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.

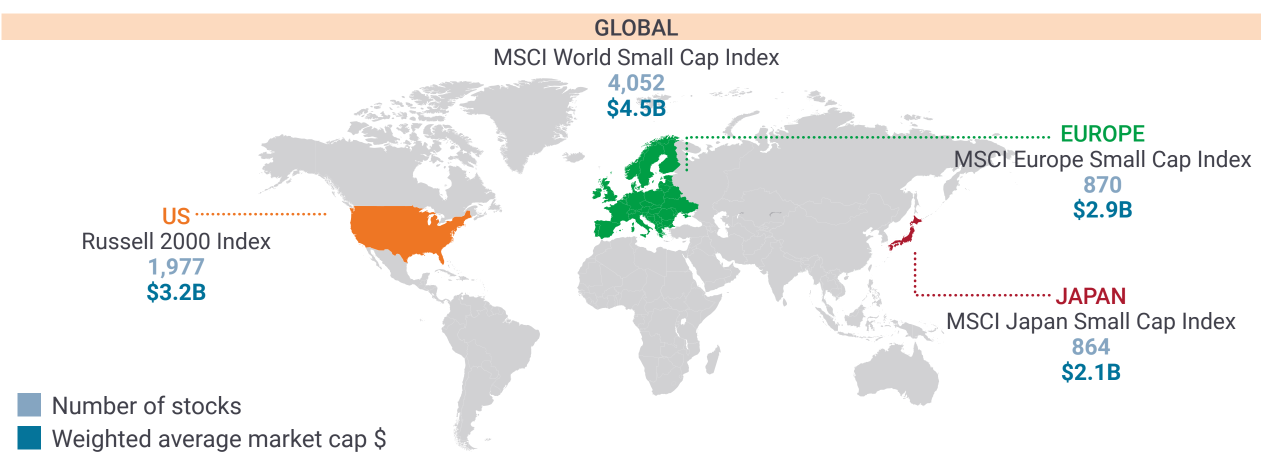
Key takeaways:

- **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?

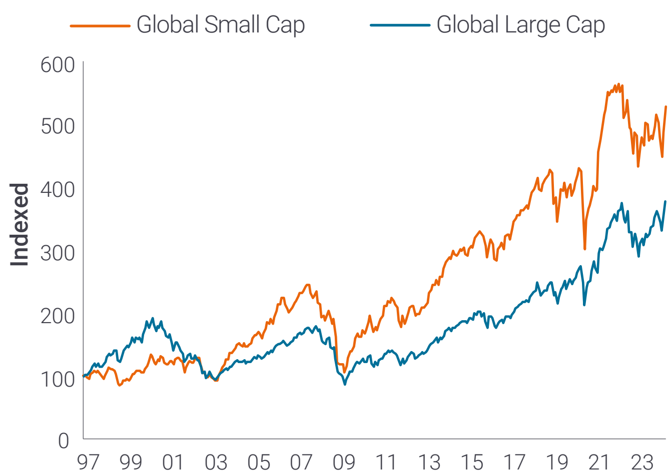
1. Long-term record of outperformance
2. M&A as a structural advantage
3. Lower concentration risk
4. More stocks, more opportunities
5. Greater beneficiaries of supply chain near-shoring
6. Greater dispersion in performance
7. Valuations

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.

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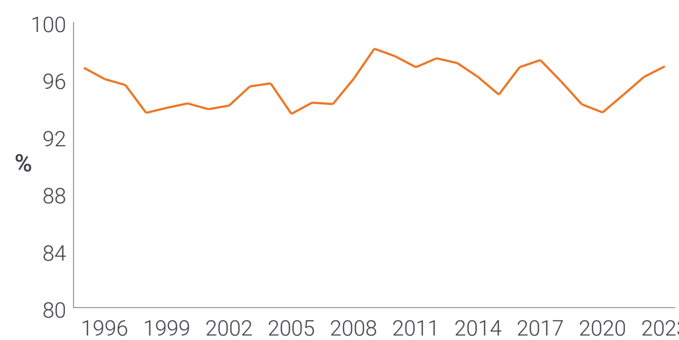
Figure 2: Higher M&A activity favours small caps

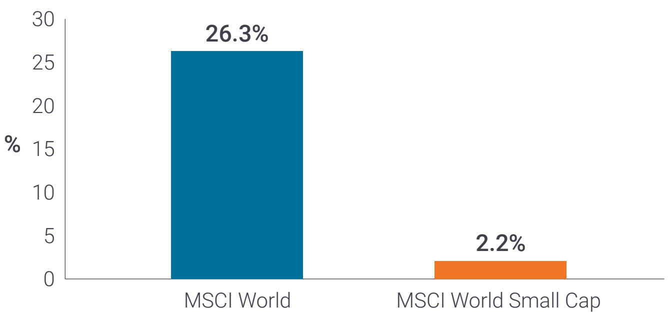


Source: Bloomberg, Factset, JP Morgan calculations, Janus Henderson Investors analysis, at 31 December 2024.

