a market capitalisation typically between USD\$300 million and USD\$2 billion. They are represented across a wide range of industries and can be innovative and agile, adapting quickly to market changes.

By focusing on growth through reinvesting profits, smaller companies can offer higher returns over time and diversification benefits for investors relative to their larger peers, although they also require careful research to consider and address any associated risks.

This discussion explores the strategic benefits of an allocation to small-cap equities, highlighting their responsiveness to supply chain changes and their capacity to capitalise on emerging market trends.

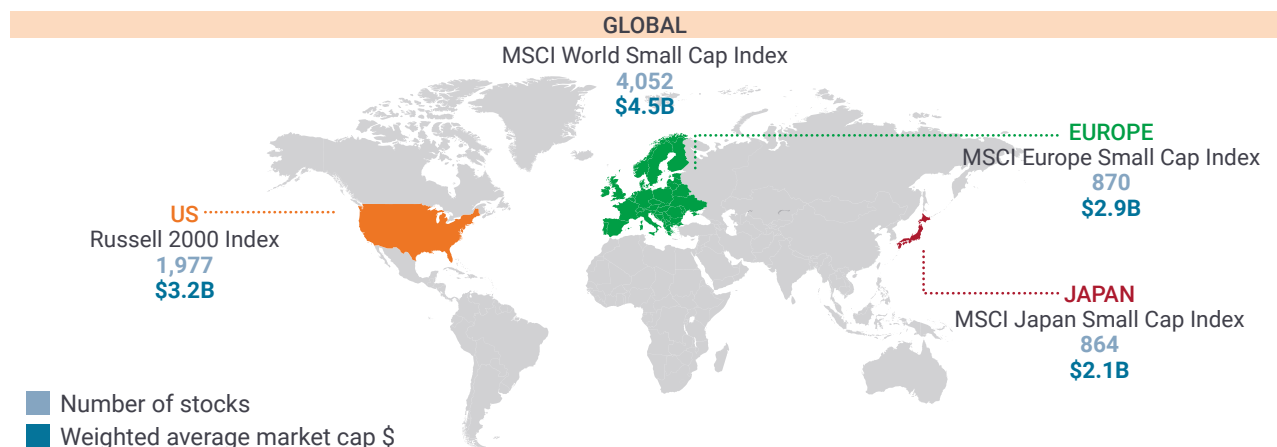
### Key takeaways:

- ▶ **Diversification and growth potential:** An allocation to small-cap equities can enhance a portfolio's diversification, tapping into a vast pool of growth opportunities in major markets like the US, Europe, and Japan.
- ▶ **Structural advantages:** Small caps offer M&A target benefits, lower concentration risks, and are often under-researched, leading to potential mispricing opportunities that can benefit informed investors.
- ▶ **Resilience and valuation appeal:** Small caps are well positioned to capitalise on the ongoing shifts in global supply chains, including trends towards near-shoring, due to their agility and localised market focus.

## How can an allocation to smaller companies benefit your portfolio?

Small-cap equities can play a valuable role in investors' portfolios, helping to improve diversification by market cap, and geographical and sector exposure. With various options available to investors, and a huge range of opportunities available across the main major markets in the US, Europe and Japan, an allocation to small-cap equities can help investors access this area of strong growth potential.

### Extensive global and regional opportunities



Source: Factset, as at 30 September 2024.

## What are the key reasons for investors to look at global small caps?

1. Long-term record of outperformance
2. M&A as a structural advantage
3. Lower concentration risk
4. More stocks, more opportunities
5. Greater beneficiaries of supply chain near-shoring
6. Greater dispersion in performance
7. Valuations

