



The value of diversifying  
with small caps

### A broad universe of companies

Small companies make up 90% of the US market and account for 43.5% of US GDP<sup>1</sup>

### Discount on valuation

Small caps trade at a significant discount to large caps<sup>2</sup> and with respect to their historical average

### Active management is important

A significant number of companies in small caps indices are unprofitable<sup>3</sup>

<sup>1</sup> Source: US Chamber of Commerce. September 2024. <https://www.uschamber.com/small-business>

<sup>2</sup> Source: American Century Investments. <https://www.americancentury.com/insights/should-investors-take-a-closer-look-at-downtrodden-small-cap-stocks/>

<sup>3</sup> Source: Furey Research Partners. Data as of September 2023.

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## What are small caps?

Small caps <sup>1</sup> are **listed companies** whose market capitalization is between USD 300mn and USD 2bn in large markets such as the US, although the range limits vary depending on the market. In smaller markets, such as Spain, the upper bound can be lower, often under EUR 1bn.

Above this tier are what are referred to as mid caps, i.e., companies with a market capitalization of between USD 2bn and USD 10bn. Large caps are companies whose market capitalization is over USD 10bn.

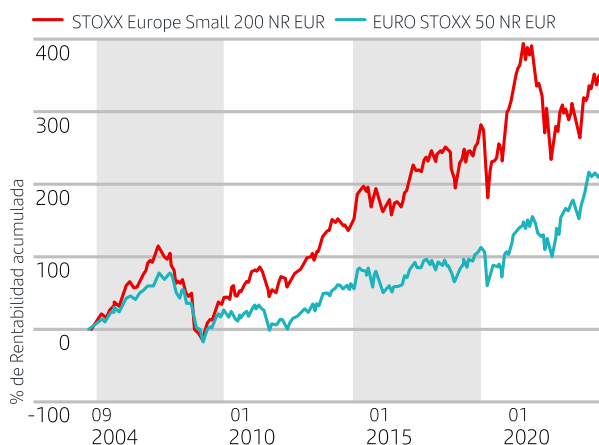
## Main investment arguments

### Growth potential

Since they tend to be at an early stage of development, small caps tend to expand faster, which can provide greater appreciation for investors in the long term. Investing in a small cap that is at an early phase of growth can offer the opportunity to share in its success from the outset.

In the past, small cap indexes have tended to appreciate more than large caps: an annualized return since 2004 of +7.7% on the Stoxx Europe Small 200 vs. 5.7% on the Eurostoxx 50<sup>2</sup>.

### Past performance of the Stoxx Europe Small 200 (small caps) vs. Euro Stoxx 50 (large caps) indexes



Source: Morningstar Direct. Data from 10 Sept. 2004 to 9 Sept. 2024

<sup>1</sup> Market capitalization is obtained by multiplying the number of outstanding shares by the share price.

<sup>2</sup> Source: Bloomberg. Data from 8 Sept. 2000 to 10 Sept. 2024.

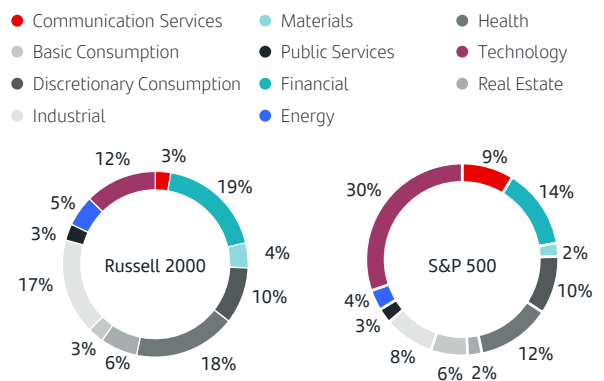
<sup>3</sup> Source: US Chamber of Commerce. September 2024. <https://www.uschamber.com/small-business>

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### Diversification

- Small caps account for a large proportion of listed companies. For example, they represent 90% of the US market<sup>3</sup>.
- Companies in this category are often exposed to market niches or emerging sectors.
- They are often at the forefront of innovation and development within their industries, and many of them are startups.
- Many of them offer exposure to megatrends such as digitalization.

