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INVESTMENT INSIGHTS
First Quarter 2025

A time and a place for small cap equities

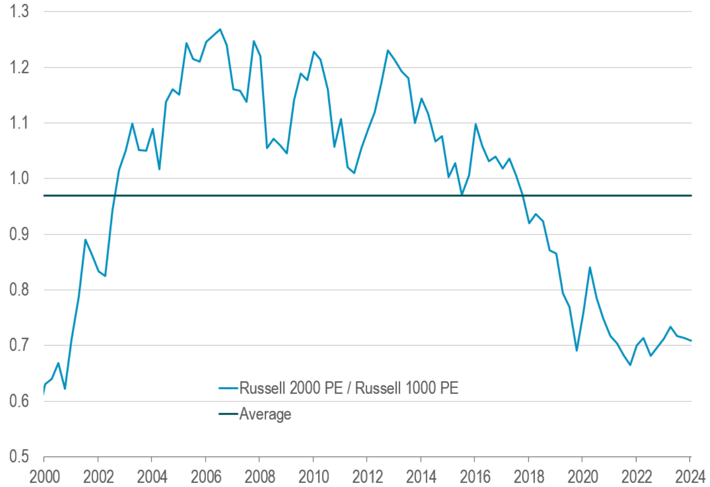
Since handily outperforming both large caps and the broader U.S. equity market for the one-year period following the end of the COVID recession in April 2020, small cap stocks have generally lagged, despite posting double-digit gains in three of the past four calendar years and besting larger companies in the second half of 2024. This small cap underperformance reflects in part the narrow but persistent market leadership of a few mega cap technology companies supported by artificial intelligence (AI) tailwinds. Of course, the attractiveness of an asset class, or select opportunities within it, isn't simply a function of recent relative performance. Valuations, earnings growth estimates and interest rate expectations are also key factors for considering small caps in the current environment. Additionally, Nuveen's equity specialists believe a strategic allocation to the asset class remains an important component of a well-diversified, long-term investment portfolio.

Global Equities Team
Nuveen

U.S. SMALL CAP STOCKS REMAIN ATTRACTIVELY VALUED

In absolute terms, valuations for U.S. small cap equities are in line with their 16.4x average over the past 25 years, as measured by the 12 months' forward price-to-earnings (P/E) ratio for the Russell 2000 Index. But after small cap returns trailed those of large caps by nearly 13 percentage points in 2024, the Russell 2000's P/E relative to the large cap Russell 1000 Index is hovering near long-term lows (Figure 1). With large caps looking expensive on this basis, valuations currently favor small caps. Similarly, albeit to a lesser degree, the Russell 2000's P/E versus that of the equal-weighted S&P 500 Index shows small caps still trading at a discount at the end of the fourth quarter of 2024.[1]

Figure 1. Small caps look inexpensive vs. large caps
P/E ratio, Russell 2000 Index relative to Russell 1000 Index*



Source: FactSet as of 31 Dec 2024. *12 months forward.

> *With large caps looking expensive on a relative P/E basis, valuations currently favor small caps.*

A number of asset class characteristics have contributed to small cap underperformance in the prevailing macro environment of the past few years. Compared to their large cap counterparts, smaller companies: (1) have shares that tend to be more reactive to changes in the economic cycle, as their growth is more tied to the U.S. economy; (2) carry higher levels of variable rate debt (41% versus only 11%, as shown in Figure 2); and (3) generally lack the advantages of scale to navigate global market challenges and what at times can be a cumbersome regulatory environment.

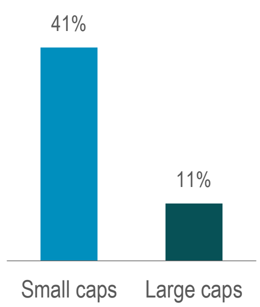
Higher interest rates are a headwind for small caps not only because interest expense dampens earnings, but also in terms of the discount rate used when assessing firm value, since many of these companies are longer-duration in nature (i.e., the present value of their future cash flows is lower).