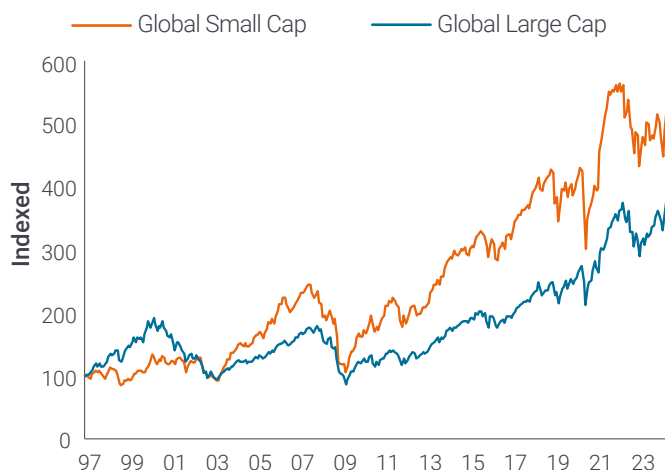
### 1. Long-term record of outperformance:

Historically, small caps have outperformed large caps globally over the long term (Figure 1), reflecting their ability to capture higher levels of earnings growth and agility to adapt to market changes, although this comes with higher potential share price volatility risk.

These companies, often in the nascent stages of development, have ample room to expand geographically, or into related markets. Their typically cyclical nature allows them to closely mirror – and hence benefit from – economic growth. Small caps have capacity to grow their earnings in a way that large cap stocks will struggle to consistently match. It is much easier for a small business to grow its sales by expanding into new markets, acquiring new clients, or broadening its product range.

Additionally, smaller companies can operate in more specialised niche markets, which tends to support robust margins, in part due to the lack of competition from larger rivals.

**Figure 1: Global small caps have historically outperformed their larger peers over time**



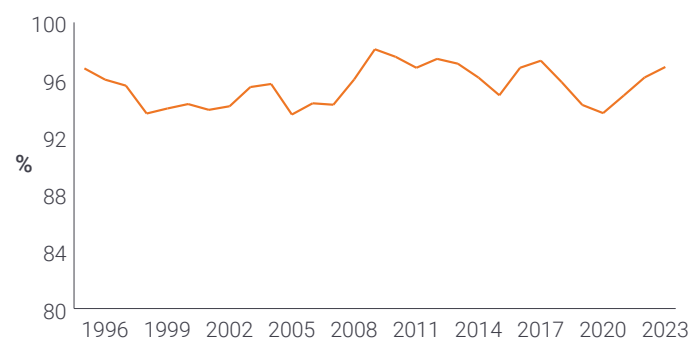
Source: Refinitiv Datastream price indices, Janus Henderson analysis, at 31 December 2024. Indices used: MSCI World Small Cap Index, MSCI World Large Cap Index. **Past performance does not predict future returns.**

**2. M&A as a structural advantage:** Smaller companies are commonly takeover targets for larger companies looking to expand their market share, acquire bolt-on operations, or to take advantage of the unique characteristics or niche market position a target company may have. Between 1995 and 2024, around 95% of all global M&A involved a smaller company being purchased by a larger company, with an average premium of 30% on the target company's share price.

We see signs of a resurgence in dealmaking in 2025, following a relatively fallow period for merger and acquisition (M&A) activity. Higher interest rates put the brake on M&A activity, with a more difficult economic picture clouding appetite. Lower interest rates mean that smaller companies are inevitably going to come under renewed focus for takeovers, as businesses look to expand, or acquire a particular technology or asset.

We see signs of a resurgence in dealmaking in 2025, following a relatively fallow period for M&A activity, a consequence of the last cycle of higher interest rates and related borrowing costs.

**Figure 2: Higher M&A activity favours small caps**

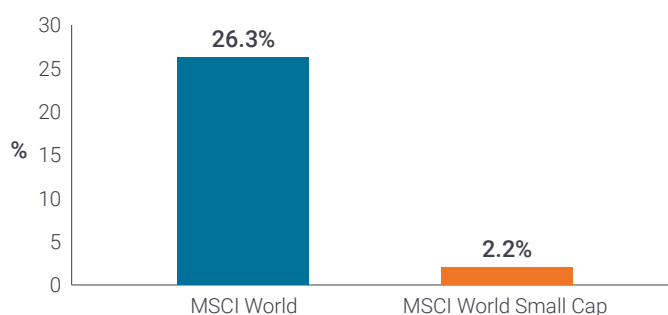


Source: Bloomberg, Factset, JP Morgan calculations, Janus Henderson Investors analysis, at 31 December 2024.