### Industry breakdown of the Russell 2000 (small caps) and S&P 500 (large caps) indexes



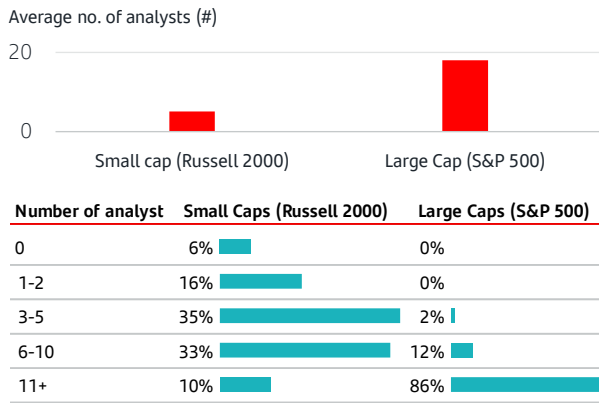
Source: iShares. Industry breakdown of the Russell 2000 and S&P 500 indexes. Data as of 6 September 2024

The indices are used as a benchmark measure of small cap risk relative to large caps and may not represent a client's investment portfolio.

### Market inefficiencies

Many of these stocks are not covered by the large research houses. Consequently, it is easier to find companies that are undervalued. Moreover, M&A transactions are more likely in this market segment (approximately twice as likely as among large caps<sup>1</sup>).

Percentage of coverage: small caps vs. large caps

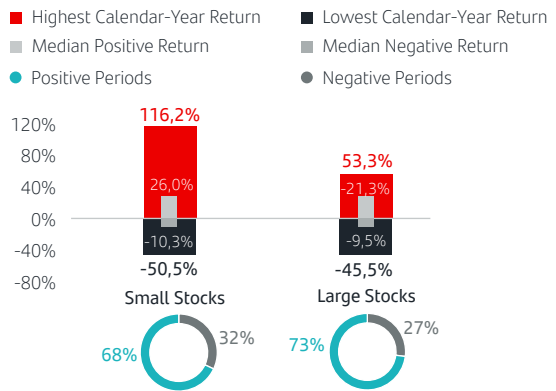


Source: FactSet. Data as of 18 Jan. 2024. Based on earnings per share numbers

### A broader set of opportunities

Not only is the number of index components greater than in the case of large caps (4,100 companies in MSCI World Small Cap vs. 1,500 in MSCI World2), but there is also a greater dispersion of returns than in large cap indices, which offers greater opportunities for generating alpha.

Dispersion of returns: small caps vs. large caps



Source: Calculated using the US Index Database 2023 from the Center for Research in Security Prices (CRSP), Chicago Booth School of Business. Returns per calendar year: 1926 to 2022. The indices are used as a benchmark measure of small cap risk relative to large caps and may not represent a client's investment portfolio.

## Main risks

### Illiquidity

Small caps usually have a lower trading volume. This means it may be harder to buy or sell shares without significantly affecting the price.

### Volatility

They tend to be more volatile in the face of market news or changes in the economy. This volatility means greater risk, but also the possibility of higher returns.

### Lower research coverage

The lower level of coverage and the shortage of information not only represents an opportunity; it also makes it difficult to make investment decisions because investors need to conduct exhaustive research themselves before making investment decisions.

## Differences between startups and SMEs

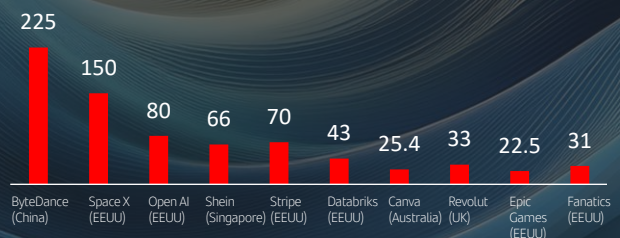
Startups are newly created companies that have a scalable business model and rely on technological innovation to maximise their scope for growth. They achieve all this with a low cost of resources, which positively impacts their profit margin, while they are financed by third parties (business angels).

In contrast, SMEs are small or medium-sized enterprises (in terms of revenue or human capital). Unlike startups, SMEs aren't necessarily new, their funding is rarely from outside sources and they tend to have a more local reach. Additionally, unlike startups, they tend not to be focused on new technology.

## Unicorns

They are companies created in the last 10 years that, without being listed or acquired by a third party, achieve a value of at least USD 1bn. According to consulting firm CB Insights, in May 2024 there were more than 1,200 unicorns worldwide; that figure continues to grow, particularly due to the use of new technologies. Most unicorns are startups.