Given the ongoing combination of late-cycle deceleration and inflation that remains above the Federal Reserve's 2% annual target, it's not surprising that small caps have tended to be out of favor — or that the number of unprofitable small cap companies has increased substantially. Weak profitability numbers require a higher risk premium for small caps, which is reflected in lower valuations.

That said, while valuations are helpful in gauging the relative attractiveness of small caps, there are other salient criteria to consider.

Figure 2. Small caps carry more variable rate debt

(as % of total debt)



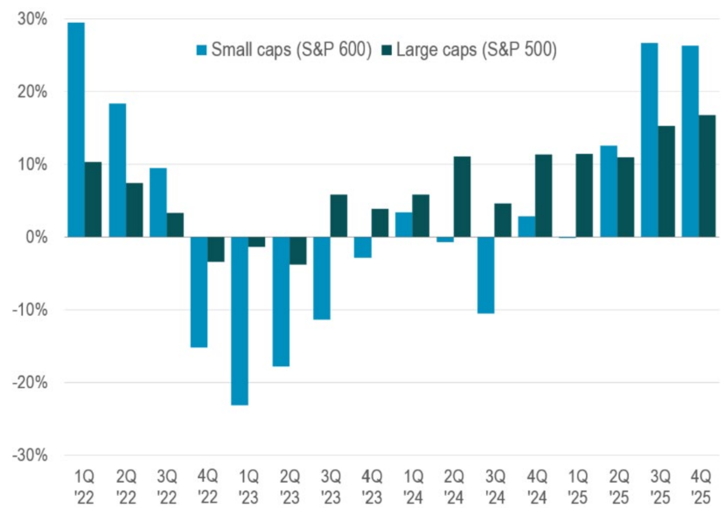
Sources: FactSet, BofA U.S. Equity and U.S. Quant Strategy as of March 2024.
Representative indexes: small caps: Russell 2000 Index; **large caps:** S&P 500 Index.

SMALL COMPANIES, POTENTIALLY BIG EARNINGS GROWTH ADVANTAGE

At the macro level, sticky inflation and a higher-for-longer rate environment have determined the trajectory of broad equity market performance over the past two years. Corporate earnings growth, however, has been the primary driver of stock price appreciation over the long run, and in our view will continue to be — particularly as inflation and interest rates gradually normalize from historically high levels. In such an environment, fundamental earnings growth and positive earnings per share (EPS) surprises may reclaim the spotlight and be rewarded accordingly.

Figure 3. Earnings growth estimates are increasing

*Bottom-up consensus earnings growth estimates**



* Year over year. Earnings growth estimates shown after 3Q24 are projections as of 31 Dec 2024.
Data source: FactSet.

That could give smaller companies an earnings growth advantage going forward, after lagging large caps on this metric for multiple consecutive quarters amid rapidly rising interest rates and heightened fears of a U.S. recession from late 2022 through early 2024. In the current environment, the odds of a recession are lower as the economy has proven resilient, productivity has improved and Fed policy appears more attuned to both the price stability and employment objectives of its dual mandate — a plus for cyclical areas of the market like small caps. Analysts expect earnings to grow faster for smaller companies beginning in the second quarter of 2025 (Figure 3, above) due to potential accelerated economic growth, lower interest rates and policy shifts from Washington, D.C.