**3. Lower concentration risk:** Small cap indices have less concentration risk relative to large cap indices, given that the largest constituents comprise a smaller percentage of the total index (Figure 3). In the large-cap universe, this means that the performance of a narrow group of stocks can have an outsized impact on the performance of a portfolio. An allocation to small caps can help to ensure a more even distribution of weight across companies and industries.

Small caps also tend to operate more in industrials or materials than technology and are generally more focused on local markets. This means that an allocation to small caps leaves investors exposed to different structural drivers, such as de-globalisation (ie. the rebuilding of domestic production lines, rather than outsourcing to places like China).

**Figure 3: Index weight of top-10 holdings**

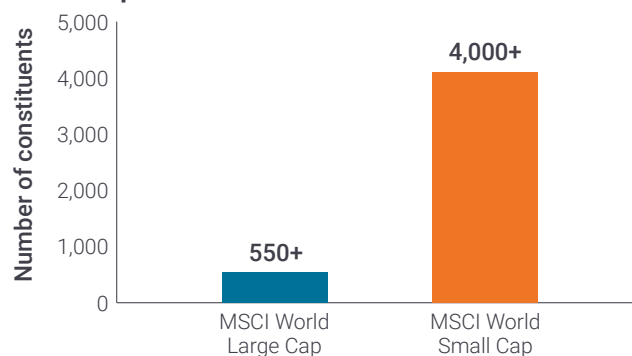


Source: Bloomberg, Factset and JP Morgan calculations, Janus Henderson analysis, using the MSCI World Index and the MSCI World Small Cap Index, at 31 December 2024. **Past performance does not predict future returns.**

**4. More stocks, more opportunities:** Smaller companies are an overlooked, under-researched and often mis-priced segment of the market, due to inefficiencies and lower coverage from analysts. Whereas larger companies often get significant coverage from asset management firms, investments banks and research houses, the MSCI World Small Cap Index sees an average of just nine analysts per stock, with about 25% of the firms in the index having a coverage of fewer than two analysts.

This can create pricing anomalies that offer significant growth opportunities for astute active stock pickers. The scale of the small cap universe, comprising thousands of companies worldwide, across all industries and sectors, provides substantial investment opportunities for investors.

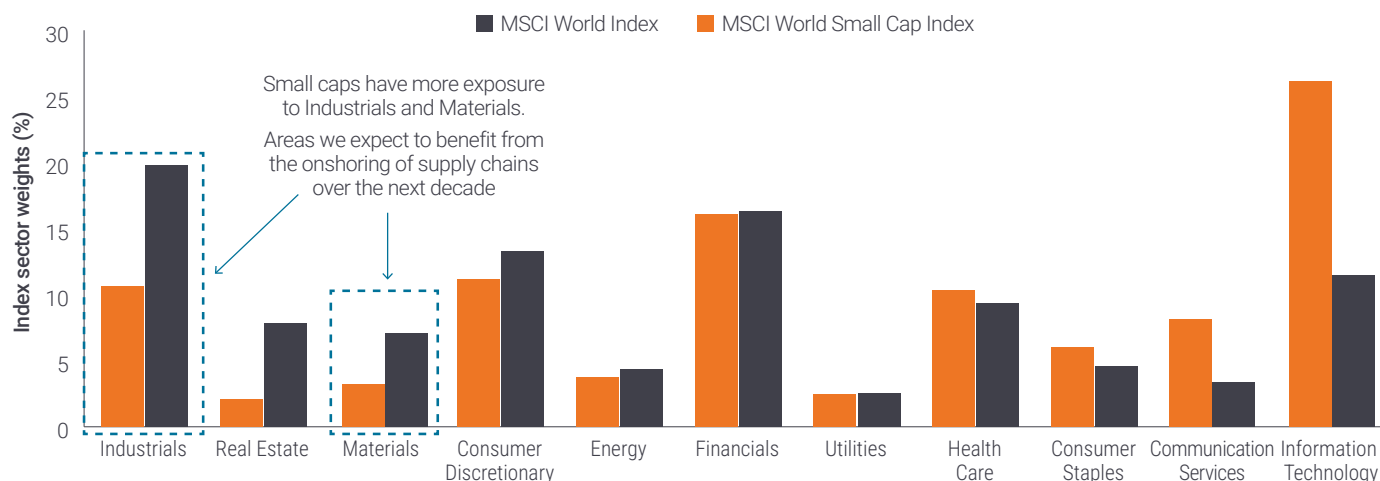
**Figure 4: Breadth of choice from the size of small caps markets**



