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The case for selective small-cap exposure in diversified portfolios

Key takeaways

1. The case for small caps in the current market cycle is strengthening as valuations remain compressed, earnings expectations improve and policy tailwinds begin to build.

2. The current mix of compressed valuations, improving earnings and a potentially more favorable policy backdrop may create a timely entry point for small-cap allocations.

3. Investors should favor quality, profitability and selectivity, and they should consider international small caps to enhance diversification and return potential.

Secular and cyclical forces align in small caps' favor

Small-cap stocks were long seen as an attractive, differentiated asset class because smaller companies tend to exhibit faster growth, low correlation and greater likelihood of price dislocations (due to lower analyst coverage). As investors have gravitated toward large caps in the past few years, many have questioned the investment premise for small caps.

That changed in 2026 as small-cap stocks assumed market leadership over large caps, with the Russell 2000® Index outpacing the S&P 500® Index amid a quiet but notable improvement in momentum and breadth. Even in the face of geopolitical uncertainty, the recovery of the Russell 2000 from the 11.2% drawdown in March has been both swift and significant. As of this writing, the benchmark small-cap index is having its strongest start to a year since 1991, climbing to record levels as underlying fundamental tailwinds provide support.

The structural advantages of small caps remain in place. In addition, a broadening set of cyclical tailwinds is beginning to support the asset class, reinforcing both the near-term opportunity and the longer-term case for outperformance, alongside already attractive valuations. The last time performance, valuation and investor preference gaps were this wide was during the tech bubble of the late 1990s, which set up the subsequent period where small caps outperformed large caps in six of the following seven years by an average of 14% per year.