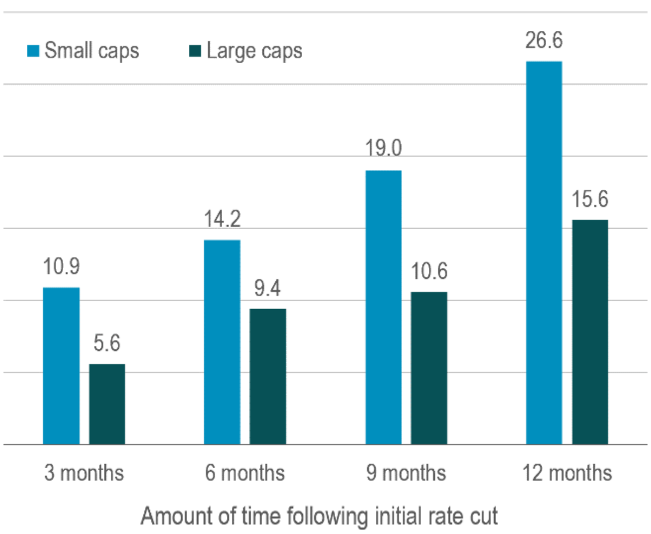
IN PRIOR FED CYCLES, INITIAL LOOSENING BOLSTERED SMALL CAP RETURNS

Nuveen currently anticipates two Fed rate cuts of 25 basis points (bps) each in the second half of this year. If enacted, this would lower the target federal funds rate to a range of 3.75%-4.25% by the end of 2025.

Historically, small cap stocks have outperformed large caps following the first move in a Fed rate-cutting cycle (Figure 4, below). Why? Because smaller companies generally benefit from easing financial conditions, rely more on borrowing through short-term variable debt to finance growth than large companies do (Figure 2) and pay higher interest rates on that debt. When the Fed eases, the cost of capital declines. A given small company can refinance at cheaper rates and use the proceeds to expand its business, which in turn can help boost its stock price. There's no guarantee history will repeat itself, but the Fed's initial cut of the current cycle, which occurred in September 2024, could serve as a potential catalyst benefiting relative returns for small caps down the road.

Figure 4. The first cut's been the kindest (to small caps)

*Returns (%) after Fed rate-cutting commenced**



* Average returns based on past 13 rate-cut environments starting Nov 1957.

Reflects the use of the federal funds rate from 1954 until 1963, the discount rate from 1963 until 1994 and the federal funds rate thereafter. Representative indexes: Large cap stocks: Russell 1000 Index, inception date 31 Dec 1978; small cap stocks: Russell 2000 Index, inception date 1 Jan 1984.

Past performance does not predict or guarantee future results. It is not possible to invest directly in an index.

Sources: Federal Reserve Board, Haver Analytics, Center for Research in Security Prices (CRSP), University of Chicago Booth School of Business, Jefferies.

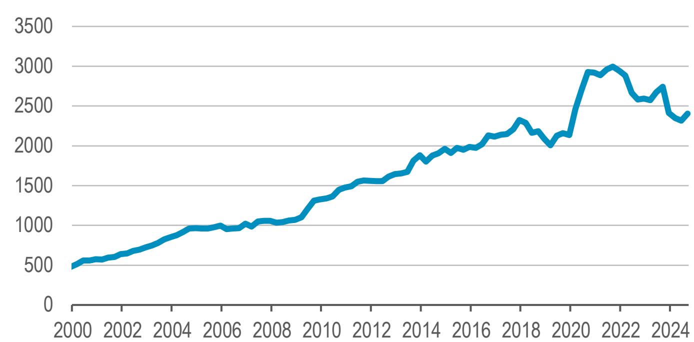
POLICY SHIFTS FROM WASHINGTON, D.C. MAY PROVE SUPPORTIVE

Following the 2024 election of Donald Trump and the return of control of both legislative branches to the Republican Party, equity markets have been optimistic about an economic policy agenda that prioritizes lower taxes and broad deregulation of business.

Developments could include an extension of the 2017 Tax Cuts and Jobs Act signed into law under the first Trump administration, easing the federal income tax burden on U.S. workers and potentially modifying state and local tax deductions. Additionally, regulatory relief could encourage an increase in mergers and acquisitions (M&A), typically a boon to smaller companies.

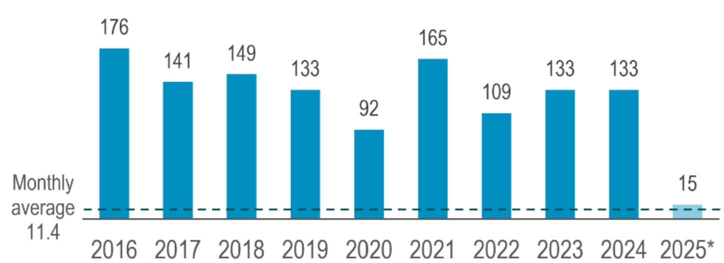
Figure 5. With corporate balance sheets still flush ...

