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# Small caps, big potential

Why smaller companies could offer stronger returns in the years ahead

## Why we invest in small caps

Strategic asset allocation is at the heart of how we invest. We use it to set a long-term framework for delivering returns by spreading risk across a broad mix of assets, from equities and bonds to property and alternative investments. Within this framework, smaller companies (or small caps) have an important role to play.

While they tend to be more volatile in the short term (their share prices can move around more than larger companies), small caps also offer exposure to a different set of risks and opportunities than larger companies. That makes them useful for diversification, helping to smooth out returns across the whole portfolio. Although small caps don't outperform all the time, history shows they've often delivered stronger returns than large caps during the right environment.

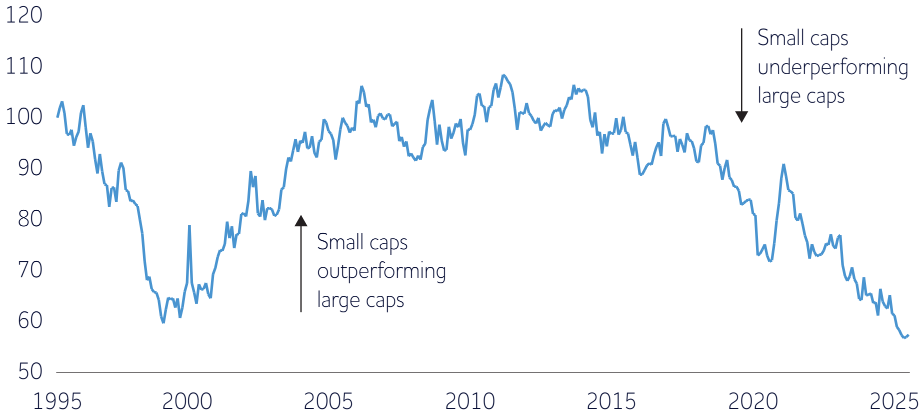
## A challenging few years for smaller companies

The past few years have been challenging for smaller companies. In fact, 2024 marked the eighth year in a row of underperformance compared to larger firms. Many small caps have been hit harder by higher inflation, rising interest rates and concerns over slowing economic growth. With more limited resources and less experienced management teams, they've often found it tougher to navigate these headwinds.

Figure 1 shows just how far small caps have lagged large caps in the US. But history also tells us that small caps often bounce back strongly after prolonged periods of weakness, especially when interest rates fall and economic conditions begin to improve.

### Figure 1: Small caps vs large caps – the long-term picture

Smaller companies have underperformed in recent years, but past cycles show the potential for strong recoveries. This chart shows the relative performance of US small caps vs large caps, rebased to 100 in January 1988




Source: Bloomberg

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## Why we see potential from here

We believe the outlook for small caps is becoming more favourable. Valuations are near their lowest levels in 25 years relative to large companies, and growth forecasts for small caps are improving, with analysts now predicting faster earnings growth in the years ahead. That's the first time this has happened in five years.

A number of broader trends also stand to benefit smaller firms:

- Deregulation and reshoring: policies designed to bring production back home may favour domestically focused businesses. This is likely to benefit US smaller companies.
- Infrastructure spending: government investment could support smaller companies across sectors
- Lower interest rates: small caps tend to be more sensitive to rate changes, so any cuts by central banks could provide a meaningful boost

At the same time, we've seen huge capital flows into a narrow group of large stocks, such as the so-called Magnificent 7 (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla). First, investors are looking to diversify away from these large companies and smaller companies should benefit from this rotation from larger to smaller companies. Second, if markets experience a downturn, some of that money may exit quickly, putting larger companies at greater risk of short-term losses. That makes the diversification benefits of small caps even more compelling.

## How Omnis invests in small caps

We include small caps in our portfolios as part of our long-term strategic asset allocation, and we also use short-term tactical positioning to increase exposure when the outlook improves, as it has recently.

Importantly, strategically, we invest in small caps through active managers who specialise in this part of the market. That's because smaller companies tend to be under-researched and less efficiently priced. In our view, this creates opportunities for experienced managers to identify strong businesses that are trading well below their true worth.

Active management also helps us avoid many of the unprofitable or lower-quality companies that often appear in small cap indices. With the right process and discipline, we believe it's possible to add meaningful value in this part of the market.

## What this means for your portfolio

It's been a tough run for small caps, but the tide may be turning. With attractive valuations, improving growth forecasts and a more supportive economic backdrop, we believe smaller companies could be well placed to outperform.

Our active approach helps us identify quality businesses in this under-researched part of the market and avoid the weaker ones. That's why we see small caps as a long-term opportunity.

To find out more about how we manage your portfolio, please speak to your financial adviser or visit omnisinvestments.com



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