The world's most valuable unicorns



Source: CB Insights. Figures in USD billion as of September 2024

1 Source: Lazard US Small Cap Strategy, April 2024.

2 Source: MSCI. Data as of 31 Dec. 2023. <https://www.msci.com/our-solutions/indices/small-cap-indices>

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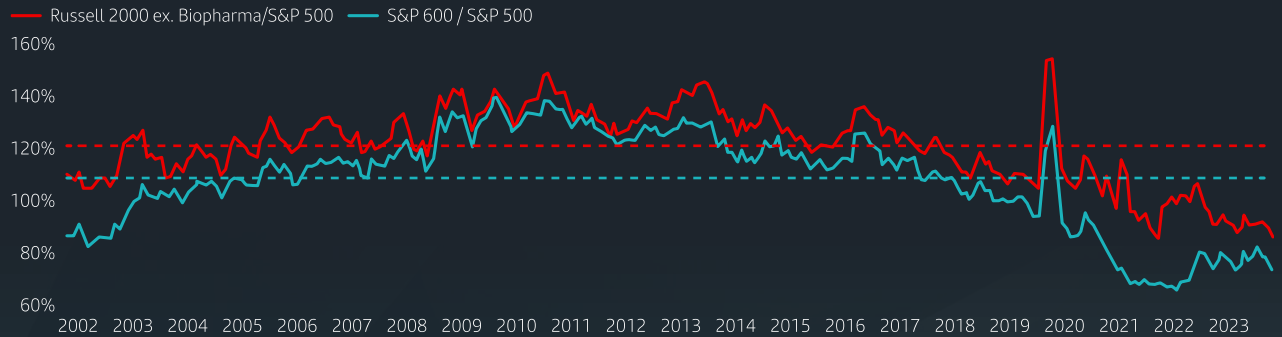


# Is now a good time to invest in small caps?

## Valuation discount

After underperforming in recent years, small caps are trading at lower multiples and offer a significant discount with respect to large caps. This valuation gap is **close to its widest in decades**, as small caps are trading around 20% below their historical average<sup>1</sup>. In addition, small caps are trading at a significant discount compared to their own historical average in most geographies, especially Europe and the USA.

### Dispersion in valuation between small and large caps



Source: T. Rowe Price based on research by Furey Research Partners. Data from 31 July 2022 to 30 June. The graph plots estimated performance (P/E) by small and large cap indices over periods of six and twelve months. To avoid distortion, the Russell 2000 curve excludes biopharma companies, which are generally not profitable and have a very high P/E ratio. Another way to analyse this ratio is to use the S&P Small Cap 600, an index that uses a profit filter (i.e., companies must have a track record of profits before they can be included)

### Relative performance of small cap indices over 5 and 10 years

Small caps indices forward P/E <sup>2</sup>	World	ACWI	Europe	USA	Japan	Asia ex Japan	Emerging
Current	19.3	18.6	14.1	23.1	16.4	18.3	14.8
5-year average	23.1	21.8	19.3	26.9	16.6	16.6	14.4
Current vs. 5-year average % diff.	-16.50%	-14.70%	-26.90%	-14.10%	-1.20%	10.20%	2.80%
10-year average	22.4	21.4	18.8	25.5	17.1	16.2	14.8
Current vs. 10-year average % diff.	-13.80%	-13.10%	-25.00%	-9.40%	-4.10%	13.00%	0.00%

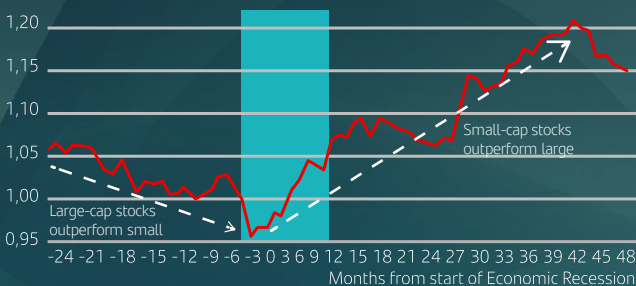
Source: Aberdeen and Bloomberg. MSCI index data as of 31 Dec. 2023. The indices are used as a benchmark measure of small cap risk relative to large caps and may not represent a client's investment portfolio.

## Good momentum

The current context includes **reshoring policies** and **fiscal stimuli** that are particularly favourable to small caps operating at the domestic level as these policies are designed to strengthen domestic production and reduce dependence on international supply chains.

In addition, according to a survey by William Blair, small companies **tend to outperform large companies after periods of economic recession**.

### Relative profitability of small caps vs large caps in recession periods



Source: William Blair Equity Research, October 2022.

<sup>1</sup> Source: American Century Investments. <https://www.americancentury.com/insights/should-investors-take-a-closer-look-at-downtrodden-small-cap-stocks/>

<sup>2</sup> Forward P/E ratio: Valuation metric that indicates whether an action is undervalued or overvalued. It is calculated by dividing the share price by the earnings per share (EPS) expected for the next 12 months.

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## Index concentration

The current concentration of large cap indices remains a challenge because it means that the indices are increasingly limited not only to certain companies, but also to certain sectors and factors. According to June data for the S&P 500, **market concentration is at a 50-year peak** as the six main stocks represent more than 30% of the index's capitalization<sup>1</sup>. Particularly at this time, investing in small caps offers a **significant opportunity for diversification in both absolute** (2000 companies in the Russell 2000, where the top 10 represent only 3.62%) and **relative** (0% overlap with the S&P 500) terms.

