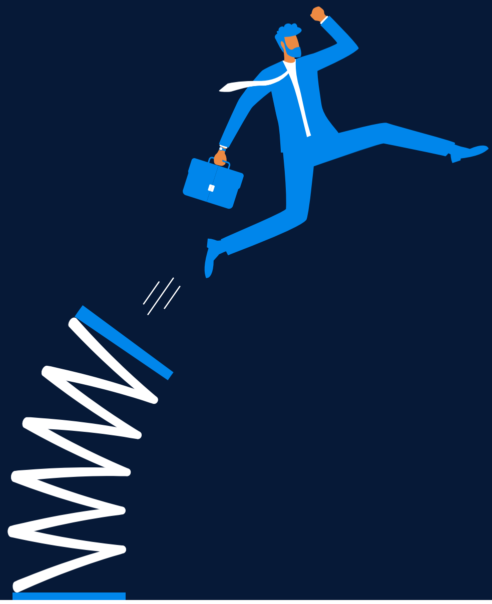
The forgotten asset class: U.S. smaller companies could be poised for a resurgence



From the Field

Key Insights

- The outlook for U.S. small-cap stocks looks better now than it has for many years.
- The intense investor focus on large-cap tech stocks in recent years means there is a lot of pent-up energy behind an eventual reallocation, down the market cap scale.
- Improved performance of U.S. smaller companies since the U.S. election in November could mark the start of a sustainable reallocation of assets within the U.S. equity market.

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The outlook for U.S. small-cap stocks looks better than it has for many years, underpinned by a combination of attractive valuations, lower U.S. interest rates, and the pro-domestic business leanings of newly elected President Donald Trump. Importantly, the rotation into U.S. smaller companies that commenced during the fourth quarter of 2024 is potentially sustainable, with some key factors supporting this constructive view.

Supportive valuations and technical backdrop

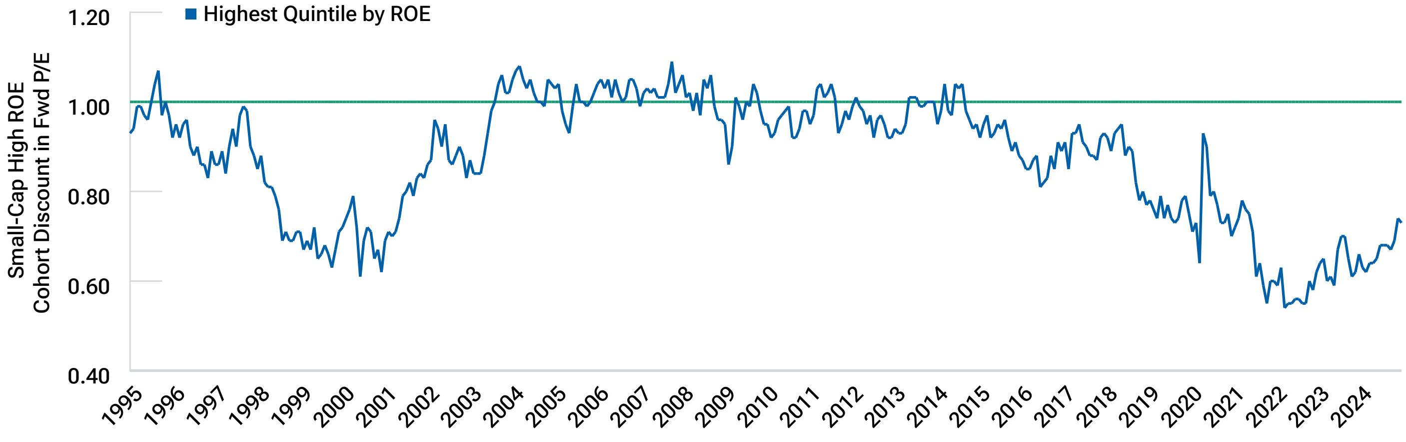
After more than a decade of lackluster performance, U.S. smaller companies are trading at a valuation discount, both compared with history and relative to larger U.S. company peers. A great deal has been written about the "extremely cheap" relative nature of smaller company valuations generally. However, an important caveat must be added to this statement, namely that it is specifically "quality" smaller companies that appear significantly undervalued.

One of the most cited reasons for the wide valuation gap that has opened between U.S. small-and large-cap companies, is the divergence in the quality of the companies in each respective universe. Indeed, the number of negative-earning small-cap companies in the Russell 2000 Index has steadily increased in recent years and now makes up around 40% of the entire index. In comparison, negative-earning large-cap companies represent less than 10% of the S&P 500 Index[1]

[1] Source Thomson Reuters Refinitiv, as of December 31, 2024.

