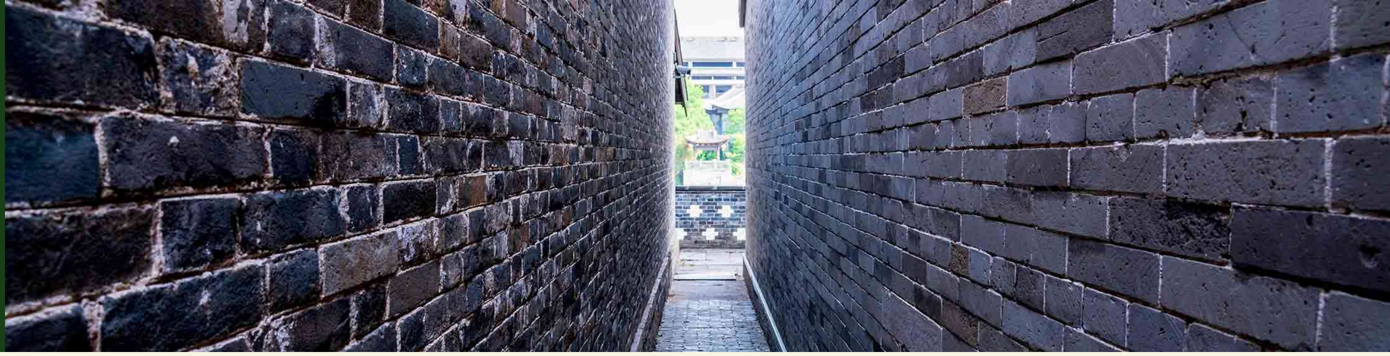

Research

Closing the global small cap portfolio gap

How allocations to small cap global stocks can improve diversification, resilience, and long-term return potential in an evolving market.

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Key takeaways

- Many global equity portfolios remain unintentionally concentrated in large companies, leaving a meaningful portion of the opportunity set underrepresented.
- Global small caps provide diversification that is both economic and behavioral, with returns driven more by local fundamentals as opposed to global macro positioning.
- The opportunity set is broader and less efficient, with double the stocks versus the MSCI ACWI, less analyst coverage, and quantitative metrics that point to opportunities for active security selection.
- Excluding global small caps may increase concentration risk in an investment environment led by a narrow set of mega cap stocks and themes.
- Since the '90s, global small caps generated a better return than global large caps.

Are global portfolios truly diversified?

Too many investment portfolios share a common feature: they own substantial equity investments in large, liquid U.S. and international companies, some diversified fixed income for ballast, and they stop there.

As a result, they capture global scale while missing global breadth: They *appear* diversified, but they may omit thousands of publicly listed companies that make up a substantial part of the global economy. This can create a "small cap gap" in client portfolios.

Investment allocators seeking to build client portfolios that more closely match the composition of the world economy can fill this gap with global small cap strategies.

Why global small caps?

Global small caps represent a distinct segment of the market, both economically and behaviorally. Compared with large caps, they tend to be more domestically focused, more sensitive to local demand, and less exposed to large, coordinated capital movements driven by macroeconomic forces.

Therefore, local consumption trends, regulatory changes, labor dynamics, and capital investment cycles tend to play a bigger role in driving the results. This can help create differentiated return streams within an equity allocation.