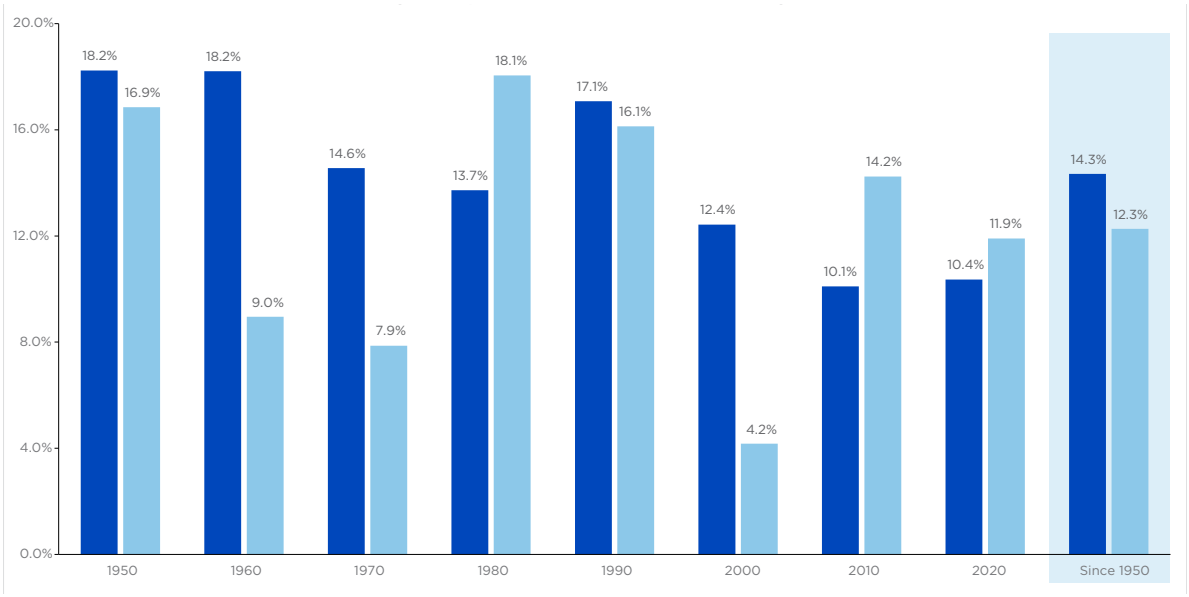
Secular factors favoring small caps

- Small caps have historically outperformed large caps across long stretches of market history, including eight of the past 10 decades (see Chart 1 below).
- Smaller companies are earlier in their development and therefore can offer faster growth potential over time.
- As an asset class, small caps don't receive as much analyst coverage as large caps, creating opportunities for active managers to add value through fundamental research.
- Small-cap indexes have materially different sector exposures and far less concentration than large-cap benchmarks, which can improve diversification and broaden opportunity sets.

Cyclical factors favoring small caps

- The current valuation gap offers the potential for a significant catch-up story, similar to the period after the dot-com bubble.
- Small caps tend to be more sensitive to short-term rates and Fed rate cuts given small companies often borrow at variable rates. This is less of a catalyst with the Fed effectively on hold, but the yield curve will likely steepen.
- Earnings growth is projected to grow 18% per year for the next two years (using the S&P SmallCap 600® Index as a proxy), despite trading at steep discount relative to large caps.
- Market leadership is showing signs of shifting from large caps to small caps.
- The S&P SmallCap 600 can offer more than cyclical upside. It also carries a dividend yield premium to the S&P 500 Index.

Chart 1: Average annual performance for smallest 30% stocks vs. largest 30% stocks

