

BEYOND THE MAGNIFICENT SEVEN

REBALANCING PORTFOLIOS WITH
GLOBAL SMALL CAPS



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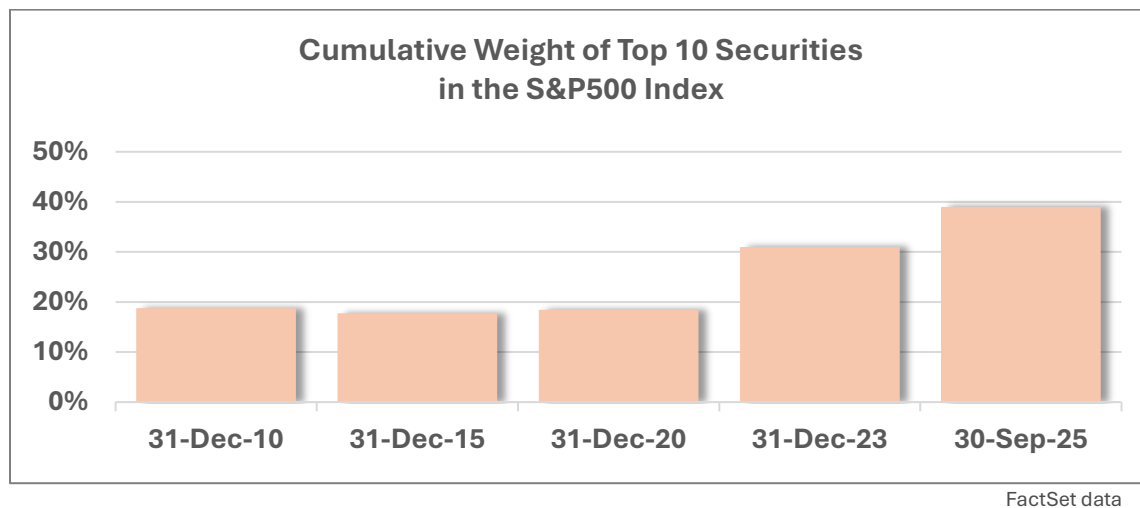


BEYOND THE MAGNIFICENT SEVEN: REBALANCING PORTFOLIOS WITH GLOBAL SMALL CAPS

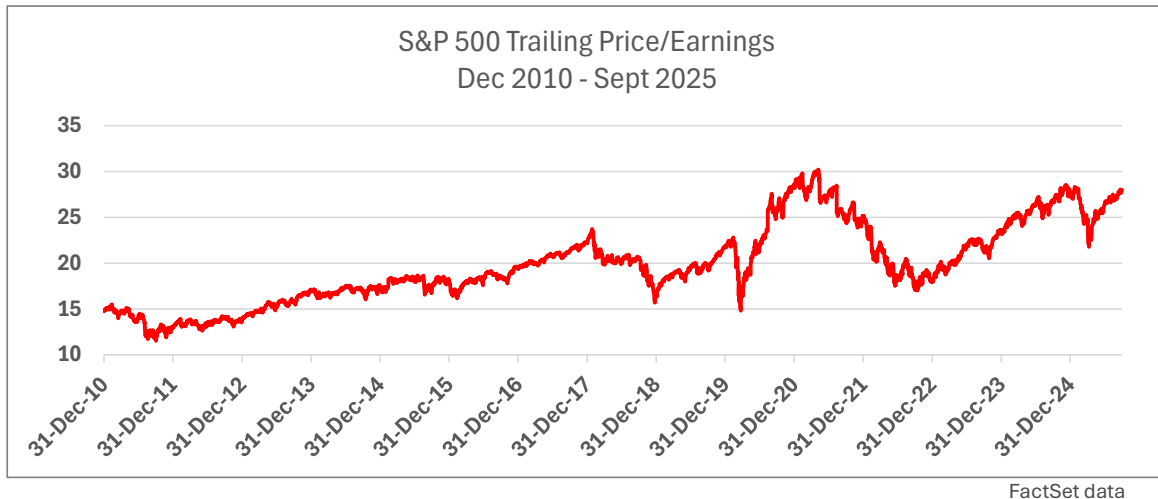
For over a decade since the 2009 bull market began, U.S. large-cap equities - especially a handful of mega-cap technology stocks - have delivered stellar gains. This dominance of a few giants has rewarded investors handsomely, but it has also introduced new vulnerabilities. Today, U.S. large-cap benchmarks are unusually top-heavy and expensive, which raises the risk profile for investors. To lower potential downside risk, the prudent path forward is to reallocate a portion of portfolios into high-quality global small-cap equities.

