Any given Sunday

We ask if the stars are aligning for US small-caps...

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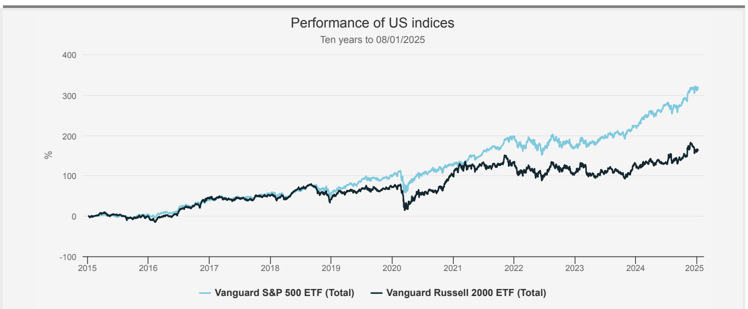
One of the interesting aspects of college football across the pond is that it offers the opportunity to spot the potential future stars of the NFL. This is where younger American football players develop their skills and showcase their talent, with the best ones likely to make it to the big league eventually. Similarly, the US small-cap space is the place where the next S&P 500 superstars may be currently listed. For example, NVIDIA was once a constituent of the Russell 2000 Index, a US small-cap index, before joining the S&P 500 in November 2001. Similarly, Netflix was included in the Russell 2000 Index in June 2002 and moved up to the S&P 500 in December 2010. One attraction of investing in US small-caps is the potential to capture the growth of future giants early on, perhaps similarly to NFL scouts looking to spot their future quarterback in college football teams.

And more importantly, as small-caps are typically at an earlier stage in their life cycle compared to large-caps, they theoretically have greater potential to grow their earnings at a faster pace. This, in turn, should drive quicker share price appreciation over time compared to their large-cap peers. However, this is the theory, and reality has played out differently over the past decade. If we look at the past ten years (to 08/01/2025), the Russell 2000 Index generated a total return of 162.2% in US dollar terms, which pales in comparison to the 320.3% return of the S&P 500 Index over the same period (both indices are represented by an ETF in the chart below). Several factors have contributed to this dominance of US large-caps over their small-cap counterparts. One is the rapid and consistent growth of technology companies, with the information technology sector making up 32.5% of the S&P 500 Index. For instance, NVIDIA's revenue grew c. 782.6% between the company's financial years 2014 and 2024. Another example outside of the Magnificent Seven is Salesforce, which saw its revenue increase c. 751.2% over its financial years 2014 and 2024. In contrast, the Russell 2000 Index has much less exposure to technology, with only 11.7% of its index comprised of tech companies. Additionally, many companies are staying private longer, only going public when they are large enough to qualify as large-caps. This means that indices like the Russell 2000 miss out on capturing their growth during their earlier, faster-growing phases.

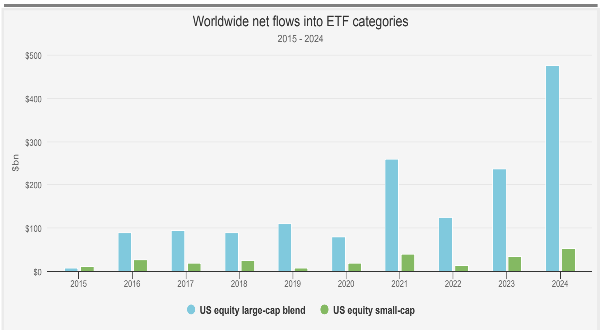
Given the outperformance of the S&P 500 Index (relative to the Russell 2000 Index), along with its larger exposure to the information technology sector and the higher visibility of its constituents, it is perhaps understandable that investors continue

Fig.1: Performance Over Ten Years



Source: Morningstar
Past performance is not a reliable indicator of future results.

Fig.2: Flows Into ETFS



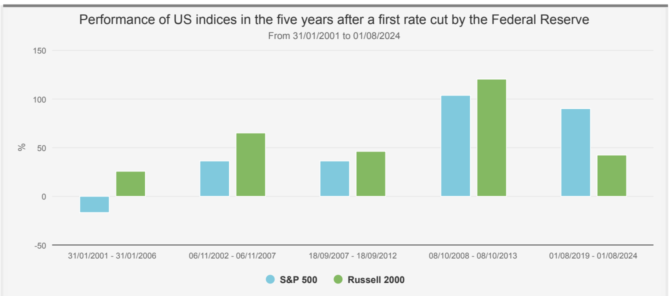
Source: Morningstar

to pour money into ETFs focussing on US large-caps. However, inflows into US small-cap ETFs have been steadily rising since 2022 as the chart below shows, although they remain a fraction of those directed toward large-caps. Could this trend to prefer large over small reverse? This is the question we explore below.