Source: MSCI / Factset, as at 31 December 2024. Note: Indices used: MSCI World Large Cap and MSCI World Small Cap.

**5. Greater beneficiaries of supply chain near-shoring:** The AI mega-trend has defined the performance of large-cap stocks in recent years, and the sector now makes up a significant weighting on the MSCI World Index. The nature of recent geopolitical changes, however, has led a push towards onshoring and near-shoring of supply chains – a trend we expect to persist over the longer term. This disproportionately benefits smaller companies, given their relatively large presence in the industrials and materials sectors, and greater domestic exposure.

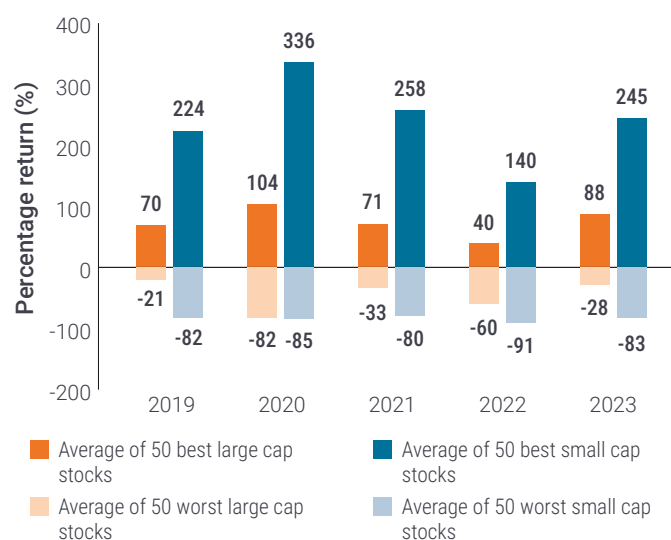
**Figure 5: Navigating global disruption**



Source: Bloomberg, Factset and JP Morgan calculations, Janus Henderson analysis, using the MSCI World Index and the MSCI World Small Cap Index, at 31 December 2024. **Past performance does not predict future returns.**

**6. Greater dispersion in performance:** The years following the Global Financial Crisis were characterised by near-zero interest rates, during which companies – even unprofitable ones – were able to navigate financial waters with relative ease. That era is now behind us, and with borrowing costs normalising, the gap between successful companies and those struggling has room to become more pronounced. While the small-cap space contains plenty of opportunities, it comes with a greater proportion of loss-making firms than typically found in large-cap indices – favouring stock selection as a primary driver of performance.