THE CONCENTRATION RISK IN U.S. LARGE CAPS

The recent run-up in U.S. large caps, driven by the “Magnificent Seven” tech megacaps, has left the market dangerously concentrated. Just seven stocks (Apple, Microsoft, Amazon, Alphabet/Google, Meta, Nvidia, and Tesla) now make up nearly one-third of the S&P 500’s market capitalization. In fact, the top ten holdings in the S&P 500 now represent almost 40% of the index weight, compared to 20% in 2010 (see chart below). Such dominance means the S&P 500’s performance is disproportionately dependent on a few names, undermining the benefits of diversification.



The valuation risk is evident – these mega-caps trade at high earnings multiples after their huge run-up. Their sheer size also means any stumble can ripple through the entire index. This isn’t just a theoretical concern: in 2023-2024, those seven stocks soared +159%, while the other 493 companies in the S&P 500 rose only +28%. The Magnificent Seven contributed over half of the S&P 500’s total return in 2024 alone. This narrow leadership masks weakness in many other stocks and leaves portfolios more vulnerable to a pullback in a few large tech names. If one of these giants misses earnings or faces a regulatory issue, an index-tracking portfolio could suffer an outsized hit.



Investors holding cap-weighted large-cap indices may unknowingly be carrying concentration risk that resembles a tech-heavy stock portfolio. This level of concentration is unprecedented in recent history and reduces the diversification that broad equity exposure is supposed to provide. It's a double-edged sword: the mega-caps have been fantastic performers (a testament to their earnings power and innovation), but their very success now creates a single-point-of-failure risk for investors.

AN OVERSTRETCHED CYCLE: LARGE VS. SMALL CAP PERFORMANCE

History tells us that market leadership is cyclical. Large caps and small caps have traded periods of outperformance over the decades, often in multi-year cycles. We appear to be at an extreme point in one of those cycles. For 14 years now, large caps have steadily outpaced small caps, far longer than the historical average cycle length of roughly 9–11 years, according to the CFA Institute. In fact, aside from brief spurts, small-cap equities have lagged their large-cap counterparts consistently since around 2011. Such a streak is highly unusual and past cycles of small-cap underperformance (e.g. the late 1980s–90s period) eventually gave way to strong small-cap rebounds.

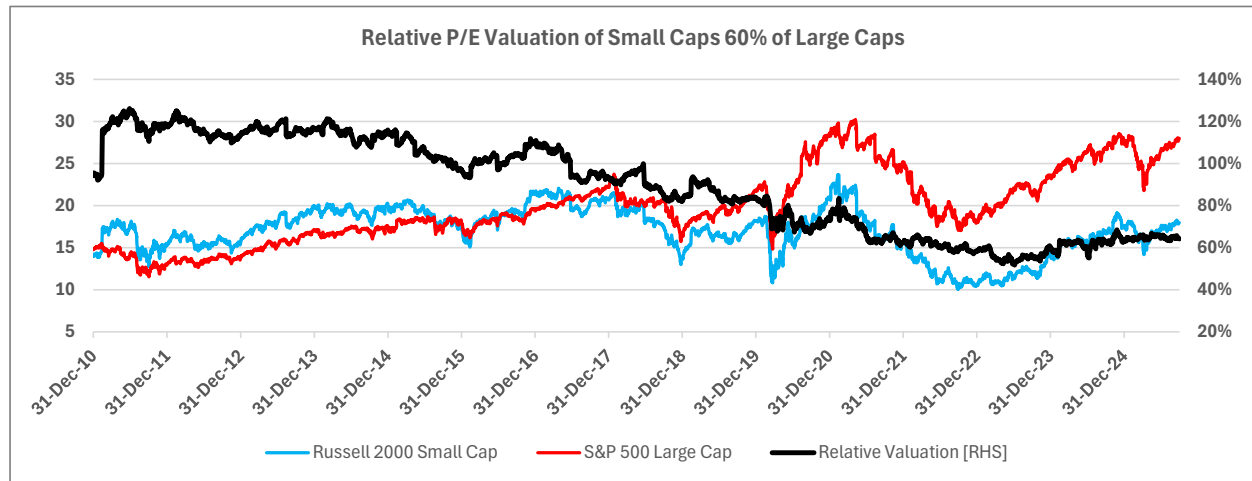
Multiple signs suggest the current cycle of large-cap dominance may be in its final innings. Market breadth is very narrow (with gains driven by a few large stocks), and valuations are excessive by historical standards. Typically, the biggest gains in each cycle occur near the beginning and the very end of the cycle. Historically, small caps often surge when a cycle turns. The extended duration of large-cap outperformance, coupled with extreme concentration, hints that a reversion could be overdue. Indeed, we saw a glimpse of this in 2025's market action: after a sharp pullback in early 2025, small-cap indices rallied strongly off the lows and in some cases began outpacing large caps. While one quarter or year doesn't make a trend, it underscores small caps' potential to recover quickly when conditions shift.