Quality smaller companies are trading at generationally low valuations

(Fig. 1) Top quintile U.S. smaller companies based on return on equity (ROE)



As of December 31, 2024.
Valuation measurement is based on median 12-month forward price to earnings, where return on equity (ROE) and forward price to earnings are available, excluding real estate, updated on a rolling monthly basis. This chart measures valuation differences between small-cap stocks and large-cap stocks that rank in the first quintile of ROE in the Russell 3000 universe. ROE is used as a measure of company quality. It is calculated by dividing the last 12 months' earnings of individual companies by the average of their book value. The Russell 3000 Index combines components of the Russell 1000 Index of large cap companies (with a market cap of more than $8 billion) and the Russell 2000 Index of small cap companies (with a market cap ranging from around $300 million to $8 billion). Sources: Russell, MSCI, Thomson/IBES, Refinitiv. All rights reserved. Analysis by T. Rowe Price. See Additional Disclosures.

However, adjusting the lens to focus only on those profitable smaller companies in the index—good businesses that have been left behind as investors have fixated on large-cap growth companies—these higher-quality smaller companies are trading at a generationally wide discount (Fig. 1).

Although the market's concentration at the top end has worked against smaller companies in recent years, we think that we are potentially approaching a turning point, creating a technical environment that could provide a substantive impetus, over a multiyear time frame.

We liken this environment to a coiled spring–there is a lot of pent-up energy behind an eventual reallocation of assets out of highly concentrated U.S. large-cap growth stocks and into other parts of the market. The potential impact of this reallocation impulse is substantial–we saw some early signs of this in the sharp rotation into smaller companies during the fourth quarter of 2024. Significantly, it does not take huge inflows to have a meaningful impact on the performance of the smaller companies segment.

Policy implications of the new administration

During campaigning, President Trump championed policies aimed at supporting domestic American business. Even if some of these pledges are ultimately watered down, the pro-domestic leanings of the new administration are particularly supportive of U.S. smaller companies:

- **Tariffs**–Mr. Trump has previously suggested applying tariffs of 10% to 20% on imports from all foreign trading partners, and between 60% and 100% on imports from China. The likelihood of these tariffs being applied at such levels remains to be seen however, any additional import costs for foreign trading partners would be advantageous for domestic U.S. competitors.
- **Deregulation**–Trump has advocated reducing federal oversight across a range of industries, including energy, financial markets, and health care. These initiatives are likely to be positive for smaller companies that can sometimes struggle with onerous regulatory requirements. The Republican Party's control of the House and Senate increases the prospect of lower regulation–in clear contrast to the heightened regulatory backdrop applied under the Biden administration.

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- **Tax cuts**–Trump has said that he will seek to lower the corporate rate to 15% from 21%. While the feasibility is uncertain, tax rates paid by smaller companies tend to have a greater impact on earnings and profits than their larger counterparts. This is because large, multinational firms can book profits in lower-tax jurisdictions around the globe.

Key areas of impact

Based on our view of where we are in the economic cycle, we believe that the extended period in which large companies have outperformed smaller companies may be easing. All that is required is for a relatively modest broadening of economic drivers and reallocation of assets to notably impact the performance of the smaller company segment of the market.

Many sectors, like industrials, for example, have been mired in recession for some time but are showing signs of emerging from that cycle. Deglobalization, lower interest rates, potentially lower taxes, and deregulation are all positives for industrial companies, encouraging management teams to potentially increase capital spending. Financials is another sector showing signs of resurgence after years of underperformance, stimulated by expected lighter regulation under the new administration. Importantly, smaller company indexes have notable weightings in both of these areas and even modest improvements in the regulatory environment, and business conditions generally can have a disproportionately significant impact on the performance of the smaller companies' asset class.

A stock pickers paradise

(Fig. 2) The size and diversity of the U.S. smaller companies market offers favorable opportunities

As of January 31, 2025.
[1] Alpha is the excess return on an investment over and above that of the market or index.
Source: T. Rowe Price.

Big opportunities in smaller companies

We see the potential for quality U.S. small companies to deliver positive absolute and relative performance, with many of these domestically focused businesses poised to benefit from the economic growth and pro-business policies that are expected from the incoming administration. There appear to be many good opportunities to invest in highly innovative, fast-growing companies that have the advantage of serving the largest domestic market in the world. Finally, any sharp reallocation of assets toward quality smaller companies could have a magnified, "coiled spring" effect on returns, given the historically cheap valuations currently available in this dynamic part of the U.S. equity market.

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