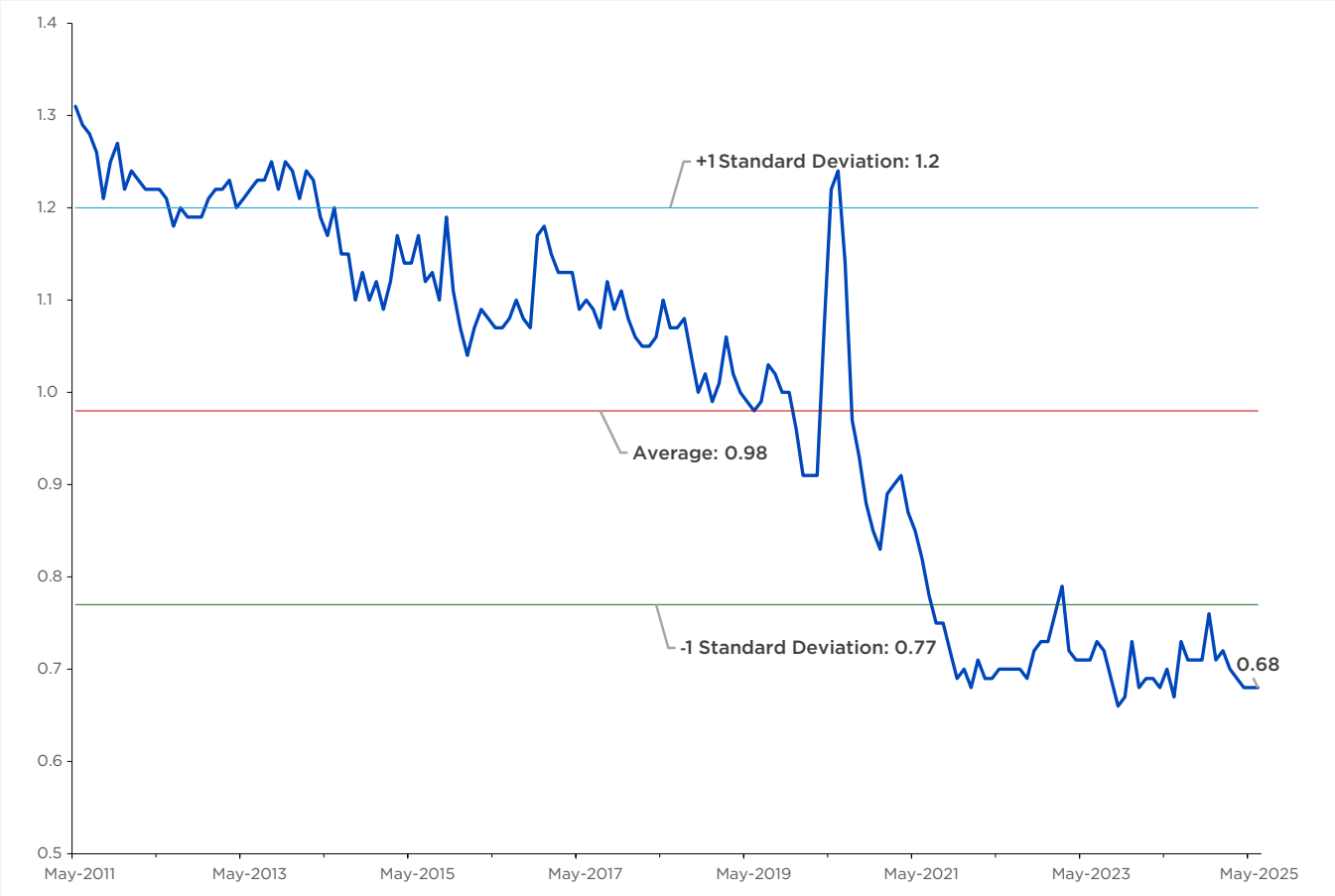


Source: Kenneth French data library, 5/31/2023. Measures all tradeable stocks and places them into groups of the smallest 30%, largest 30% and middle 40% of stocks, then takes the average of those groups to show performance over time.

Importantly, this year's small-cap outperformance has coincided with a gradual broadening in participation beneath the surface of the market, suggesting that leadership is becoming less concentrated and more cyclical in nature. At the same time, the backdrop for small companies might be shifting at the margin, with their domestically oriented revenue base and macroeconomic tailwinds providing a measure of support.

In addition, valuations remain encouraging. Even after the recent advance, small caps (as measured by the S&P SmallCap 600® Index on a forward P/E basis) currently trade at a 28% discount to the S&P 500 (see Chart 2 below). This combination of improving participation, a stabilizing macro backdrop and more compelling starting valuations raises the question of whether this period of outperformance reflects something more durable than a short-term rotation.

Chart 2: S&P SmallCap 600 vs. S&P 500 Index relative P/E (next 12 months)



Source: FactSet, data as of 5/31/26

Small caps offer a differentiated way to participate in a broadening market and enhance portfolio diversification at a time when narrow leadership in areas such as semiconductors has defined the cycle. With positioning still measured, valuations not unduly challenging and the opportunity set aligned with more cyclical and domestically-oriented dynamics, small caps may provide both meaningful return and market participation potential as the year progresses.

