Do Small-Caps Offer More Investment Appeal Than Large-Caps After 2017’s Bull Run?

Description

This calendar year has been a positive one for share prices across the globe. While many investors expected 2017 to be a rather bearish year for shares, it has in fact turned out to be a hugely positive one. Although risks remain to the global economic outlook, such as political challenges in the US and Europe, the prospects for world economic growth remain relatively bright. Therefore, stock markets could potentially move higher over the medium term.

Local opportunities

Of course, when it comes to accessing growth in the world economy, larger companies can be the most effective means of buying into it. They usually offer greater geographic diversification than their smaller counterparts, which can reduce their risk profile. Smaller companies, in contrast, tend to be more focused on their local economies. This could count against them in terms of risk, but it could also mean that they offer greater growth opportunities within a specific geography.

Furthermore, the global exposure of larger companies could mean they have been boosted to a greater extent by the Bull Run of 2017. They may now attract a larger premium regarding their valuations than their smaller counterparts, since investors may have been seeking to hedge their bets against risks facing the world economy.

For example, with Brexit dominating the outlook for Europe, political risk still high in the US and China’s growth rate continuing to slow, many investors may have preferred geographically diversified, larger companies over locally-focused ones. The result of this could be higher current valuations for larger companies, which could create more enticing buying opportunities for their smaller counterparts.

Risk/return

Lower valuations must, of course, be balanced against the higher risks of smaller companies. Just as the valuations of larger companies may have increased to a greater extent than smaller companies, the risk profiles they now have may have also changed. Wider margins of safety could equate to lower downside risk, which could make small-caps more attractive based on the risk/reward ratio. While this does not mean they are immune to share price falls, smaller companies may offer greater defensive characteristics relative to larger companies than they have in the past.

Of course, if 2017's Bull Run continues and the popularity of well-diversified, global companies remains high, large-caps could outperform small-caps. However, this does not mean that the latter should be avoided. Certainly, they may come with higher risk, but they provide investors with an opportunity to access specific niches within local economies which could provide greater alpha than among more widely-researched large-caps.

Takeaway

Therefore, the best solution could be to hold a mixture of large-caps and small-caps. They both have different risk/return profiles, and could perform differently depending upon the prevailing attitude of investors and the performance of global and local economies. As such, for investors seeking a diversified portfolio, both sets of stocks seem to be attractive for the long term.

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