

Small-cap stocks trade near historic lows relative to large caps, creating an attractive long-term entry point after years of dominance by the Magnificent Seven.

The Magnificent Seven have driven outsized returns, leaving global equity markets increasingly concentrated. By contrast, small caps have lagged meaningfully and now trade near historic relative lows, setting up what we see as an attractive entry point for long-term investors. In this note, we will cover:

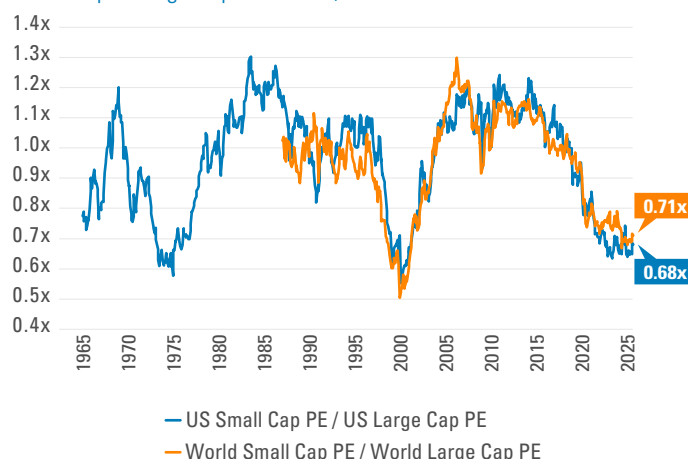
- **Performance & History:** How small caps have trailed large caps, and what past cycles of large-cap dominance suggest
- **Fundamentals vs. Sentiment:** Why earnings trends favor small caps, yet multiples have driven the gap
- **Risks & Market Structure:** Addressing leverage, unprofitable companies, index construction, and the role of private equity
- **Looking Ahead:** Why today's extreme valuation spread offers the potential for multi-year small-cap outperformance

THE SMALL-CAP VALUATION GAP

With global stock market performance dominated by the so-called Magnificent Seven over the past several years, we believe small-cap stocks worldwide are at an attractive entry point relative to large caps. Despite rising more than 140% since the depths of the COVID-19 pandemic, global small caps trade at near record lows relative to global large-cap stocks (Exhibit 1).

Exhibit 1: Small Caps Near Record Low Valuation versus Large Caps

Small Cap & Large Cap Relative P/E Ratios



Source: Empirical Research Partners, Pzena analysis
 US Large Cap = Largest 1000 US stock universe. US Small Cap = Next 2000 largest stock universe.
 World Large Cap = MSCI World universe. World Small Cap = MSCI World Small Cap universe.
 Trailing price/earnings data from January 31, 1965 – September 30, 2025.

As the Magnificent Seven have outperformed, U.S. and global equity markets have become more concentrated. Small caps have experienced the other side of that trend and now represent only 1.2% of total U.S. market capitalization, close to a 100-year low and well below the historical average of 3.6% (Exhibit 2).

Exhibit 2: Small Cap Now Makes Up Less Than 1.5% of U.S. Equity Markets

Small Cap Stocks as % of Total U.S. Market Cap



Source: Kenneth R. French, Pzena analysis
 Universe is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library. Small cap is the bottom 30% of names based on NYSE breakpoints. Monthly data from July 31, 1926 – August 31, 2025.

HOW DID WE GET HERE?

The initial recovery after the Global Financial Crisis was marked by slow growth and very low financing costs. This environment supported venture capital and public growth investing. Even so, small caps held their ground, helped by the domestic recovery and the reflation trade that followed the 2016 election.

The U.S. economy expanded further into 2017 and 2018, but uncertainty over trade wars, rising interest rates, and recession risk pushed investors toward perceived safe havens. Expensive growth companies that promised steady earnings gained favor, and from there, the valuation gap widened. After their historic decline in 2022, mega-cap growth stocks quickly regained leadership on enthusiasm for artificial intelligence, while higher-for-longer rates favored the largest companies with significant cash balances and mostly fixed-rate debt.