From a macro perspective, shifting economic winds could favor smaller companies in the coming years. Large multinational firms enjoyed a globalization-fueled boom for years, but trends like deglobalization and onshoring of supply chains are gaining momentum. Small-cap companies, which are generally more domestically focused, stand to benefit as governments and firms invest in local manufacturing, infrastructure, and defense projects. In other words, the economic backdrop

that favored mega-caps might be evolving, opening the door for smaller, locally oriented businesses to thrive as the cycle turns.

VALUATIONS: SMALL CAPS AT DECADES-HIGH DISCOUNT

One of the most compelling reasons to rotate into global small caps now is valuation. By numerous measures, high-quality small-cap stocks are trading at unusually attractive valuations relative to large caps and relative to their own history. The past years of underperformance have left small-cap valuations depressed just as large-cap valuations became stretched. The valuation gap between small and large companies is near multi-decade extremes. For example, global small-cap equities currently trade at their steepest discount to large caps in roughly 20–30 years. A recent analysis by Vanguard found that, by price-to-book ratio, the valuation discount for global small-caps is the widest it's been in two decades. Similarly, using an earnings-based metric (EV/EBIT), U.S. small caps' valuations relative to large caps are around their lowest level in 25 years. In plain English, smaller companies are much cheaper than the S&P 500 blue-chips by historical standards.



FactSet data

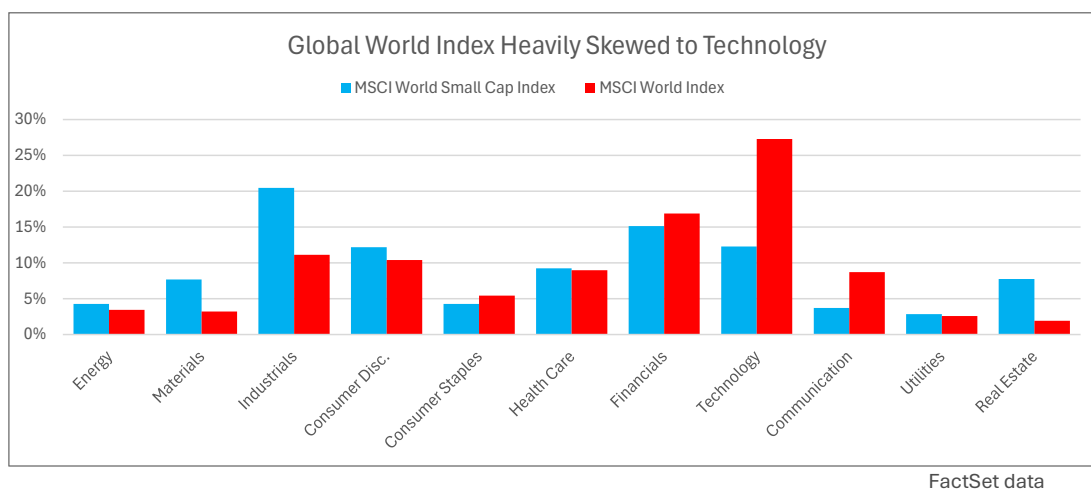
Why are they so cheap? Part of it is the lagging recent performance: investor money has been chasing the big winners (large tech), leaving smaller firms overlooked and undervalued. Another factor is that small caps went through a tough earnings stretch in the last two years, which kept their prices down. Now, however, the outlook is brightening. Many smaller companies are emerging from a earnings recession and could see a sharp rebound in profits off a low base. In fact, consensus forecasts for 2024–2025 show small-cap earnings growth finally exceeding that of large caps after a long gap. This combination of low valuations and improving earnings is a recipe for potentially strong future returns.