Falling interest rates: a game changer?

Monetary policy could be one catalyst for small-cap outperformance, as US smaller companies have historically tended to outperform in environments of falling interest rates. In fact, the Russell 2000 has often outpaced the S&P 500 in the five years following a first rate cut, as the chart below shows. The reasons for this recurring pattern are multiple. First, companies with higher expected earnings growth should be more sensitive to interest rates, as earnings further into the future will be more affected by falling discount rates. Secondly, small-caps tend to be more sensitive to the domestic economy, meaning that efforts aimed at stimulating economic growth can support their activities. Additionally, smaller companies often have higher debt and lower credit ratings than their large-cap peers, meaning that falling interest rates can provide them with some relief.

Fig.3: Performance Of US Indices In The Five Years After A First Cut In Interest Rates



Source: Morningstar
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However, it is important to remember that this pattern does not occur systematically. For instance, it did not happen in the five years following the first rate cut on 01/08/2019. One reason for this might be that this rate cut was simply an adjustment in the middle of the expansion–recession cycle, rather than a measure aimed at reigniting a flagging economy. As a result, it did not lead to a recovery phase during which small-caps tend to outperform large-caps. On the other hand, the S&P 500 Information Technology Index returned 200.5% over that period, largely outperforming both the S&P 500 and Russell 2000 indices. Much of this outperformance was generated during the COVID pandemic when large-cap tech companies provided critical solutions for the problems of the time. The outperformance of the US tech index was further reinforced by the AI rally that gained momentum following the launch of Chat GPT in December 2022. Therefore, even if the Fed continues cutting interest rates into 2025, there is no certainty that monetary policy alone will be enough for small-caps to outperform, especially if tech mega-caps continue delivering profitable innovation breakthroughs.

Moreover, although the Fed cut interest rates three times in 2024, Fed's chair Jerome Powell expressed caution regarding monetary policy at the end of last year. This could mean that further interest rate cuts may be paused and/or there may be fewer cuts than previously expected. Notably, the programme of the incoming US president Donald Trump—which we will discuss in the next section—could prove inflationary, potentially hindering further rate cuts or even leading to rate hikes.

New manager, new playbook?

One of the most important policy proposals of Donald Trump is a tariff regime on all foreign-made goods. While potentially inflationary, tariffs would also make imported goods more expensive, which may incentivise American consumers to buy fewer foreign-made goods and services or businesses to reduce their dependence on foreign suppliers and shift their demand towards domestic producers. This could benefit US smaller companies, which may capture more market share if they face less foreign competition and potentially increase their revenues. However, it remains to be seen whether those tariffs will be effectively implemented or not.

The incoming US president has also pledged to cut corporate tax from 21% to 15% for businesses that produce goods within the United States. This shift could offer significant advantages to US smaller companies, which tend to be more domestically focussed than their larger, more internationally oriented counterparts. With their often global footprint and supply chains, US large-caps might benefit less from those domestic tax incentives. On the other hand, lower taxes would encourage them to continue to reshore their activities. On balance, we think Trump's policies look better for small-caps than large-caps, although it is hard to be confident in this and large-caps should benefit too.

Blitzing towards earnings growth

Earnings growth might be another source of excitement for US small-caps among investors, with the Russell 2000 Index expected to grow its earnings-per-share

(EPS) c. 78.8% over the next three years. In comparison, the S&P 500 Index is expected to grow its EPS by 28.9% over the same period, as the table below shows. This is not unusual, as smaller companies are generally expected to have higher earnings growth than their larger counterparts. Many small-cap companies are in the early stages of their life cycle and tend to operate in emerging industries with greater addressable markets. They may also be more willing to embrace changes compared to larger companies. For instance, an established large-cap company benefiting from a monopolistic market position might not be less inclined to new markets (or markets that do not exist yet), whereas for a smaller company, venturing into such markets could be an opportunity to win market share early on or even a matter of survival.