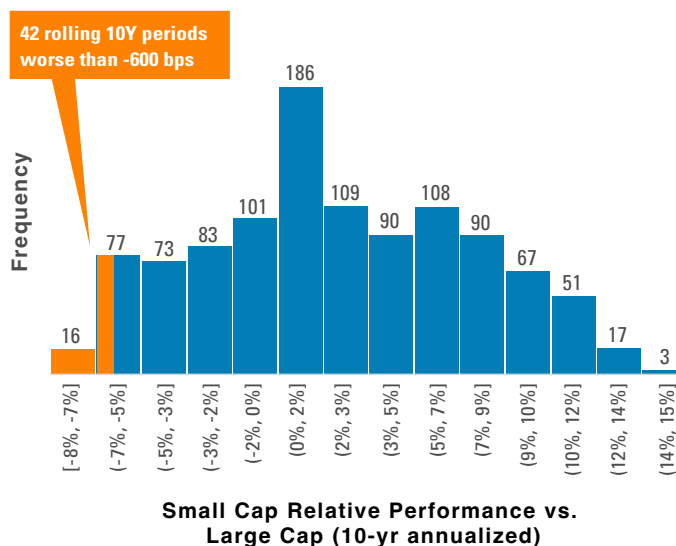
A DECADE OF DIVERGENCE

Over the past decade, global small caps delivered a decent annual return of 9.6%, compared with 12.4% for global large caps. The biggest driver of this gap was the United States: U.S. large caps returned 15.0% per year, while U.S. small caps returned only 9.8%¹.

The disparity is significant but not unprecedented. Rolling 10-year periods of large-cap dominance similar or greater than the recent period have occurred 42 times between 1926 and 2025 (Exhibit 3). The current stretch ranks among the more severe, but history suggests such cycles are part of long-term market patterns rather than permanent shifts. The picture of global small caps is similar, with the most recent rolling 10-year relative return in the tenth percentile of relative returns versus large-cap returns.

Exhibit 3: Frequency of Rolling 10-Year Relative Returns Since 1926

U.S. Small Cap Has Underperformed Large Cap by 600bps the Past 10 Years



Source: Kenneth R. French, Pzena analysis
 Universe is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library.
 Cap-weighted monthly data, July 31, 1926 – August 31, 2025.
 Small cap = smallest 30% of companies based on NYSE breakpoints,
 Large cap = largest 30%.
 Does not represent any specific Pzena product or service.
 Past performance is not indicative of future returns.

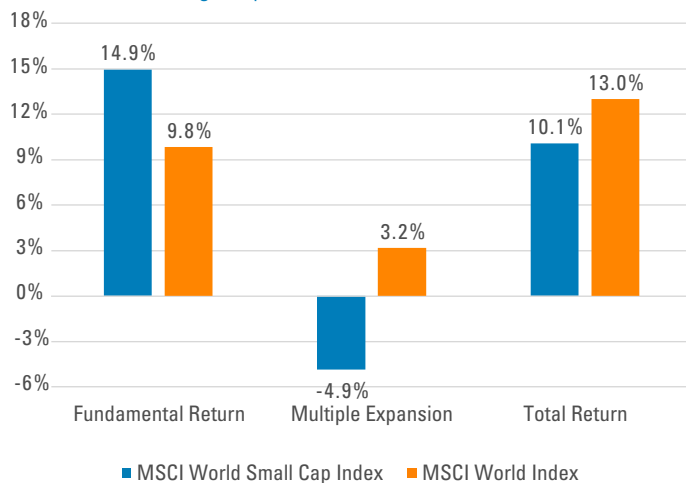
IS THE PERFORMANCE DISPARITY JUSTIFIED?

If stronger fundamentals explained the outperformance of large caps, the disparity might be easier to accept. But fundamentals tell a different story. Small caps generated significantly higher combined free cash flow growth and dividends (fundamental return)—in excess of 500 basis points per year more than large caps. The difference in returns has been driven entirely by sentiment and relative multiple expansion (Exhibit 4).

1. Source: MSCI and FTSE Russell

Exhibit 4: Global Small Cap Last 10 Years: Superior Free Cash Flow Growth

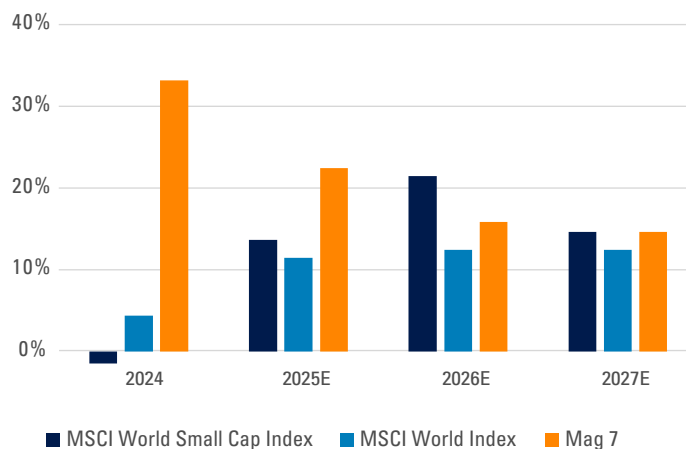
Small vs. Large Performance Drivers Based on FCF
Last 10 Years Through Sep 2025



Source: FactSet, Pzena analysis
Fundamental Return = dividend return + free cash flow growth.
Analysis uses LTM free cash flow data. Free cash flow was chosen instead of the more commonly used GAAP EPS because write-downs and unusual expenses for small cap stocks are commonplace.
All data annualized in US dollars as of September 30, 2025. Past performance is not indicative of future returns.