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

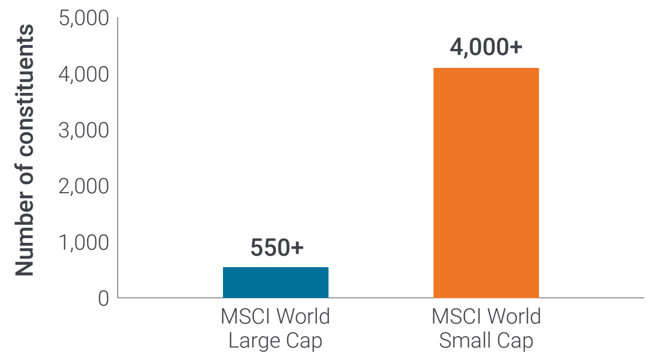


Source: Bloomberg, Factset and JP Morgan calculations, Janus Henderson analysis, using the MSCI World Index and the MSCI World Small Cap Index, at 31 December 2024. **Past performance does not predict future returns.**

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.

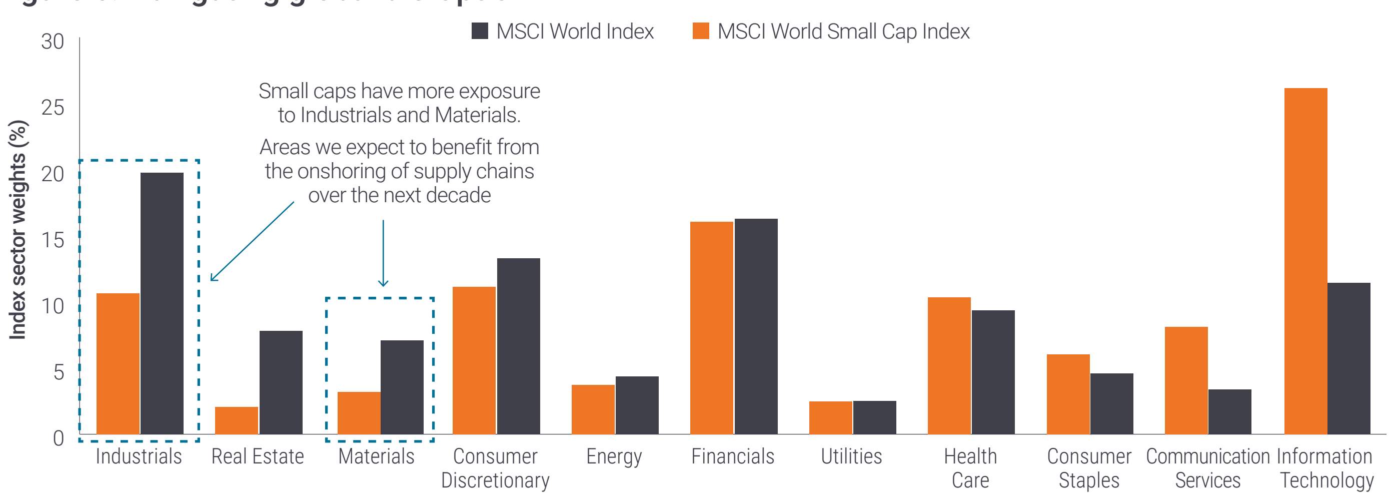
Figure 4: Breadth of choice from the size of small caps markets



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.