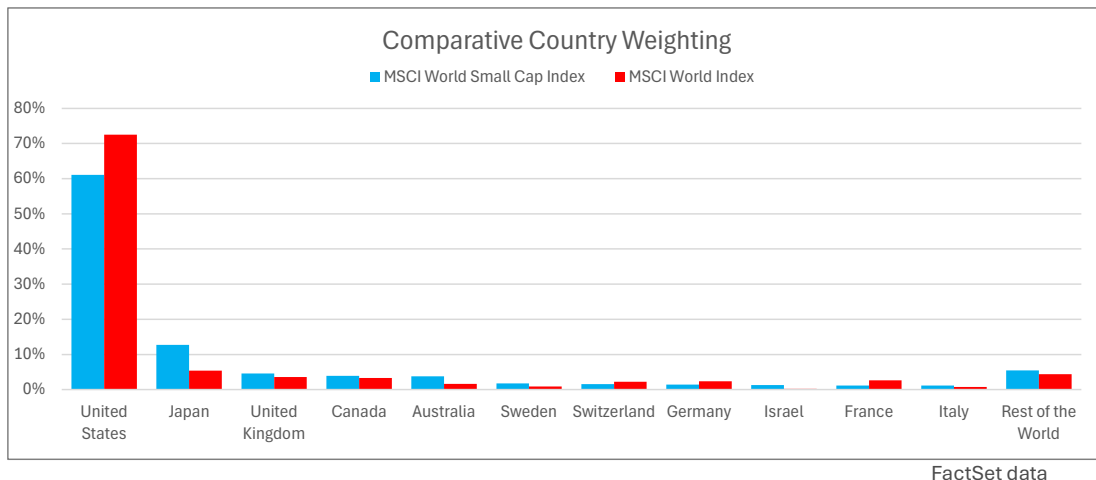
It's worth noting that small-cap indexes include a mix of both profitable, growing businesses and some unprofitable or speculative ones (such as early-stage biotech or tech firms). This can sometimes skew aggregate valuation metrics. However, even when focusing on the higher-quality segment of small caps, the opportunity is clear. Many “hidden gem” smaller companies are fundamentally sound yet trade at discounts simply because they're under the radar. As investors, that's exactly where we want to hunt for value.

DIVERSIFICATION AND RESILIENCE OF GLOBAL SMALL CAPS

In a world where big-cap indices have become increasingly concentrated in a few sectors and stocks, global small caps offer much-needed diversification. This diversification comes in several forms:

- *More Balanced Market-Cap Exposure:* Large-cap indices are dominated by the top holdings, whereas small-cap indexes are far more evenly spread out. For instance, the top 10 stocks in the MSCI World (large cap) Index make up over 27% of the index, while the top 10 in the MSCI World Small Cap Index account for ~2.4% (Ref: MSCI Sept 30, 2025). And the small-cap index holds 3,855 companies worldwide, versus 1,320 in the standard World Index. This means small-cap investors are not putting all their eggs in just a few baskets, and no single company can dominate the performance. The concentration risk is dramatically lower.
- *Sector and Geographic Breadth:* Global small caps provide exposure to different sectors and regions that are underrepresented in U.S. large caps. As noted earlier, today's large-cap MSCI benchmarks are heavily skewed towards U.S. technology and internet-related companies. Over 35% of the S&P 500 is concentrated in the IT and communication services sectors, reflecting the dominance of a few tech giants. By contrast, small-cap indices have a more even distribution across sectors (16% in IT and Communication), often with greater weights in areas like industrials, materials, consumer, and real estate that get less attention in mega-cap land. While both global indices have large US weights, the World market has over 72% weight in the US (remember the tech overweighting) compared to 61% World Small Cap, which tends to have higher weights in markets like Japan and Europe. The top five country weighting after the US weight is almost 27% in the global small cap index compared to less than 15% in the World index. This breadth means global small caps can thrive off different economic trends (e.g. a manufacturing rebound in Germany or consumer growth in emerging Asia) widening the opportunity set.