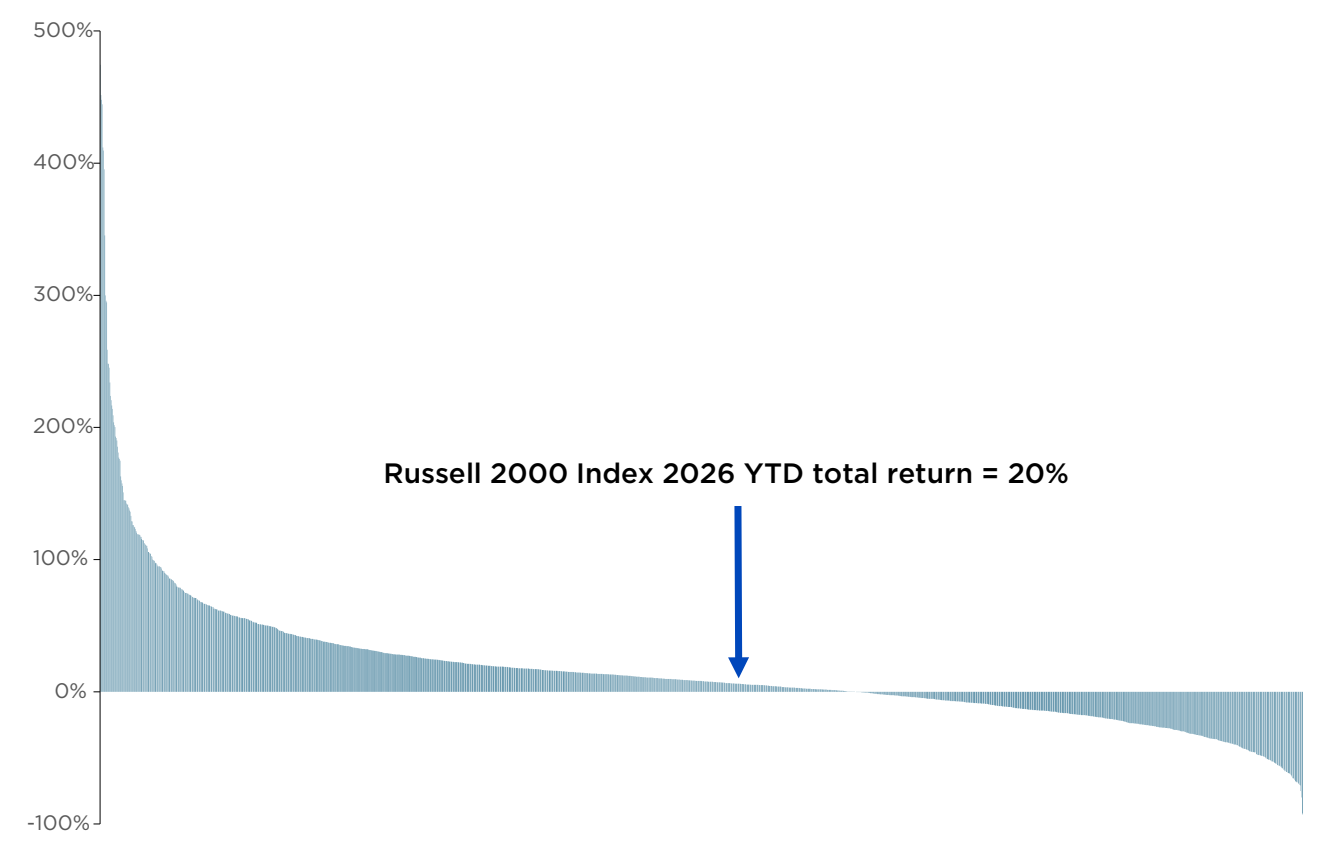
Small caps participate in AI-driven momentum

Small caps have not been immune to the intensity of the momentum around the AI infrastructure buildout. Small-cap leadership has coalesced around several sectors that have outperformed the broader market, including energy and basic materials (advancing 62% over the past year), biotechnology (gaining close to 90%), and communications and related equipment manufacturers (up more than 200%).

What appears at first glance as a collection of independent fundamental stories increasingly looks like an expression of a broader capital cycle where innovation, earnings revisions and thematic alignment reinforce one another and compress dispersion into a more unified, momentum-driven advance.

While each of these factors is a distinct fundamental catalyst, the connective tissue is becoming more apparent as these gains are increasingly reinforced by a broader dynamic tied to the AI investment cycle. As capital concentrates around areas of improving earnings visibility and structural growth, dispersion among small-cap stocks seems to be widening at the margin (see Chart 3 below). In this environment, the challenge is not deciding whether to participate in small caps but how — balancing exposure to areas benefiting from momentum with allocations to higher-quality, attractively valued companies that may ultimately drive more durable returns. It also underscores the importance of active management in this space.