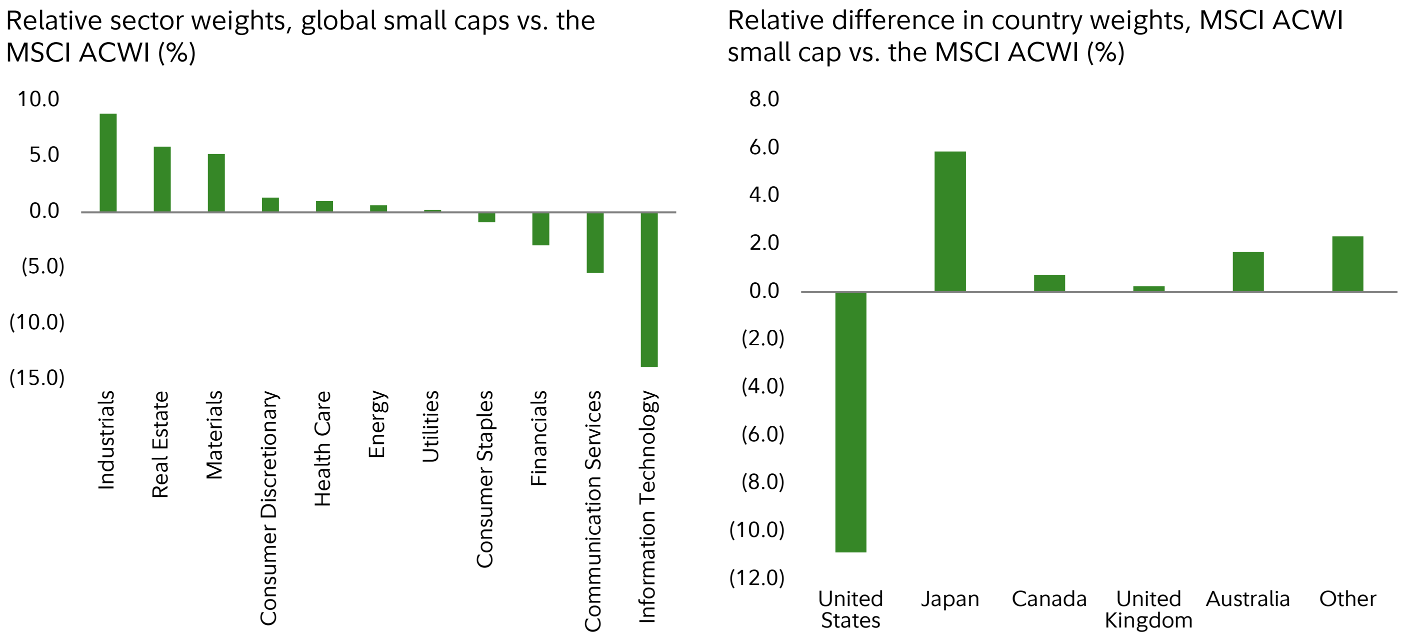
Adding global small caps to the investment mix aligns with modern portfolio theory, which is based on the diversification benefits of owning the broadest possible global portfolio.

The risk of not owning global small caps

As global markets have become more interconnected, correlations among large cap stocks have risen. Many large companies share similar customer bases and supply chains. As a result, portfolios that concentrate solely on global large caps may carry more embedded risk than investors might expect.

Adding global small cap exposure can partly help mitigate this risk, while adding different economic and sector exposures. For example, global small caps have relatively higher weightings in industrials, materials, and real estate versus global large caps, and, as a percentage, heavier representation outside the U.S. (Exhibit 1).

Exhibit 1: Relative sector and country exposures



Global small caps represented by the MSCI ACWI Small Cap Index. Source: FactSet and Fidelity Investments, as of 3/31/26.

The themes large cap-focused portfolios may be missing

Global small caps also offer thematic diversification. Many global large cap investors have heavily focused on the capex boom in artificial intelligence, data center buildouts, and obesity drugs—and popular stocks exposed to these themes.

Conversely, many global small caps have focused on structural investment themes that are not only different, but difficult to access through large cap-only exposure.

For example:

- In Europe, defense spending is rising within a fragmented opportunity set. Small and mid-sized suppliers that provide specialized components, electronics, and advanced materials could benefit from this trend.
- In Japan, corporate governance reforms and improving capital discipline have created opportunities among regional service providers, consumer brands, and business outsourcing firms that remain lightly covered by global investors.
- China's ongoing industrial modernization has generated under-the-radar opportunities in factory automation, robotics, sensors, and industrial software, often supported by government policy and long-term contracts.
- Similarly, the expansion of artificial intelligence extends beyond mega-cap platforms, benefiting smaller companies tied to power demand, data enablement, and specialized software.