Looking ahead, consensus forecasts show small caps continuing to outpace large caps over the next three years, and beating the Magnificent Seven in 2026 and 2027 (Exhibit 5).

Exhibit 5: Earnings Convergence Mag 7 Earnings Growth Is Moderating



Source: FactSet, Pzena Analysis
Year-over-year earnings growth. Mag 7 = Apple, NVIDIA, Microsoft, Amazon.com, Meta Platforms, Tesla, and Alphabet.
Earnings data per FactSet as of September 30, 2025.

RISKS AND ACTIVE MANAGEMENT

Two issues are often raised to explain small-cap underperformance: leverage and unprofitable companies. While smaller companies do carry more debt, the exposure is highly concentrated. Excluding financials, which naturally employ leverage, just 77 companies account for more than half of the Russell 2000 Index's \$935 billion in net debt². These firms represent only 8.2% of the index's non-financial market capitalization.

Profitability shows a similar pattern. More than 40% of the Russell 2000 Index is unprofitable, compared with just over 10% of the Russell 1000³. Both issues can be managed; active investors can avoid the weakest balance sheets and the persistently loss-making companies, while selectively investing in those with attractive risk-reward potential.

THE PRIVATE EQUITY EFFECT

Another explanation often cited for small-cap underperformance is the role of private equity. Over the past 30 years, the number of listed U.S. companies has fallen by 40-50%, as firms stay private longer and as public companies are taken private at elevated rates. This trend has reduced the universe of publicly traded small-cap stocks.

However, the impact is often overstated. Most of the decline has taken place in the micro-cap space, which sits below the traditional small-cap range. Since 1980, the number of small-cap stocks in the smallest cohort has fallen by 13%⁴, while the number of micro-cap stocks has fallen by 52%. In addition, private equity can serve as a stabilizing force, stepping in as a buyer during periods of small-cap weakness. In our own 30-year history, which coincides with the reduction in public listings, small-cap investing has delivered some of our strongest long-term alpha.

[See our writeup on The Small Cap Value Opportunity for more details on this topic.](#)

2. Source: FactSet, Pzena analysis
3. Source: FactSet, Pzena analysis
4. Kenneth R. French, Pzena analysis

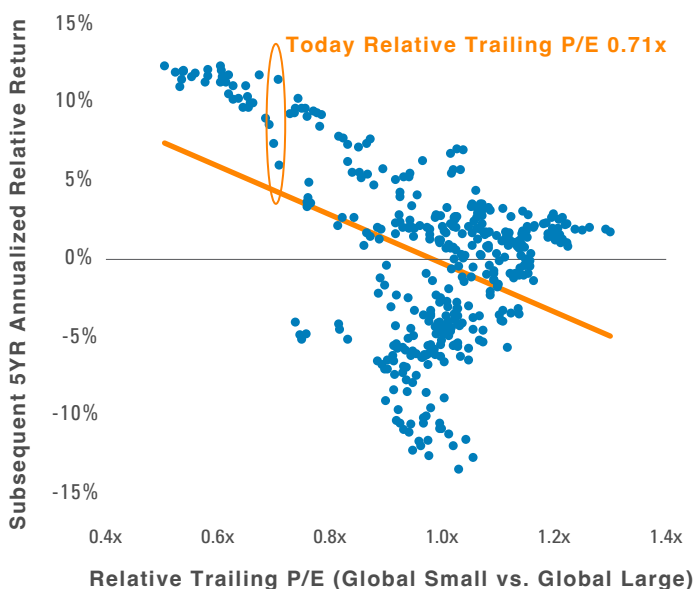
WHERE TO FROM HERE?

The past decade has seen sustained multiple compression for small caps relative to large caps. We believe this trend sets up an attractive starting point for future outperformance. Timing a turn in the cycle is never certain, but history shows that extreme valuation gaps (like today's) have often been followed by multi-year periods of small-cap leadership (Exhibit 6).

It is also worth noting that the last two periods of similar dislocation were marked by powerful investment themes: the Nifty Fifty and the Dot-Com era. Both included companies that went on to be highly successful, but in each case, valuations rose far beyond what fundamentals could justify. The result was a long stretch of strong small-cap performance once the cycle turned.