Chart 3: Russell 2000 Index year-to-date total return dispersion



Source: FactSet, data as of 5/31/26

Riding the tailwinds of a resilient economy

The U.S. economy remains on relatively firm footing in 2026, supported by targeted fiscal stimulus measures, a resilient labor market and a broadly neutral monetary policy stance from the Federal Reserve as it seeks to balance rising inflation pressures from higher energy prices. Even as the likelihood of Fed rate cuts in 2026 has diminished, small caps —historically among the most rate-sensitive segments of the stock market — have not capitulated but instead demonstrated strong relative performance, suggesting that the underlying drivers of small caps' recent gains extend beyond the traditional interest rate factors.

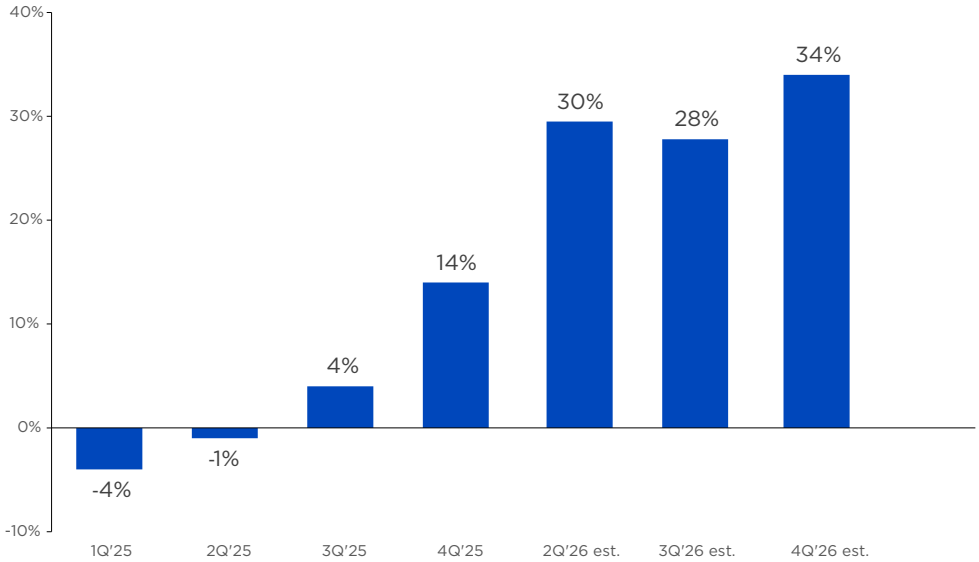
One explanation may be that the more domestically-oriented revenue base of smaller companies adds an important layer of support to small-cap outperformance. Roughly 72% of small-cap revenues are derived from within the U.S., compared to less than 60% for large caps. That leaves small companies more directly exposed to the policy-driven tailwinds shaping the domestic economy, while also benefiting from greater visibility during periods of geopolitical uncertainty. At the same time, as the U.S. dollar firms up following its early 2025 decline, earnings for large multinational companies are under pressure when repatriated from non-domestic markets, giving small companies a relative advantage.

An improving picture for small-cap fundamentals

Several factors support the case for moderating equity market returns in the coming months: the strength of the recent momentum-driven rally, midterm election seasonality and a new Federal Reserve chair navigating persistent inflation. Beneath that more constrained near-term outlook, however, the relative setup for small caps appears to be quietly improving.

Even against a backdrop that should theoretically create headwinds, small caps have begun to show early signs of stabilization in relative performance. More importantly, that resilience coincides with a meaningful shift in fundamentals where earnings and revenue expectations are improving after a prolonged period of underperformance. If that combination persists, the cyclical headwind that's been in place for much of the last decade may transition into a more constructive backdrop for small-cap leadership. For example, in 2026 earnings growth has powered almost all the return for the S&P SmallCap 600 (see Chart 4 below).

Chart 4: Small caps poised for stronger earnings growth



Source: FactSet, data as of 5/31/26

Furthermore, indicators such as the NFIB Small Business Survey show profits and optimism trending higher among smaller companies, reflecting the lagged benefits of prior Fed easing and aligning with the recent upturn in business activity. This matters for small caps, as these companies are more directly tied to domestic economic cycles and policy support, including fiscal stimulus through lower taxes, tariff relief and deregulation.