- **Lower Correlation & Downside Mitigation:** Because of their broader spread and different drivers, small-cap stocks don't always move in lockstep with large caps. In fact, the small-cap segment has shown *marginally lower correlation to the broader equity market*, providing a potential cushion when large caps hit turbulence. Think of global small caps as an extra layer of diversification on top of the usual asset allocation – by owning them, you're tapping into thousands of unique businesses across various countries and industries. This can help stabilize portfolio returns when the largest stocks or sectors fall out of favor. Notably, during past market selloffs that originated in overhyped large-cap areas, small caps often held up better or rebounded faster. Their independence can make a portfolio more resilient.

Finally, it's important to address the notion of "risk". Yes, small-cap stocks are generally more volatile day-to-day and can suffer bigger drawdowns in recessions. They represent smaller businesses which can be more sensitive to economic swings. However, risk is also a function of price and concentration. At today's low valuations, a basket of quality small caps arguably carries *less* fundamental risk than chasing overvalued mega-caps that have nowhere to go but down if the rosy scenarios don't pan out. And as discussed, the diversified nature of an allocation to thousands of small companies can mitigate idiosyncratic risk – you're far less exposed to any single company blow-up compared to a FAANG-heavy (FAANG: Facebook Apple, Alphabet, Netflix, Google) portfolio. In essence, global small caps can decrease the overall risk of a portfolio that is currently over-dependent on a few large stocks, even if individually those small stocks have higher volatility.

OVERLOOKED "HIDDEN GEMS" AND ALPHA OPPORTUNITIES

Another advantage of global small caps is that they represent the less explored, less efficient frontier of the equity markets. In the U.S. and developed markets, large-cap stocks are picked over by dozens of Wall Street analysts and institutional investors. Information about Apple or Google is widely disseminated and priced in within seconds while many global small caps have no analyst coverage at all, or only local brokerage coverage. This information gap creates an opportunity for diligent investors and active managers to uncover mispricing.

For skilled active managers, the small-cap arena is rich with these “hidden gems.” Fundamentally strong businesses can be temporarily ignored or misunderstood, allowing stock-pickers to buy them at a discount. Indeed, data shows that active management tends to add more value in small caps than in large caps. One industry analysis found that the *median* active small-cap fund manager outperformed the small-cap index in most periods, whereas large-cap active managers struggled to beat their benchmarks. The combination of more inefficiencies and the ability to stray from benchmark weights (since no single stock dominates the index) means active small-cap strategies have greater alpha potential.

It’s also notable how under-represented small caps are in many investors’ portfolios. Large institutions and even retail investors often have a home bias towards large, well-known companies. Global indices like the MSCI World or ACWI have only a modest allocation to small caps by design, and some portfolios omit dedicated small-cap exposure entirely. As a result, small-cap equities are often the “missing piece” in portfolios, or at least underweight relative to their economic importance. This under-ownership can be an advantage going forward: as more investors wake up to the value and diversification benefits of small caps, increased flows could propel the segment higher. We’ve seen this cycle before – what’s unloved and under-owned eventually gets rediscovered

MACRO TAILWINDS FOR SMALL CAPS

Apart from the market dynamics and fundamentals, there are broader macro factors that could act as tailwinds for small-cap stocks in the coming years:

- After aggressive interest rate hikes in the fight against inflation, central banks are now slowing or halting rate increases. In some regions (like Europe) rate cuts have even begun, and markets anticipate that the U.S. Federal Reserve may cut rates as inflation moderates. Falling or stabilizing interest rates are generally positive for small-cap companies, which often have more floating-rate debt and are more sensitive to financing costs. As borrowing costs come down, it relieves pressure on smaller firms and can boost their earnings. Lower rates also tend to improve investor appetite for risk, which bodes well for the more volatile small-cap sector. Essentially, the tighter monetary environment that hurt small caps is poised to reverse into a friendlier backdrop.
- Around the world, governments are investing in infrastructure, energy transition, and domestic industry – policies that favor the “real economy” where many small caps operate. For example, U.S. legislation like the *Infrastructure Investment and Jobs Act* and the *CHIPS Act* are pouring capital into manufacturing, construction, and tech hardware within the U.S. Similarly, Europe and other regions have initiatives to support local businesses and build resilient supply chains. Defense spending is rising in many countries, which often benefits specialized smaller contractors and suppliers down the chain. All these efforts act as a tailwind for many small-cap companies that are geared to local and niche needs.
- There are signs of a pickup in mergers and acquisitions involving small-cap companies, as well as a pipeline of new IPOs that will expand the investable universe. With stock prices

