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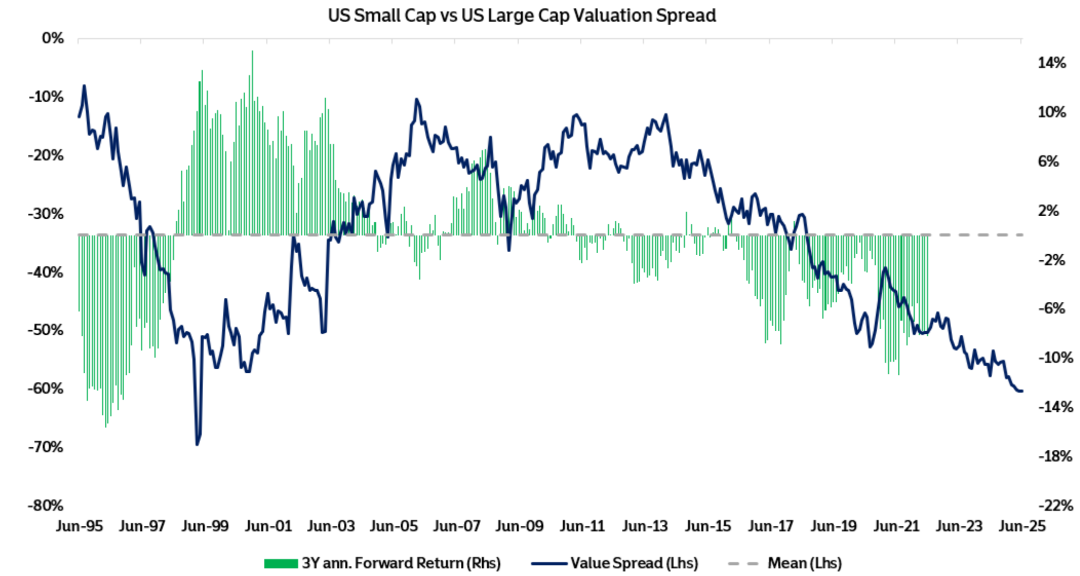
Small Opportunities

Stephen Nguyen, CFA



Source: Bloomberg Finance L.P., data as at 30 June 2025

What this chart shows

Markets have had an eventful year to date with ongoing geopolitical tensions, Trump's tariff threats and questions over Fed independence. Risk assets have largely shrugged these off as equities across the board have posted strong returns. US equities dominated headlines, with the S&P 500 recently hitting new highs. As a result, US large cap valuations look stretched at the headline index level, leaving investors searching for value. There may be more attractive opportunities if one is willing to venture further down the market capitalisation spectrum. Smaller US companies (measured by the Russell 2000 index) have lagged larger caps in recent years, creating a significant valuation gap. Today, US small caps trade at historically wide discounts, suggesting meaningful relative upside.

This chart shows the valuation spread (blue line, a composite of price-to-book and price-to-sales) of small versus large caps. Small caps have typically traded at around 30% discount to large caps over the past 30 years but currently sit at over 60% - near record levels. The chart also shows that small caps tend to outperform when discounts are unusually wide, as shown by the green bars, which represent the subsequent 3-year annualised relative performance versus large caps.

Why this is important

While it is difficult to ignore the strong run of large and mega cap stocks, these trends rarely last forever. An allocation to small caps at this opportune time could enhance returns over the medium to longer-term.

The Russell 2000 index has outperformed the S&P 500 over the past three months (to 27th August 2025) – potentially signalling the start of a reversal.

For small caps to deliver meaningful returns, a catalyst is needed for the valuation gap to narrow. Whilst it is difficult to predict the exact timing, there are a few factors that could be supportive. Further expected US rate cuts should benefit smaller companies, which are typically more rate sensitive due to higher leverage. Easing trade tensions, more clarity around tariffs, and likely more lenient regulatory policies under the Trump administration (such as deregulation and tax cuts) could also provide a more supportive environment. These factors may spur corporate activity, such as M&A, which again will be particularly beneficial for smaller businesses.

We acknowledge the risk that the valuation gap may persist, so remain cautiously optimistic. However, for patient investors, the medium to long term opportunity could prove worthwhile.

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Belvest 研富

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

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