This shift toward earnings-driven performance reinforces the distinction between companies with durable profitability and those more reliant on multiple expansion or speculative growth assumptions.

Notably, this sequence tends to be self-reinforcing. Rising small business profitability historically leads to increased hiring and investment, creating a feedback loop between earnings, employment and economic growth. If the current improvement in small business sentiment and profitability is sustained, it can provide an incremental (and often underappreciated) tailwind that supports small caps beyond traditional valuation and rate sensitivity narratives.

As the market continues to navigate volatility, broadening earnings growth should likely remain an anchor for long-term investors, with an increasing share of companies outside of the "Magnificent 7" beginning to participate in the expansion. For instance, consensus expectations point to continued strength in small-cap earnings through the back half of this year and into 2027, reinforcing the case for more balanced leadership. The key tension, however, lies in financial conditions, as higher rates could still constrain capital access and weigh on margins. Even so, the anticipated acceleration in earnings across the equal-weighted index should help sustain the ongoing shift toward broader market participation.

Emphasizing value and quality within small caps

While small caps are often discussed as a broad asset class, dispersion within the category remains significant — particularly between the higher-quality, fundamentally sound businesses and the more speculative, momentum-driven companies.

Despite the recent rally, many small-cap companies with strong balance sheets, consistent cash flows and disciplined capital allocation continue to trade at attractive valuations relative to both their own history and larger-cap peers. This creates a compelling case for small-cap value strategies that focus not just on low valuations, but also on the intersection of valuation and quality. In that sense, value within small caps is not simply about owning the cheapest companies in the market. It's about identifying businesses where valuations fail to reflect balance-sheet strength, earnings durability and disciplined capital allocation.

At a more granular level, the case for pairing value with quality in small caps reflects the growing dispersion beneath the surface of the asset class, a key theme in 2026. A meaningful share of the small-cap universe consists of companies with limited or negative earnings, cash flows that are further in the future and valuations that are more sensitive to changes in the cost of capital. In that context, traditional valuation multiples can become less informative, particularly when earnings lack durability or visibility. By contrast, companies with positive near-term cash flows, stronger balance sheets and higher asset productivity offer a clearer anchor for valuation.

This has long been a feature of the small-cap segment rather than a one-time factor. The opportunity set often includes a mix of high-quality businesses alongside earlier-stage or structurally unprofitable companies, which can skew index-level characteristics and elevate volatility. While this dynamic is not always decisive, it becomes more important when financial conditions tighten or discount rates rise, shifting investor emphasis toward near-term cash flows and earnings credibility. If the market transitions from a capital expenditure-focused cycle to one where investors place greater emphasis on profitability and margins — especially if the marginal impact of incremental capex, particularly within concentrated AI-driven investment, begins to moderate — the ability to sustain margins and generate consistent earnings becomes increasingly critical.

In these environments, broad value exposure can inadvertently tilt toward firms with lower-quality balance sheets or less durable business models, increasing the risk of dispersion. As a result, quality serves as a necessary filter in distinguishing between companies that are simply inexpensive and those with sustainable earnings power.

The case for pairing value with quality becomes more compelling in a market increasingly defined by elevated dispersion, growing concentration risk and a narrower leadership cohort tied to the AI buildout. As returns have become more uneven and capital more selectively allocated, strategies that rely primarily on sentiment or thematic momentum face a higher bar. Against that backdrop, combining valuation discipline with earnings durability offers a more resilient way for small-cap investors to participate in any potential upside while preserving a clearer margin of safety, particularly as the sustainability of the current leadership comes into sharper focus.