Adding value via active management

Moreso than some other equity asset classes—particularly large caps—quantitative data suggest global small caps may be rich in stock selection opportunities.

Global small caps have shown greater monthly return dispersion, more variation caused by stock-specific risk factors, and slightly lower return correlations versus global large caps historically, and this also has been the case as of Q1 2026 (Exhibit 2).

Exhibit 2: Quantitative differences, MSCI ACWI vs. MSCI ACWI Small Cap

	MSCI ACWI Small Cap	MSCI ACWI
Monthly return dispersion (more is better)	**12.1%**	**11.1%**
Historical average (more is better)	10.6%	8.5%
Stock-level return correlation (less is better)	**0.14**	**0.15**
Historical average (less is better)	0.11	0.15
Variation caused by stock-specific risk* (more is better)	**62.9%**	**56.9%**
Historical average (more is better)	68.9%	61.7%

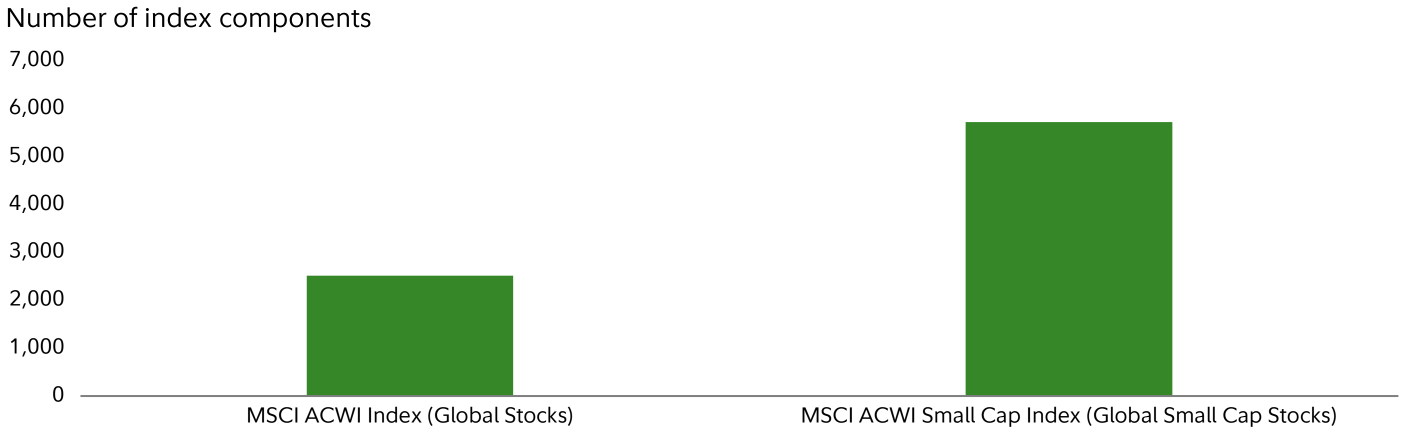
Historical averages compiled monthly since 12/1/94. **Monthly return dispersion** gauges the variability of individual stock returns relative to each index. High dispersion suggests divergent performance and wide market breadth. The monthly return dispersion reflects the standard deviation of 1-month trailing returns in percentage points. **Stock-level return correlation** measures how closely two stocks move together. Low correlation indicates stocks move more independently of each other. Correlation analysis above uses trailing 60 days of daily returns. **Variation caused by stock-specific risk** measures the percent of returns attributed to idiosyncratic stock events, rather than market-driven factors ("beta"). High stock-specific risk volatility usually points to high dispersion. It is represented by percent of total variance not attributable to the top 5 factors in a principal component analysis (PCA).* Percent of total variance not attributable to the top 5 factors in a principal component analysis. Source: Bloomberg Finance LP, FactSet, and Fidelity Investments Equity Quantitative Research, as of 4/3/26.