Although the Russell 2000 Index is expected to experience faster EPS growth than the S&P 500 Index, we think this is already reflected in higher price-to-earnings (P/E) ratios compared to the large-cap index, with the valuations looking very similar on a three-year forward basis (see table below). And in the shorter term, a higher P/E ratio may introduce greater volatility. Strong expectations for earnings growth can lead to significant market reactions if these expectations are not met, even by a small margin, which could result in large price swings. Additionally, a change in the macroeconomic environment—such as a shift in interest rates—can have a detrimental impact on stocks trading on higher P/E ratios. That said, as noted previously, the trend in interest rates has been downward since 2024, and further cuts are expected this year.

Forward Price-To-Earnings Ratio

	S&P 500	RUSSELL 2000
Trailing P/E	24.6x	34.4x
1-year forward P/E	25.3x	45.1x
2-years forward P/E	22.1x	29.3x
3-years forward P/E	19.7x	19.2x
Trailing EPS	$238.72	$65.97
1-year forward EPS	$235.80	$50.23
2-years forward EPS	$270.98	$77.38
3-years forward EPS	$303.98	$117.93

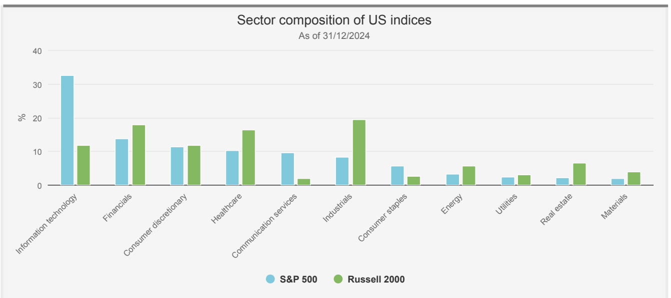
Source: Bloomberg, as of 07/01/2025

While the Russell 2000 Index is expected to see stronger earnings growth than the S&P 500 Index, we think it is also important to consider the impressive earnings growth achieved by tech mega-caps over the past decade and whether it is likely to continue. These companies are at the forefront of breakthroughs in emerging industries like artificial intelligence, cloud computing, autonomous driving, etc, while also maintaining dominance in more established industries. For example, Microsoft holds a quasi-monopolistic position in operating systems and productivity software, while Amazon leads the e-commerce market. Given their dominant positions in high-growth industries, diversified across various industries, and strong balance sheets that can support R&D investments or strategic acquisitions, US tech mega-caps may continue to see rapid earnings growth in the years ahead. However, they are not immune to competition that could erode their market. Their global footprints also expose them to potential risks from trade tensions, while regulators could target them about antitrust issues.

Diversifying the roster

Regardless of monetary policy, political tailwinds or headwinds, and earnings growth, one reason for gaining exposure to US small-caps could simply be diversification. The Russell 2000 and S&P 500 indices differ significantly in their sectoral composition. While the industrials and financials sectors dominate the small-cap index, the information technology sector makes up a significant portion of the large-cap index, accounting for 32.5%. As such, US small-caps offer a distinct exposure to the US equity market, capturing potential growth opportunities in different industries, and may help reduce a portfolio's overreliance on the fortunes of the US tech sector.

Fig.4: Sector Breakdown



Source: S&P Global, FTSE Russell

Moreover, US small-caps provide better exposure to the domestic US economy, with companies of the Russell 2000 Index deriving only c. 19.8% of their revenue from overseas, compared to c. 39.4% for the Russell 1000 Index, which includes US large- and mid-cap companies. For the Magnificent Seven, non-US revenue tends to be even higher. For instance, c. 60.8% of Meta's revenue for the year ended 31/12/2023 came from international markets. In other words, the Magnificent Seven rather offer exposure to the global economy, whereas US small-caps give exposure to the US economic cycle, tapping into the world's largest consumer market.