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Looking internationally for further diversification

When thinking of broadening market participation, it's common to look beyond U.S. borders where similar dynamics are beginning to take shape. Over the past year, non-U.S. small caps have quietly outperformed their large-cap counterparts, with the MSCI EAFE® Small Cap Index outperforming the broader MSCI EAFE® Index on a rolling one-year basis, reinforcing the idea that improving breadth is not purely a domestic phenomenon.

Importantly, the case for international small caps extends beyond relative performance. Valuations remain compelling, particularly in regions where policy frameworks are evolving to support domestic growth through fiscal reform, targeted industrial investment and shifting geopolitical alignments that favor local firms (see Chart 5 below). In that context, smaller companies can offer differentiated exposure to regional growth cycles, often with sector compositions that are tilted more toward cyclicals, industrials and financials — a distinct contrast to the growth-heavy composition of U.S. large-cap indexes.

Chart 5: International small-cap valuations remain attractive for long-term investors

Source: FactSet, data as of 5/31/26. P/E ratios based on 12-month forward earnings

At the same time, the opportunity set is inherently less efficient. International small caps tend to be underfollowed and less widely covered by research analysts, creating a wider dispersion of outcomes and, by extension, a more fertile environment for active management. As macroeconomic conditions diverge across regions, selectivity becomes critical. But for investors willing to navigate that complexity, international small caps may offer a compelling, complementary source of diversification within a global equity portfolio.

Conclusion

The path forward for small caps won't be without volatility. Well-structured portfolios can benefit, however, from the inclusion of small caps, especially for investors concerned about market concentration following the surge in the AI-infrastructure trade. For the most part, small-cap stocks are levered to a domestic economy that's supported by policy stimulus, tied to an earnings cycle that is turning higher and priced at a discount that already reflects a more cautious outcome. Add to that a market structure defined by lower correlations and higher dispersion, and the case becomes less about timing a rotation and more about recognizing an asset class that's gradually evolving.

In that sense, the opportunity in small caps is more about a gradual erosion of the forces that once constrained them. The factors that used to define small caps — narrow leadership, elevated rate sensitivity and limited earnings visibility — are beginning to give way to a more balanced environment. If improving breadth is sustained and earnings momentum continues to build, small caps may have the potential to evolve into more enduring leadership that reward diversification, active management and a willingness to look beyond the most crowded areas of the market.

Today, investing in small caps may increasingly reward selectivity, whether through quality-focused value strategies or targeted exposure to global opportunities. Together, these dynamics suggest that the small-cap opportunity is becoming more nuanced and more compelling at the same time. As leadership broadens, valuations remain supportive and earnings momentum improves, investors may want to rethink small caps not as a single allocation decision but as a selective opportunity set. Emphasizing quality and value within U.S. small caps, while complementing that exposure with carefully selected international small caps, may offer a more durable way to participate in a market increasingly defined by both concentration and dispersion.

About the author

Mark Hackett, CFA®, CMT®, CFP®, is the Chief Market Strategist for Nationwide's Investment Management Group, bringing more than 20 years of experience in the asset management industry to the role.

In this role, Mark is a leader for Nationwide's capital markets analysis and thought leadership initiative. He is responsible for developing content to educate financial professionals and their clients on financial markets and implications for investors. Additionally, he develops asset class research, market commentary, white papers and topical market collateral. His strong skills and work have been featured in numerous financial publications and webinars, including CNBC, The New York Times, The Washington Post, ABC News, CNN Money, the Associated Press, BuzzFeed, Investor's Business Daily, Cheddar and others.

Mark refined his skills in the industry from his prior research roles and holds a FINRA Series 7 license. Before coming to Nationwide, he completed research for both the Vanguard Group and Nuveen, where he also served as a Portfolio Manager.

Mark is a graduate of the University of Richmond with a BBA in finance and economics. He also holds the Chartered Financial Analyst (CFA), Chartered Market Technician (CMT) and Certified Financial Planner (CFP) designations.

Access more insights on our website or contact us at 1-877-877-5083 if you have investment-related questions.

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