**Figure 6: More opportunities to select higher-performing stocks**

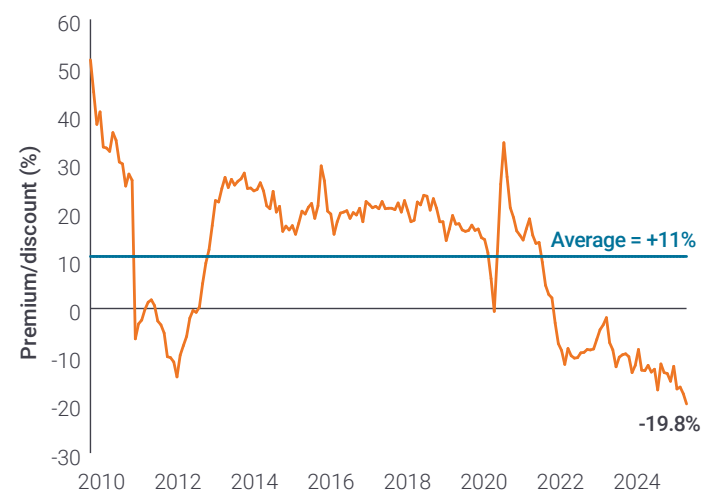


Source: Bloomberg, Janus Henderson Investors Analysis, as at 31 December 2024.  
Note: Indices used: MSCI World Large Cap and MSCI World Small Cap.  
**Past performance does not predict future returns.**

**7. Valuations:** The market has for some time shunned small-cap stocks in favour of larger, more established companies. Global smaller caps endured a difficult time during what was an aggressive interest rate cycle, with many smaller companies facing higher cost of debt, and a broader heightened level of risk aversion that favoured larger companies more generally perceived as defensive. Yet, as we move further into the current cycle of global interest rate cuts, stronger companies in the small-cap sector stand to benefit significantly. Small-cap valuations are currently attractive relative to their history and larger counterparts (Figure 7) and have historically been the asset class to own when the economy is in recovery.

From here, we anticipate a broadening and revitalisation of the equity market landscape, away from its current narrow and homogenised state. In our view, any potential earnings upgrades can act as a potential catalyst for small-cap stocks.

**Figure 7: Small caps are heavily discounted vs global large caps relative to history**



Source: Bloomberg, Janus Henderson Investors analysis, comparing the relative forward P/E for the MSCI Europe Small Cap Index, the MSCI Europe Large Cap Index, and the S&P 500 Index, at 13 March 2025. **Past performance does not predict future returns.**

## Conclusion

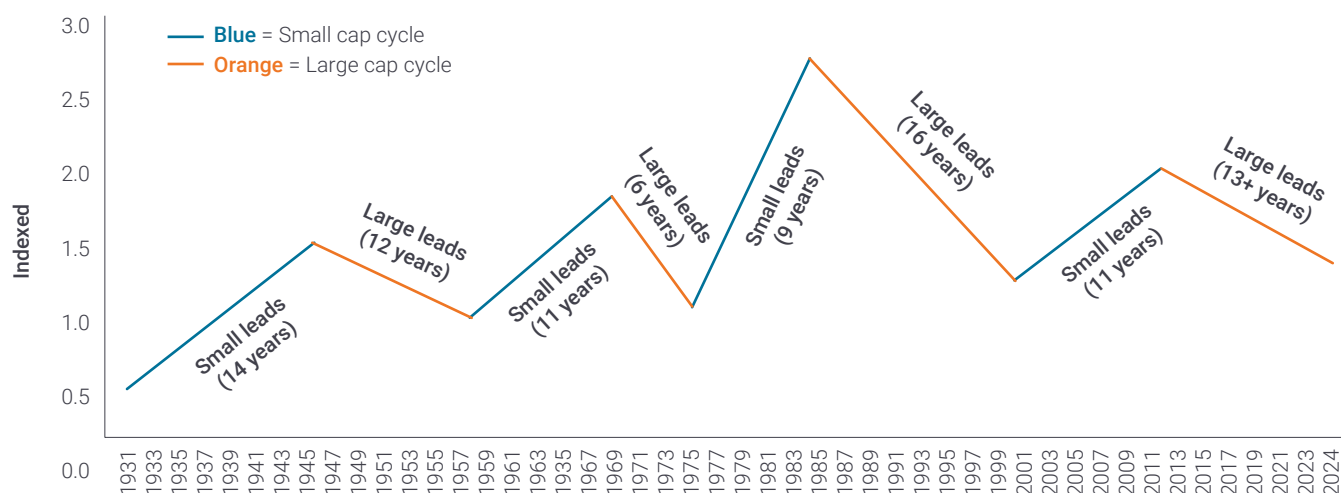
### Is this a favourable environment for small caps?