Revenue/Net Sales Of Magnificent Seven

	Type Of Income	% Of Us Revenue/ Net Sales	% Of Non-Us Revenue/Net Sales	Year Ended
Alphabet	Revenue	47	53	31-12-2023
Amazon*	Net sales	72.9	27.1	31-12-2023
Apple	Net sales	42.7	57.3	28-09-2024
Meta	Revenue	39.2	60.8	31-12-2023
Microsoft	Revenue	50.9	49.1	30-06-2024
NVIDIA	Revenue	44.3	55.7	28-01-2024
Tesla	Revenue	46.7	53.3	31-12-2023

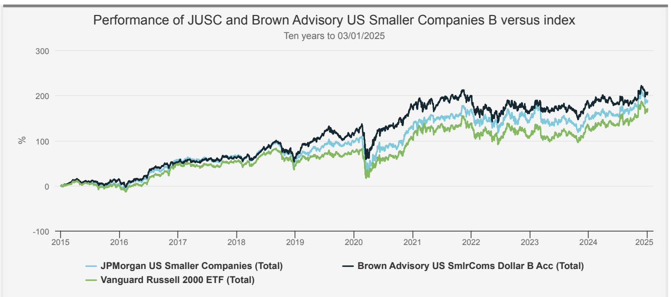
*We did not include the AWS segment in our calculations
Sources: Companies' Forms 10k, Kepler calculations

The draft

Smaller companies are typically less liquid than large-caps and require investors to take a long-term view for their investment to pay off. As such, we believe that the closed-end structure of investment trusts is particularly well-suited for this asset class, as it allows managers to hold on to their stocks during periods of market volatility, ensuring they are not forced to sell at inopportune times.

The AIC North American Smaller Companies sector is made of two constituents: **JPMorgan US Smaller Companies (JUSC)** and **Brown Advisory US Smaller Companies (BASC)**. Since Brown Advisory only took over the management of BASC in March 2021, we have replaced it with the open-ended fund Brown Advisory US Smaller Companies B (which follows a similar approach) in the chart below. As the chart shows, both strategies have outperformed the Russell 2000 Index (represented by an ETF) over the past ten years.

Fig.5: Performance Over Ten Years



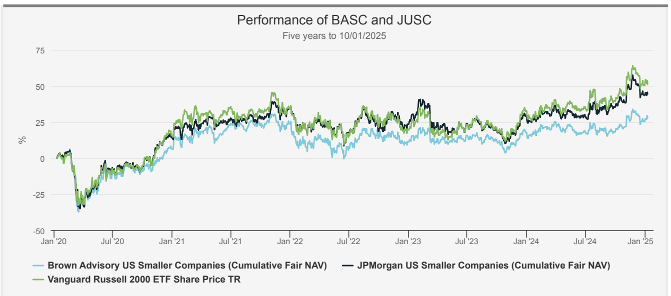
Source: Morningstar
Past performance is not a reliable indicator of future results

JUSC focusses on quality companies benefiting from an enduring competitive advantage and is led by competent management teams with a strong track record of capital stewardship. Managers Don San Jose, Dan Percella, and Jonathan Brachle also pay close attention to valuation, owning stakes that are at a discount to their intrinsic value. JUSC is trading on a 3.3% discount (as of 06/01/2025).

BASC also follows a quality growth approach, with the portfolio consisting of c. 80 stocks. Managers Chris Berrier and George Sakellaris summarise their strategy as the '3G approach': growth, governance, and go-to-market. This means they look for companies leading (or gaining market share) in large or growing industries, managed by transparent, capable and shareholder-friendly teams, and with the capacity to deliver unique value propositions to customers and to achieve a competitive advantage. BASC is trading at a wide discount of 9.8% (as of 06/01/2025).

While both strategies have outperformed the Russell 2000 Index over 10 years, it is important to note that both BASC and JUSC have underperformed over five years, with JUSC lagging by a smaller margin. Over that period, BASC notably trailed both the Russell 2000 Index and JUSC in calendar year 2020 when the trust was still managed by its previous investment manager (and known as Jupiter US Smaller Companies).. BASC also lagged JUSC and the Russell 2000 Index in calendar year 2024.

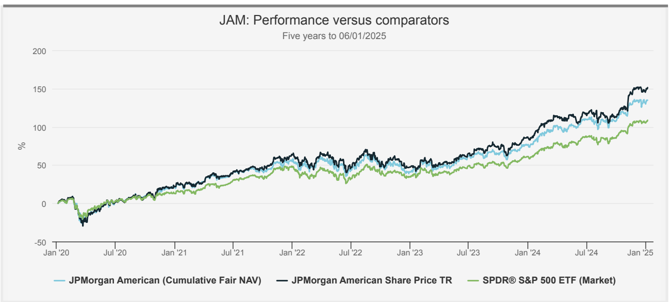
Fig.6: Five Year Performance



Source: Morningstar

Finally, for investors interested in dipping their toes but not too keen on taking the plunge, **JPMorgan American (JAM)** could be a suitable option. The strategy is managed by three managers, focussing respectively on growth, value, and small-cap stocks, with smaller companies accounting for c. 10% of the portfolio, providing investors with comprehensive exposure to the US equity market. JAM has outperformed the S&P 500 over five years, which we think is particularly impressive, as active managers have historically struggled to beat the US equity market. In fact, only 21% of them have done so in the five years to 30/06/2024 according to AJ Bell.

