



There's value in both small and large companies; they just offer different things (UBS)

# Sizing your equity allocation correctly matters

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**Diversification and the search for returns comes in many ways, and it can be accomplished via different approaches. It can happen through an economic sector basis (go long healthcare, short utilities), geographically (go long US, short Italy), even style-wise (go long growth stocks, short value firms). Hence, there's a variety of strategies, which, if implemented appropriately, enable investors to have a diversified portfolio and capture alpha.**

**In this note, we focus on explaining the particularities of size-driven allocation, which is relevant given our current most preferred recommendation on small-cap versus large-cap equities.**

## **First, though, what is this small-cap, large-cap thing?**

As per the Financial Industry Regulatory Authority (FINRA), small-cap companies are those with a market capitalization of between USD 250mn and USD 2bn, while large-cap are those greater than USD 10bn. This metric is a general outline, though, and shouldn't be taken as a specific rule; remember, a market rally can suddenly change the market cap of a firm in a matter of seconds.

So, let's put a face to the numbers; a real life example could give us a better idea:

**Small-cap:** Bank of Hope – ticker: HOPE; market cap: USD 1.3bn. This is a “small” bank, headquartered in Los Angeles, focused on the Korean American community.

**Large-cap:** Ford Motor Company – ticker: F; market cap: USD 47.7bn. Your correspondent is pretty certain you've heard of this firm.

In the most simplistic terms, large-cap firms are generally those with substantial market value, which generally also come with brand recognition; in turn, small-caps, as the word suggests, tend to be small firms, which potentially you didn't even know traded in the stock market.

### **In any case, why is it a good idea to have allocations in both of these types of stocks?**

Large-caps are valuable holdings as a long-term investment, as they provide sturdy returns in a variety of economic environments. These companies tend to be less volatile, are better suited to manage in activity slumps, and have scale advantages that enable them to have more reliant earnings.

Meanwhile, small-cap companies have a greater degree of upside, as these firms are theoretically expected to grow faster over time. Thus, acquiring small-cap exposure enables investors to capture the shareholder value that is created as firms evolve. However, the risk is that many smaller companies have less proven business models and generally weaker balance sheets—in other words, they are lower-quality.

### **So what's the best thing to do?**

Well, to own both types of stocks. As per the textbook, large-caps give you resilience and help to assuage volatility, while small-caps—if properly managed—can provide you with out-of-the-ordinary returns. Remember, the whole point of having a balanced portfolio is to appropriately allocate eggs in different baskets to accomplish the best performance possible.

### **What's our take on small-caps at this moment?**

In the Chief Investment Office (CIO), we think certain dynamics will benefit small-caps more than large-caps this year.

1) Our base case of Fed rate cuts this year implies a backdrop that should substantially aid small-cap firms' balance sheets. Note that nearly half of the firms on the Russell 2000<sup>1</sup> have floating-rate debt. Hence, as rates come down, the financing costs of these firms will, too, and profitability metrics should improve. Better profitability should fuel earnings and potentially stock prices.

2) Small-cap firms appear cheap relative to large-caps and compared to their own history; this is notable across several metrics, including forward price-to-earnings and price-to-book ratios. The headwinds to valuations (high rates, the regional banking crisis, declining profits) look to be in the rear-view mirror. Hence, we expect that as the year progresses, and some of these factors dilute, investors should start recognizing the upside value that small-caps are offering.

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For more, see the recent report: [US Equity and style](#)

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<sup>1</sup>A small-cap equity benchmark.

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