The 'big tech' trend has been a key driver behind the relatively strong performance of large-cap stocks over the past decade and more, relative to their small- and mid-cap peers. But all market cycles have a duration. While investors can easily fall in the trap of recency bias, history shows us that market leadership changes over time (Figure 8), no matter how long a particular cycle lasts.

While small caps have underperformed in the most recent cycle, investors do not necessarily need to make a huge allocation to gain the benefits of diversification, both in terms of sector exposure and the drivers of performance. When/if the next cycle of small cap outperformance begins, investors could be well positioned to benefit from any closing in the valuation gap.

Now may be the right time for investors to look beyond the giants.

Figure 8: Small caps to re-take the lead?



Source: FRP, FactSet, Morningstar, as at 31 December 2024. Note: Russell 2000 Index and S&P 500 Index.

**Past performance does not predict future returns.**

Please note: Past performance does not predict future returns. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested. There is no guarantee that past trends will continue, or forecasts will be realised.

References made to individual securities do not constitute a recommendation to buy, sell or hold any security, investment strategy or market sector, and should not be assumed to be profitable. Janus Henderson Investors, its affiliated advisor, or its employees, may have a position in the securities mentioned.

## Glossary

**Cyclical stocks:** Companies that sell discretionary consumer items (such as cars), or industries highly sensitive to changes in the economy (eg. mining).

**Diversification:** A way of spreading risk by mixing different types of assets/asset classes in a portfolio, on the assumption that these assets will behave differently in any given scenario. Assets with low correlation should provide the most diversification.

**Forward PE:** A popular ratio used to value a company's shares, compared to other stocks, or a benchmark index, using future expectations of earnings. It is calculated by dividing the current share price by its earnings per share. It is calculated by dividing the current share price (P) by its earnings per share (E).

**Global Financial Crisis:** The global economic crisis from mid-2007 to early 2009 that began with losses related to mortgage-backed financial assets in the US and spread to affect financial markets and banks globally. Also known as the 'Great Recession'.

**Market Cap:** The total market value of a company's issued shares. It is calculated by multiplying the number of shares in issue by the current price of the shares. The figure is used to determine a company's size and is often abbreviated to 'market cap'.

**On-shoring/Near-shoring:** The process of bringing business operations back in-house, or relocating them within domestic (or regional, in the case of the EU) borders. While it can be more expensive to run local operations, due to higher wages or the cost of regulation, it offers more control, and helps to reduce the impact of geopolitical uncertainty or currency changes.

**Small cap:** Companies with a valuation (market capitalisation) within a certain scale, eg. \$300 million to \$2 billion in the US, although these measures are generally an estimate. Small cap stocks tend to offer the potential for faster growth than their larger peers, but with greater volatility.

**Valuations:** A quantitative process of determining the fair value of an asset, investment, or business. A company can generally be valued on its own on an absolute basis or a relative basis compared to other similar companies or assets.

**MSCI Europe Large Cap Index:** An index that represents the prices of listed large companies across 15 developed market countries in Europe.

**MSCI Europe Small Cap Index:** An index that captures the prices of listed smaller companies across 15 developed market countries in Europe.

**MSCI World Index:** An index that captures the prices of large and mid-sized companies across 23 developed market countries.

**MSCI World Large Cap Index:** An index that captures the prices of larger companies across 23 developed market countries.

**MSCI World Small Cap Index:** An index that captures the prices of smaller companies across 23 developed market countries.

**Russell 2000 Index:** A stock market index that measures the performance of 2,000 smaller companies included in the Russell 3000 Index.