Cash on hand ($ billions), Russell 3000 Index companies



... the pace of M&A activity may pick up

Number of deals, 2016-2025



Sources: FactSet, FTSE Russell, Jefferies. Last observation date for amount of cash on balance sheets is 30 Sep 2024. *Number of M&A deals for 2025 is as of 31 Jan 2025.

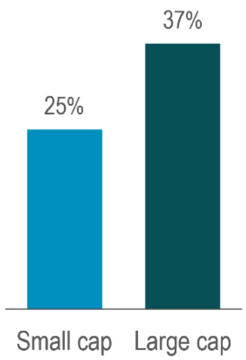
This is because larger companies may be looking for ways to grow their business as small cap valuations remain compelling and companies have ample cash on their balance sheets (Figure 5, above). M&A activity got off to a good start in 2025, with the number of deals in the month of January exceeding the full-year monthly average over the prior nine years (Figure 5). The pace could pick up if anticipated deregulation materializes.

The impact of expanded U.S. tariffs, another key focus of the Trump administration, may vary. Overall, such tariffs are likely to be more disruptive for U.S. companies that derive significant revenue from non-U.S. sources of demand, which tend to be larger cap.

As an example, we looked at firms whose reported non-U.S. revenue accounted for more than half of their total revenue in the last fiscal year. Of those firms, 37% were large caps, compared to 25% for small caps (Figure 6).

Figure 6. U.S. small caps less exposed to tariffs

% of firms with > half of revenues from non-U.S. sources



Source: Bloomberg, L.P., Feb 2025. Based on reported revenue for last fiscal year. **Representative indexes: small caps:** Russell 2000 Index; **large caps:** S&P 500 Index.

We are mindful, however that the imposition of new U.S. tariffs on imported goods, especially from major trading partners, could exacerbate global trade tensions. Tariffs also might contribute to a reacceleration in U.S. inflation, which could elevate interest rates and would be an unwelcome source of heightened volatility for both equity markets generally and small caps in particular.

THERE'S NO ONE "RIGHT" WAY TO INVEST IN SMALL CAPS

Investors seeking opportunities in small cap equities can choose from a range of approaches:

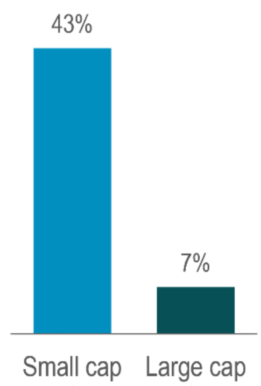
- Growth, value, core or multistyle
- Active, quantitative or index
- U.S. or global/international

Nuveen offers strategies across the complete small cap spectrum for both individual and institutional investors. Whether separately or in combination, these approaches have the potential to deliver attractive long-term returns and may be well-suited for the small cap equity portion of a diversified portfolio. A core, actively managed mandate, for instance, can aim to provide flexibility in a market where small cap index performance is often bifurcated between growth and value. Relative weightings of cyclical and defensive sectors may help active core managers navigate risk-on and risk-off environments, which tend to favor one style over the other. And because the small cap arena is less followed by analysts and less efficient than the broader market, active managers may have enhanced opportunities to add excess returns through stock selection.

Moreover, active managers have the opportunity to limit exposure to lower-quality companies and increase exposure to higher-quality companies — a notable advantage given the relatively high percentage of unprofitable names in the small cap space (Figure 7). Of course, any investor's choice of a particular small cap approach depends on many factors, starting with their investment objectives and time horizon.

Figure 7. Active management may help avoid lower-quality names

*% of unprofitable small vs. large cap companies**



*As of 4Q 2024. Data source: FactSet. **Representative indexes: small caps:** Russell 2000 Index; **large caps:** S&P 500 Index.