improving and financing stabilizing, larger companies and private equity are again looking to acquire smaller innovative firms. Small and mid-caps tend to benefit the most from increased M&A activity, since they are often the targets acquired at a premium. In the tech sector, stricter antitrust enforcement has curbed the FAANGs from gobbling up every startup, which ironically leads to more startups to pursue IPOs instead. There is a backlog of late-stage private companies (in areas like software, fintech, health, and AI) ready to go public when conditions allow. Most of these will list at valuations in the small- or mid-cap range, refreshing the small-cap indices with new growth leaders. Access to these newly public innovators gives small-cap investors exposure to cutting-edge themes (AI, climate tech, biotech) that can drive future returns. The bottom line: corporate activity and capital markets trends are beginning to shine a spotlight on small caps.

In short, many of the macroeconomic and policy trends ahead – from potentially lower interest rates to government support for local industry and a friendlier M&A climate – create a more favorable playing field for smaller companies than we’ve seen in years. These are not speculative hopes, but observable shifts that reinforce the case for owning small caps alongside big names.

CONCLUSION: A BALANCED APPROACH FOR THE NEXT DECADE

To be clear, this is not about abandoning U.S. large-cap equities entirely. The Apples and Microsoft’s of the world will likely remain core holdings and continue to innovate and grow (albeit perhaps at a more moderate pace than in the past). However, prudence dictates we don’t keep all our equity exposure tethered to one narrow segment of the market – especially one that’s at peak valuations and concentration. Reallocating a portion of a portfolio from crowded large caps into high-quality global small cap equities can enhance diversification, reduce concentration risk, and position us to capture the next phase of market leadership.

Global small caps today offer a rare mix of lower valuations, improving fundamentals, and structural advantages that long-term investors should find compelling. They provide things that the current large-cap allocation lacks: exposure to thousands of differentiated companies, more balanced sector and geographic mix, and ample room for active stock picking to add value. Importantly, they can serve as a “portfolio diversifier” at a time when the broad market indices have become increasingly narrow. In an equity market that’s been described as “the market of the Magnificent Seven,” adding global small caps ensures you’re invested in the other seven thousand companies too – the overlooked engines of innovation and growth around the world.

Within the global small-cap universe, it’s also important to distinguish between speculative names and the lower-beta, higher-quality businesses that tend to hold up better in adverse markets. These are companies with consistent free-cash-flow generation, high returns on invested capital, and modest leverage—traits that provide resilience when volatility spikes. Historically, the highest-quality quartile of small-cap stocks has delivered materially better downside capture than the broader small-cap index, falling roughly half as much during major market drawdowns. In effect, they behave more like “compounders in miniature”—participating meaningfully in up cycles but protecting capital when the market turns. For allocators worried that small caps mean higher risk,

this segment shows that selectivity and quality can reshape the risk profile, offering exposure to smaller, faster-growing companies without sacrificing defensive characteristics.

History shows that cycles rotate and market leadership changes multiple times. No trend lasts forever, and often the best opportunities emerge from areas that have been left behind. U.S. large caps will always have a role, but incremental capital at this juncture may be better directed to the small-cap space where potential rewards are higher. This balanced approach pairs large-cap stability with small-cap dynamism and can help us navigate the next decade. It allows participation in any continued strength of the tech giants, while also reaping the benefits of a small-cap resurgence when the pendulum swings.

In summary, U.S. large-cap equities now carry higher risk than they have in years, after an extraordinary run that has concentrated both wealth and vulnerability at the top. By redistributing some of that exposure into global small-cap equities, investors can reduce portfolio risk and open up new return drivers. The case for global small caps rests on sound principles: diversification, valuation, cyclicalality, and plain common sense.

For investors seeking to navigate what may be the most consequential portfolio realignment in over a decade, we believe the time to act is now. The case for reallocating from an overconcentrated, fully valued large-cap universe into high-quality global small caps is both rational and timely. Our global equity team has spent years studying and investing in this universe, identifying durable, cash-generative businesses positioned to outperform across cycles. We invite investors, consultants, and fiduciaries to engage with our team to explore how a dedicated global small-cap allocation can strengthen portfolio resilience, broaden opportunity, and capture the next decade of compounding.

FOR MORE INFORMATION (US & CANADA),
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