**S&P 500 Index:** An index that tracks the stock market performance of the largest 500 listed companies in the US.

FOR MORE INFORMATION, PLEASE VISIT [JANUSHENDERSON.COM](http://JANUSHENDERSON.COM)

**Janus Henderson**  
INVESTORS

#### Important information

The views presented are as of the date published. They are for information purposes only and should not be used or construed as investment, legal or tax advice or as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. Nothing in this material shall be deemed to be a direct or indirect provision of investment management services specific to any client requirements. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, are subject to change and may not reflect the views of others in the organization. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. No forecasts can be guaranteed and there is no guarantee that the information supplied is complete or timely, nor are there any warranties with regard to the results obtained from its use. Janus Henderson Investors is the source of data unless otherwise indicated and has reasonable belief to rely on information and data sourced from third parties. Past performance does not predict future returns. Investing involves risk, including the possible loss of principal and fluctuation of value.

Not all products or services are available in all jurisdictions. This material or information contained in it may be restricted by law, may not be reproduced or referred to without express written permission or used in any jurisdiction or circumstance in which its use would be unlawful. Janus Henderson is not responsible for any unlawful distribution of this material to any third parties, in whole or in part. The contents of this material have not been approved or endorsed by any regulatory agency.

Janus Henderson Investors is the name under which investment products and services are provided by the entities identified in the following jurisdictions: (a) Europe by Janus Henderson Investors International Limited (reg no. 3594615), Janus Henderson Investors UK Limited (reg. no. 906355), Janus Henderson Fund Management UK Limited (reg. no. 2678531), (each registered in England and Wales at 201 Bishopsgate, London EC2M 3AE and regulated by the Financial Conduct Authority), Tabula Investment Management Limited (reg. no. 11286661 at 10 Norwich Street, London, United Kingdom, EC4A 1BD and regulated by the Financial Conduct Authority) and Janus Henderson Investors Europe S.A. (reg no. B22848 at 78, Avenue de la Liberté, L-1930 Luxembourg, Luxembourg and regulated by the Commission de Surveillance du Secteur Financier); (b) the U.S. by SEC registered investment advisers that are subsidiaries of Janus Henderson Group plc; (c) Canada through Janus Henderson Investors US LLC only to institutional investors in certain jurisdictions; (d) Singapore by Janus Henderson Investors (Singapore) Limited (Co. registration no. 199700782N). This advertisement or publication has not been reviewed by Monetary Authority of Singapore; (e) Hong Kong by Janus Henderson Investors Hong Kong Limited. This material has not been reviewed by the Securities and Futures Commission of Hong Kong; (f) South Korea by Janus Henderson Investors (Singapore) Limited only to Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations); (g) Japan by Janus Henderson Investors (Japan) Limited, regulated by Financial Services Agency and registered as a Financial Instruments Firm conducting Investment Management Business, Investment Advisory and Agency Business and Type II Financial Instruments Business; (h) Australia and New Zealand by Janus Henderson Investors (Australia) Limited (ABN 47 124 279 518) and its related bodies corporate including Janus Henderson Investors (Australia) Institutional Funds Management Limited (ABN 16 165 119 531, AFSL 444266) and Janus Henderson Investors (Australia) Funds Management Limited (ABN 43 164 177 244, AFSL 444268); (i) the Middle East by Janus Henderson Investors International Limited, regulated by the Dubai Financial Services Authority as a Representative Office. This document relates to a financial product which is not subject to any form of regulation or approval by the Dubai Financial Services Authority ("DFSA"). The DFSA has no responsibility for reviewing or verifying any prospectus or other documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorised financial adviser. No transactions will be concluded in the Middle East and any enquiries should be made to Janus Henderson. We may record telephone calls for our mutual protection, to improve customer service and for regulatory record keeping purposes.

**Outside of the U.S., Australia, Singapore, Taiwan, Hong Kong, Europe and UK:** For use only by institutional, professional, qualified and sophisticated investors, qualified distributors, wholesale investors and wholesale clients as defined by the applicable jurisdiction. Not for public viewing or distribution. Marketing Communication.

Janus Henderson is a trademark of Janus Henderson Group plc or one of its subsidiaries. © Janus Henderson Group plc.