Fig.7: Performance Over Five Years



Source: Morningstar
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The European leagues

Similarly to the US, European smaller companies have lagged large-cap stocks over the past decade. The Euro STOXX Small Index has returned 102.3% over the ten years to 08/01/2025, lagging the 117.9% return of the Euro STOXX 50 Index. However, as in the US, European smaller companies are expected to achieve faster earnings growth than large-caps. The STOXX 200 Europe Small Index is projected to see a 24.7% EPS growth over the next three years, compared to 5.9% for the Euro STOXX 50 Index. Although European smaller companies offer lower earnings growth potential than their US peers, they are trading at much lower valuations, meaning investors pay less for $1 of earnings. Additionally, European smaller companies look cheaper on a three-year forward basis than e European large-caps, unlike in the US, as the table below shows.

Valuations

	Euro STOXX 50	STOXX 200 Europe Small
Trailing P/E	14.5x	15.1x
1-year forward P/E	14.8x	14.9x
2-years forward P/E	14x	12.8x
3-years forward P/E	12.9x	11.5x
Trailing EPS	$382.55	$24.35
1-year forward EPS	$352.38	$23.43
2-years forward EPS	$372.33	$27.24
3-years forward EPS	$405.10	$30.37

Source: Bloomberg, as of 07/01/2025

Furthermore, the potential interest rate tailwind also applies to European smaller companies, as the European Central Bank (ECB) also began its easing cycle in 2024. In fact, the ECB lowered interest rates before the Fed and rates are already lower in the Eurozone than in the US, with potential further cuts in 2025.

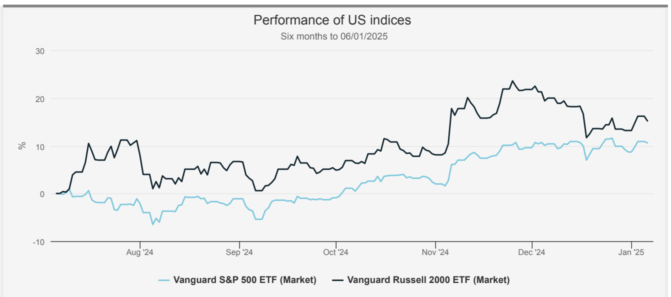
We are aware that Europe is facing challenges that can be off-putting for some investors, including political instability in Germany and France, trade tensions with the USA and China, a war at its borders, and negative demographic trends. However, we believe that some of those concerns may not be as consequential for equity markets as investors tend to assume, as we discuss **here**.

Finally, we note that UK smaller companies, which we have discussed at length in previous pieces, may also benefit from similar tailwinds as their US and European counterparts, backed by a track record of strong performance in recovery phases. As we **previously** discussed, we believe there is plenty of value in the smaller end of the domestic equity market, with a number of UK smaller company investment trusts trading at compelling discounts, which may offer an opportunity for long-term investors.

Conclusion — kneel down

The past decade has been disappointing for US smaller companies as the small-cap effect—the historical tendency for small-caps to outperform large-caps over the long term—did not play out. However, falling interest rates and some of the policies proposed by Donald Trump during his election campaign could create a more conducive environment for smaller companies. Interestingly, the Russell 2000 Index has quietly outperformed the S&P 500 Index over the past six months, reaching a peak after the US elections (05/11/2024). While it is of course a short-term period, we think it is still encouraging, and we think the diversification small caps offer to the US large-cap market is attractive.

Fig.8: Performance Over Six Months



Source: Morningstar
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That said, there is no clear indication that US small-caps are under-valued. It is true that they are expected to deliver strong earnings growth over the coming three years. However, this comes with a higher price tag than for the earnings growth of US large-caps or European small-caps. In fact, European small-caps look slightly more attractive on a valuation basis, although the difference is not large. We will explore this sector in more detail in the coming weeks.

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