These metrics suggest individual company outcomes drove a larger share of returns as opposed to broad market movements.

More stock choices

With more than 5,700 components, the MSCI ACWI Small Cap Index includes more than double the number of stocks in the MSCI ACWI Index (about 2,500), which consists mainly of large and mid cap equities (Exhibit 3).

Exhibit 3: Comparing the global opportunity sets.



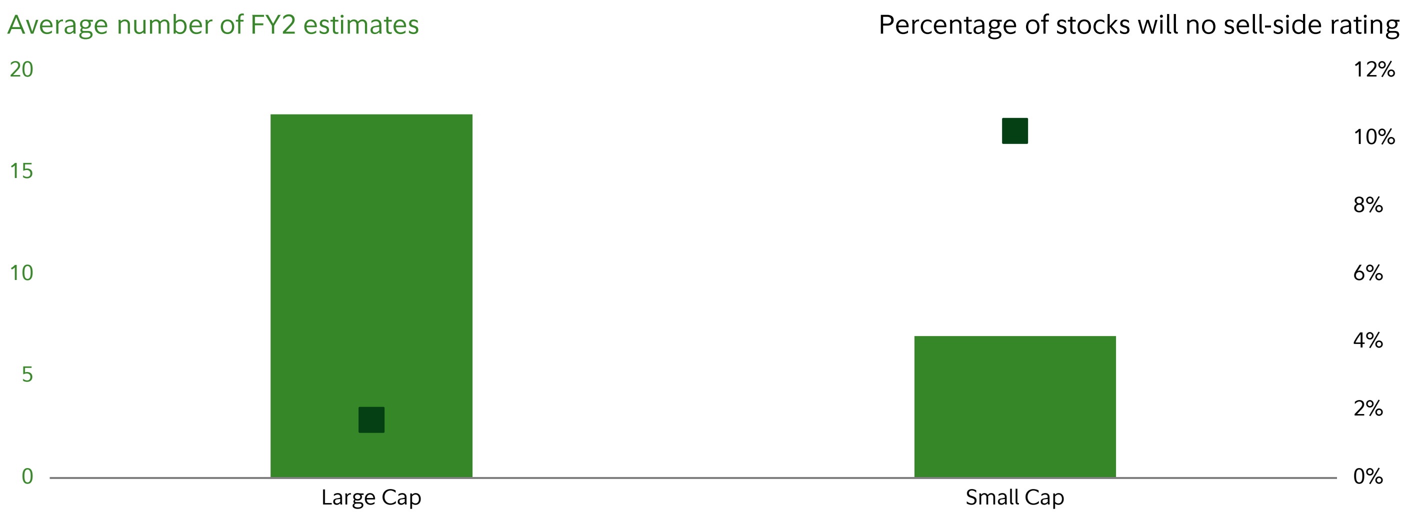
MSCI ACWI Small Cap Index (global small cap stocks): 5,719 components; MSCI ACWI Index (global stocks, large caps, and mid caps): 2,514 components. Source: MSCI fact sheets for the respective indexes, as of 4/30/26.

This depth matters. A larger opportunity set increases the possibility of active managers finding mispricing, structural growth, and idiosyncratic return.

Because fewer equity analysts cover the small cap asset class, it is less researched, potentially increasing the opportunities for managers to find undervalued opportunities that are known by fewer investors.

Exhibit 4 shows that an average of 7 analysts cover every stock in the MSCI ACWI Small Cap Index, compared with about 18 analysts for the MSCI ACWI Index.