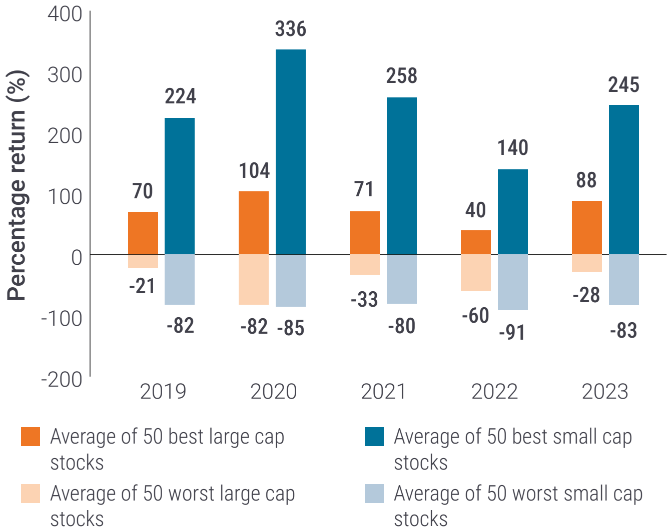
Figure 5: Navigating global disruption



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.
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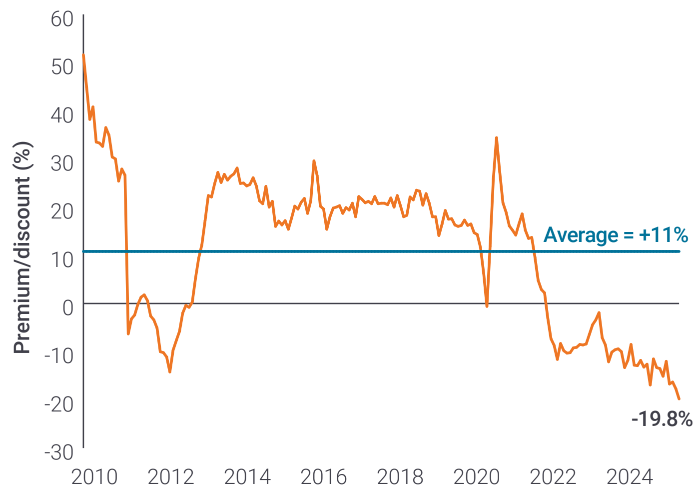
7. Valuations: The market has for some time shunned small-cap stocks in favour of larger, more established companies. Global smaller caps endured a difficult time during what was an aggressive interest rate cycle, with many smaller companies facing higher cost of debt, and a broader heightened level 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

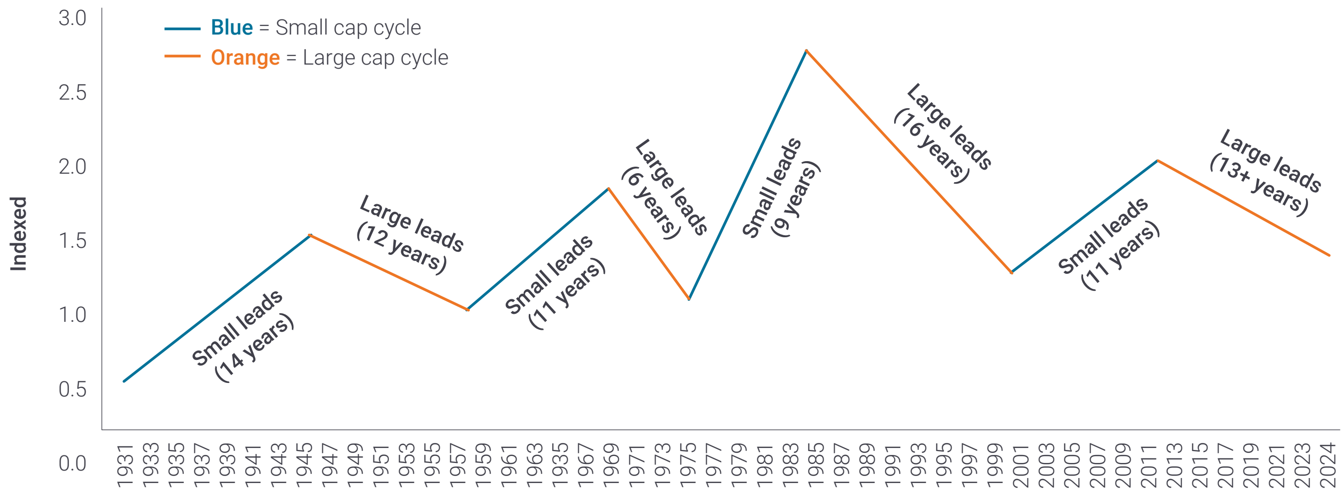
Is this a favourable environment for small caps?

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.

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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.

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