



Honey I shrunk the market

Why it's time to look beyond the giants for the next big thing.

Update
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The Magnificent Seven may have delivered some impressive returns but this year has seen a clear reversal in fortunes. Over the past six months, Europe and Asia have comfortably outpaced the S&P 500, and in the past three, the small-cap Russell 2000 has led the pack. In short, the narrative around US mega-cap exceptionalism is starting to crack.

Flows often chase performance, with legendary investor Howard Marks observing: "Money flows into asset classes and strategies after they've delivered good performance, which is the exact opposite of what the motto 'buy low, sell high' would recommend."

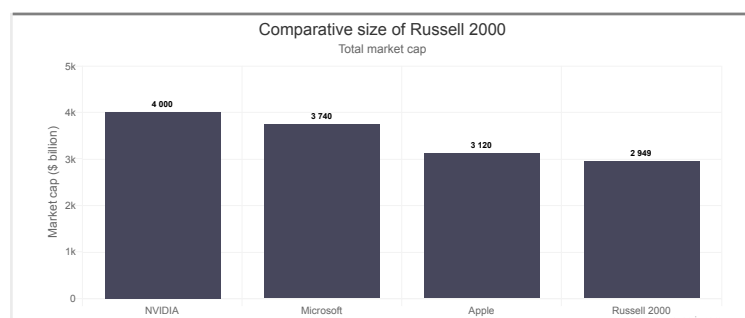
While there are early signs of a rotation away from US large-caps, the sheer weight of global capital has yet to meaningfully unwind. And, as this year's top-performing sectors show, it's often the early movers who capture the most attractive returns by 'buying low' before valuations catch up with performance.

Putting it into context

US large-caps have ridden a decade-long wave of global capital inflows, fuelled by a virtuous cycle of money, momentum and excitement over digitalisation and AI. The Magnificent Seven now makes up a third of the S&P 500, with its MSCI World weighting near-doubling to a 25-year high.

To put this extreme concentration into context, the Russell 1000 accounts for 95% of the total market cap of the Russell 3000, leaving just 5% for the smallest 2000 companies. Remarkably, NVIDIA's market cap alone would be large enough to buy the entire Russell 2000 (and still leave a trillion dollars in change...).

Fig.1: The Magnificent Seven Dwarfs The Russell 2000



Source: Bloomberg (Russell 2000 Index as at 30/06/2025, rest as at 15/07/2025)

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As investors look beyond the Magnificent Seven for returns, even a modest unwinding of capital could have outsized effects further down the market-cap scale. By way of example, just a 1% outflow from NVIDIA, Microsoft and Apple could buy the ten largest companies in the Russell 2000.

The strong investor culture in the US further amplifies the home bias, with 60% of Americans holding equities versus only 10% in the UK. As the exceptionalism of the Magnificent Seven starts to fade, US investors may naturally turn to the familiar territory of small-caps in their home market.

Hunting for the next big thing

Decades of global capital crowding have driven record valuations for US mega-caps but question marks are now growing over whether these companies still warrant their premiums, with Apple and Tesla in negative territory this year.

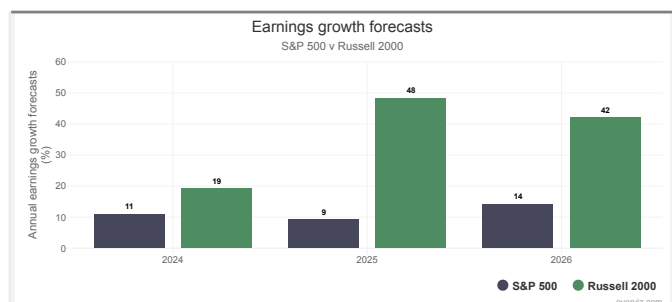


As a result, investors may be prompted to rebalance their portfolios in the hunt for superior returns beyond the Magnificent Seven, particularly given their extreme concentration in US and global ETFs.

Some investors may look overseas but the US retains the considerable appeal of a well-regulated system, cutting-edge innovation and a vibrant entrepreneurial culture. Despite political turbulence, reshoring efforts may provide a tailwind for domestically focused companies.

While US small-caps have been overlooked in recent years, their fundamentals remain appealing. Valuations sit near historical averages, but, as the chart highlights, the Russell 2000 offers far stronger forecast earnings growth than the S&P 500, which should provide a solid foundation for returns.

Fig.2: The Russell 2000 Offers Attractive Growth prospects



Source: Yardeni Research (as at 15/07/2025), based on analyst consensus estimates

Don't be passive

The US small-cap universe is vast, with the Russell 2000 covering around half of all US-listed companies. Research coverage, however, drops steeply down the market cap spectrum: S&P 500 companies have an average of 25 analysts, compared to just six for the Russell 2000.

This creates a fertile hunting ground for stock-pickers to identify mispricing opportunities, though selectivity is key as the indiscriminate flow of passive capital has propped up lower quality, unprofitable small-caps that are ill-equipped to survive tougher conditions.

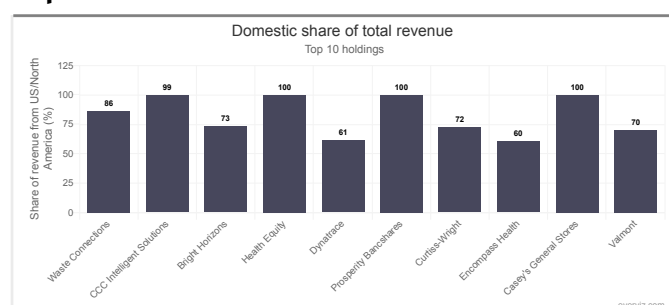
Brown Advisory US Smaller Companies (BASC) takes an 'all weather' approach to the US small-cap sector, focusing on quality companies with scalable models, pricing power, strong balance sheets and experienced management teams. Despite the headwinds for small caps, BASC has delivered a 10-year share price return of over 90%, including a 10% gain in the past three months alone (as at 27/07/2025).

Tariff uncertainty has undoubtedly weighed on sentiment but active management can help to navigate such external

shocks. BASC's close engagement with management teams has enabled manager Christopher Berrier to assess both the downside risks and upside potential posed by tariffs.

Starting with the risks, many of BASC's top holdings generate most (or all) of their revenue in the US, offering resilience against the supply chain challenges facing more internationally-exposed businesses.

Fig.3: BASC's Portfolio Has High Domestic Exposure



Source: Company filings

However, a more nuanced and granular approach is required beyond the headline numbers. Companies with international exposure, such as childcare services provider Bright Horizons, may benefit from captive customer bases or local supply chains.

On the upside, re-shoring initiatives could benefit domestic manufacturers and accelerate AI-driven innovation. Christopher has also recently shifted allocations from defensive holdings into high-quality names affected by tariff concerns, viewing Liberation Day as "an opening salvo, not the end game" and an opportunity to capitalise on attractive risk-reward prospects.

Looking ahead

The Magnificent Seven may continue to dominate the headlines for now but opportunity is quietly gathering lower down the market-cap ladder. For investors willing to look beyond the crowd, US small-caps offer compelling growth and valuations yet to catch up with fundamentals.

With the benefit of active management to identify the most promising opportunities, the stage could be set for small-cap outperformance in the years ahead. After all, as Howard Marks reminds us, real success often comes from buying low, not chasing past winners.

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