### Main components of the large cap and small cap indices

Small Caps		Large Caps	
Russell 2000	Peso	S&P 500	Peso
Vaxcyte	0.48% ↓	Apple	6.85%
FTAI Aviation	0.47% ↓	Microsoft	6.54%
Insmed	0.44% ↓	Nvidia	5.62%
Sprouts Farmers	0.39% ↓	Amazon	3.41%
Ensiar	0.33% ↓	Meta	2.42%
Fabrinet	0.32% ↓	Alphabet A	1.98%
Fluor	0.31% ↓	Berkshire Hathaway	1.86%
Halozyne Therapeutics	0.30% ↓	Alphabet C	1.66%
Mueller Industries	0.29% ↓	Eli Lilly	1.62%
Applied Industrial Tech	0.29% ↓	Broadcom	1.44%
Top 10	3.62%	Top 10	33.40%

Source: iShares. Data as of 6 September 2024. Overlap between Russell 2000 and S&P 500 indices calculated as of 9 September 2024. Source: T.Rowe Price. The indices are used as a benchmark measure of small cap risk relative to large caps and may not represent a client's investment portfolio.

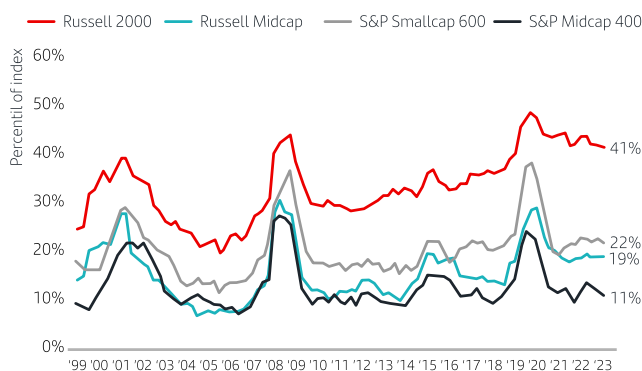
## The importance of active management in this segment

One of the challenges of investing in indexed small- and medium-cap products is that one is investing in all the index components.

The cost of being a listed company has increased and more and more companies are staying private for longer<sup>2</sup>. The **number of listed companies in the US has declined**, from more than 7,000 in 1998 to less than 4,000 today (according to the Wilshire 5000 Index<sup>3</sup>). Nevertheless, **the small cap market is deep**, with **over 4,100<sup>4</sup> companies** to choose from.

A very important justification for active management is that the quality of small caps indices has deteriorated significantly, since a **significant number of companies in these indices are not profitable**. Currently, **more than 40% of the Russell 2000<sup>5</sup> index and, consequently, of the passive funds and ETFs that track it**, consists of companies that are not profitable. It is clearly advisable to avoid or, at least, underweight unprofitable companies: **the profitable companies in the Russell 2000 have outperformed the unprofitable ones by 994% since 1999<sup>6</sup>**.

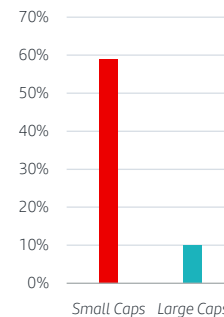
### Percentage of unprofitable companies in the S&P and Russell indices



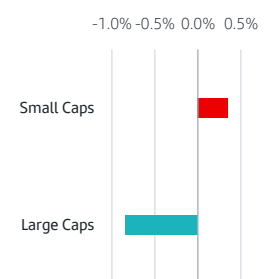
Source: T. Rowe Price based on data from Factsheet. Figures as of December 2023.

### Stock picking is vital

#### Percentage of managers beating the index



#### Average excess return of Small caps vs Large caps



Source: Morningstar. Returns net of fees through 31 March 2024. Management data obtained from the Morningstar US Fund Small Blend and US Large Blend categories. Index data refer to the Russell 2000 Total Return (small caps) and S&P 500 Total Return (large caps)

1 Source: "Tendencias de la renta variable más allá de la gran capitalización estadounidense". Estrategias de Inversión. July 2024.

2 Source: American Century Investments. <https://www.americancentury.com/insights/should-investors-take-a-closer-look-at-downtrodden-small-cap-stocks/>

3 The Wilshire 5000 Total Market Index contains all listed companies in the US market. Data from 31 Dec. 1998 to 30 Sept. 2023.

4 Source: MSCI. Data as of 31/12/23. <https://www.msci.com/our-solutions/indexes/small-cap-indexes>.

5 Source: Furey Research Partners. Data as of September 2023.

6 Source: T.Rowe Price based on Factset data. Data from 31 Dec. 1999 to 31 Dec. 2023.

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