Exhibit 4: Analyst coverage comparison (global small caps vs. large caps)



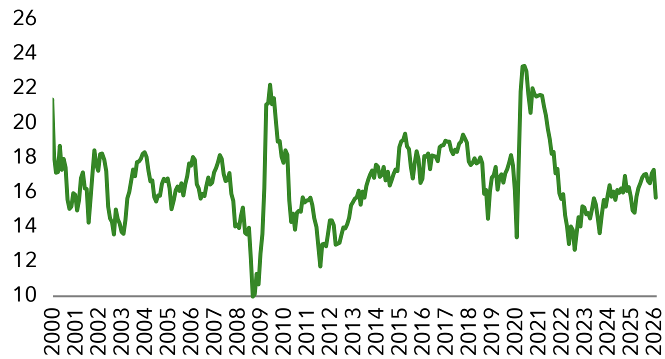
Large cap = MSCI ACWI. Small cap = MSCI ACWI Small Cap Index. Source: FactSet, as of 12/31/25.

The valuation argument

Global small cap stocks in the MSCI ACWI Small Cap Index trade at a discount to the MSCI ACWI on multiple metrics (Exhibit 5, left). This is partly due to the relatively higher sensitivity of the asset class to growth cycles, and the greater exposure of small firms to credit conditions compared with larger companies.

Exhibit 5: Earnings surprises

	MSCI ACWI Small Cap	MSCI ACWI
Price/book	1.9	3.5
Price/sales	1.5	2.7
Price/earnings trailing, ex negative earnings	17.5	21.2
Forward price/earnings	15.7	17.4

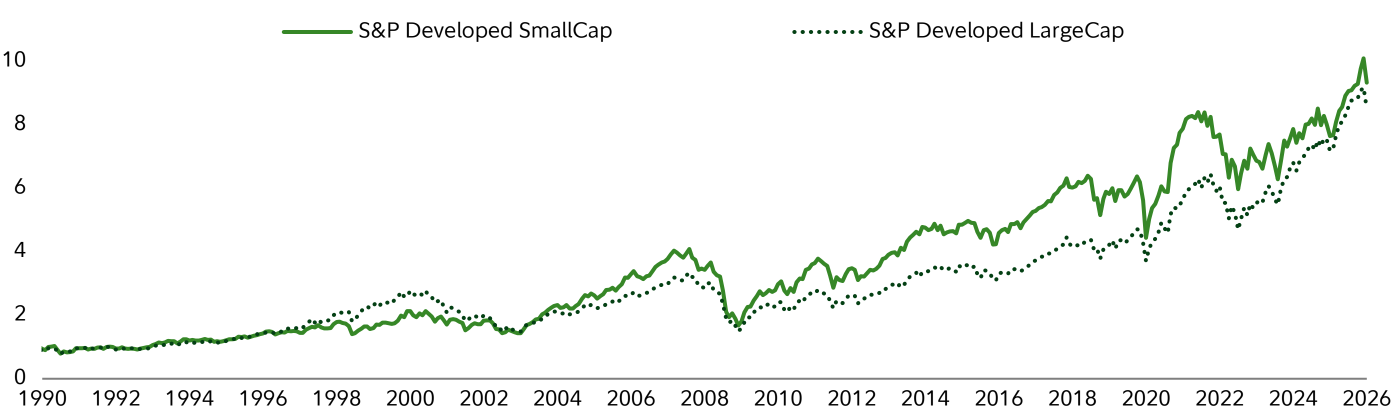


LEFT: Price/book = price-to-book ratio (market value divided by book value of equity); Price/sales = price-to-sales ratio (market price divided by revenue per share); Price/earnings trailing, ex negative earnings = price divided by past 12-month earnings, excluding companies that reported negative earnings. Forward price/earnings = share price divided by aggregate analyst estimates for the next 12 months. Source: MSCI and Fidelity Investments, as of 3/31/26. RIGHT: P/E = price-to-earnings ratio. NTM = next 12 months. Source: FactSet and Fidelity Investments, as of 3/31/26.

The long-term return potential

As shown in Exhibit 6, global small cap equities have delivered strong absolute and relative returns over history. While this has not necessarily been the case for global small caps in recent years (3-, 5-, and 10-year periods), the longer-term performance results may make the case for maintaining a strategic allocation to the asset class over a full market cycle.