CONCLUSION

With their potential for strong long-term earnings growth and total returns, small caps have earned a place as a strategic equity component of diversified portfolios. Over the course of nearly a century, small caps have not only outpaced the rate of inflation but have also generated a higher compound annual return than other major U.S. asset classes, including large cap stocks (Figure 8).[2] The relative performance of small caps has varied over shorter periods, with the economic and market dynamics discussed in this opinion piece suggesting opportunities for a potentially improving outlook.

Identifying and taking advantage of small cap opportunities requires an asset manager who knows where to look and has investment capabilities across multiple styles, approaches and geographies.

At Nuveen, experienced equity professionals are empowered by our integrated platform to focus on adding alpha and building portfolios that meet our clients' objectives. We currently manage $482 billion in equities, including $28 billion in small and mid cap assets.[3]

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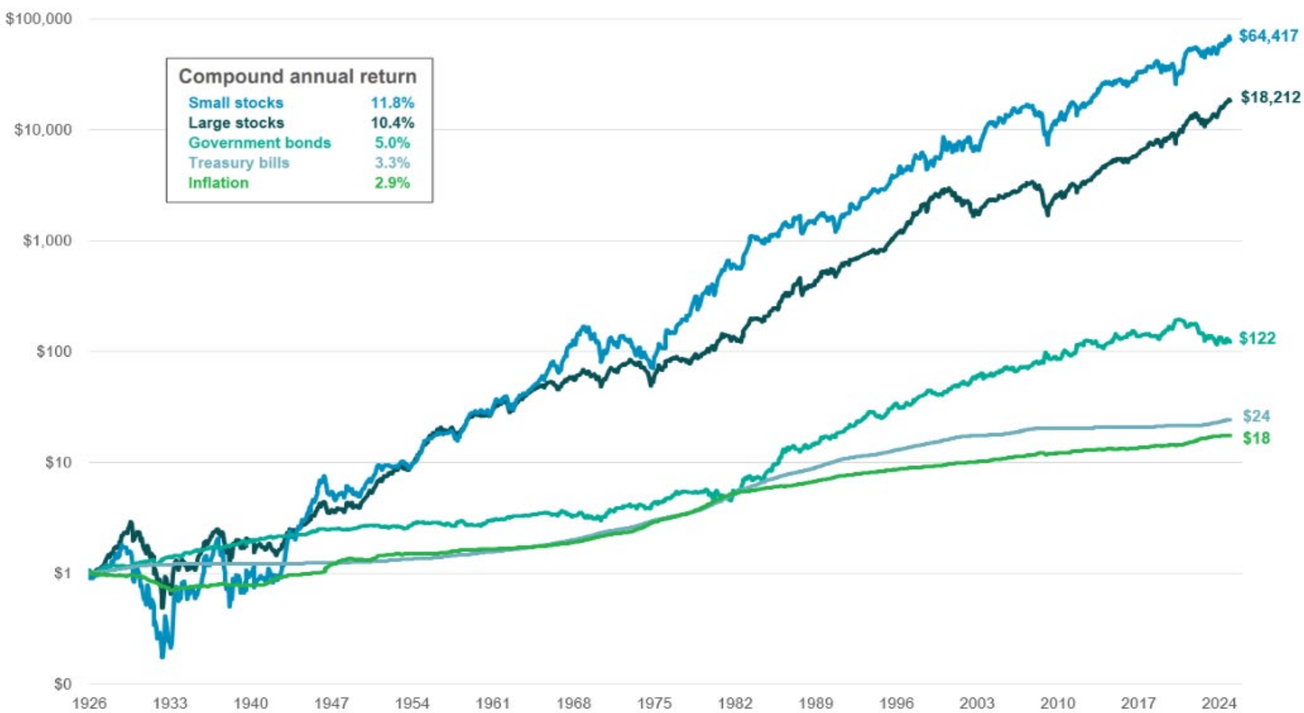
Figure 8. Small caps have substantially outperformed over the long run

Ibbotson® Stocks, Bonds, Bills and Inflation BBI® (SBBI), 1926-2024



Last data observation: 31 December 2024. Source: Morningstar Direct.

For more information, please visit us at nuveen.com.

Endnotes

1 Source: FactSet.
2 Source: Morningstar.
3 As of 31 Dec 2024.

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