Exhibit 6: Global Small Cap vs. Large Cap Relative Valuation & Forward Returns

Relative Trailing P/E of Global Small Cap vs. Global Large Cap
& Subsequent 5YR Annualized Relative Returns (1987 - Sep 2025)



Source: Empirical Research Partners, Pzena analysis
Global Large Cap = MSCI World universe. Global Small Cap = MSCI World Small Cap universe.
Trailing price/earnings and US dollar total return data from January 31, 1987 – September 30, 2025.
Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

CONCLUSION

Small caps have endured a decade in which they were overshadowed by mega-cap growth stocks and weighed down by sentiment, higher rates, and structural shifts in capital markets. Yet fundamentals remain intact. Earnings growth has matched or exceeded that of large caps, valuations are near historic lows, and history shows that periods of extreme underperformance have often marked the beginning of strong multi-year recoveries.

While risks around leverage, profitability, and private equity flows are real, they can be addressed through prudent active management. With global small caps trading at one of the most attractive entry points in decades, we believe investors are well positioned to benefit from the next phase of the cycle.

FURTHER INFORMATION

These materials are intended solely for informational purposes. The views expressed reflect the current views of Pzena Investment Management (“PIM”) as of the date hereof and are subject to change. PIM is a registered investment adviser registered with the United States Securities and Exchange Commission. PIM does not undertake to advise you of any changes in the views expressed herein. There is no guarantee that any projection, forecast, or opinion in this material will be realized. Past performance is not indicative of future results.

All investments involve risk, including loss of principal. Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. The price of equity securities may rise or fall because of economic or political changes or changes in a company’s financial condition, sometimes rapidly or unpredictably. Investments in foreign securities involve political, economic and currency risks, greater volatility and differences in accounting methods. These risks are greater for investments in Emerging Markets. Investments in small-cap or mid-cap companies involve additional risks such as limited liquidity and greater volatility than larger companies. PIM’s strategies emphasize a “value” style of investing, which targets undervalued companies with characteristics for improved valuations. This style of investing is subject to the risk that the valuations never improve or that returns on “value” securities may not move in tandem with the returns on other styles of investing or the stock market in general.

This document does not constitute a current or past recommendation, an offer, or solicitation of an offer to purchase any securities or provide investment advisory services and should not be construed as such. The information contained herein is general in nature and does not constitute legal, tax, or investment advice. PIM does not make any warranty, express or implied, as to the information’s accuracy or completeness. Prospective investors are encouraged to consult their own professional advisers as to the implications of making an investment in any securities or investment advisory services.

The MSCI information may only be used for internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the MSCI Parties) expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.

London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). ©LSE Group 2025. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trademark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

For U.K. Investors Only:

This marketing communication is issued by Pzena Investment Management, Ltd. (“PIM UK”). PIM UK is a limited company registered in England and Wales with registered number 09380422, and its registered office is at 34-37 Liverpool Street, London EC2M 7PP, United Kingdom. PIM UK is an appointed representative of Vittoria & Partners LLP (FRN 709710), which is authorised and regulated by the Financial Conduct Authority (“FCA”). The Pzena documents have been approved by Vittoria & Partners LLP and, in the UK, are only made available to professional clients and eligible counterparties as defined by the FCA.

For Jersey Investors Only:

Consent under the Control of Borrowing (Jersey) Order 1958 (the “COBO” Order) has not been obtained for the circulation of this document. Accordingly, the offer that is the subject of this document may only be made in Jersey where the offer is valid in the United Kingdom or Guernsey and is circulated in Jersey only to persons similar to those to whom, and in a manner similar to that in which, it is for the time being circulated in the United Kingdom, or Guernsey, as the case may be. The directors may, but are not obliged to, apply for such consent in the future. The services and/or products discussed herein are only suitable for sophisticated investors who understand the risks involved. Neither Pzena Investment Management, Ltd. nor Pzena Investment Management, LLC nor the activities of any functionary with regard to either Pzena Investment Management, Ltd. or Pzena Investment Management, LLC are subject to the provisions of the Financial Services (Jersey) Law 1998.

For South African Investors Only:

The Pzena Emerging Markets Focused Value Fund, Pzena Emerging Markets Select Value Fund, Pzena Global Focused Value Fund, Pzena Global Value Fund are registered and approved under section 65 of CISA.

Collective Investment Schemes in Securities (CIS) should be considered as medium- to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CISs are traded at the ruling price and can engage in scrip lending and borrowing. A schedule of fees, charges and maximum commissions is available on request from the Manager. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. There is no guarantee in respect of capital or returns in a portfolio. Representative Office: Prescient Management Company (RF) (Pty) Ltd is registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). For any additional information such as fund prices, fees, brochures, minimum disclosure documents and application forms please go to www.pzena.com.

© Pzena Investment Management, LLC, 2025. All rights reserved.