Exhibit 6: Growth of $10 million, S&P Developed SmallCap Index vs. S&P Developed LargeCap Index



Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indices are unmanaged. Index performance not meant to represent any Fidelity product. Values on the axis at left are indexed to 100 as of 7/31/89 for comparison. S&P Developed SmallCap and S&P Developed LargeCap indexes used in place of the MSCI ACWI Small Cap Index and MSCI ACWI for this analysis, as the S&P Developed Small Cap data series goes back further in time (early 90s, vs. 2007 for the MSCI ACWI Small Cap). Source: FactSet and Fidelity Investments, as of 3/31/26.

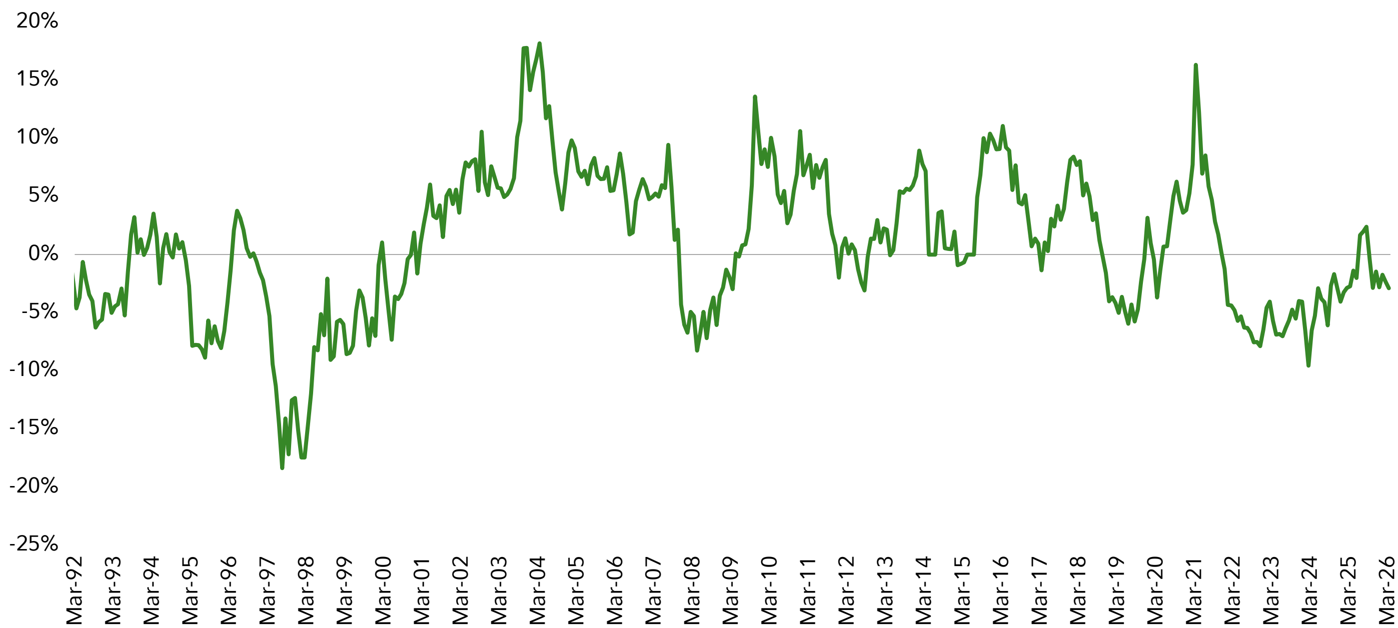
Importantly, the global small-versus-large performance differential has, by some measures, tended to be cyclical over shorter time periods.

1. Global small caps have outperformed, then underperformed in multiyear stretches.
2. Since the early 1990s, the outperformance cycles have been longer in duration than the periods of underperformance.
3. Global small caps have performed differently than large caps at market inflection points.

To illustrate the latter point, Exhibit 7, which tracks developed-market small caps in Europe and the Asia-Pacific region, reflects that global small caps:

- Lagged large caps for much of the 1990s, then outperformed in the years after the dot-com crash in 2000.
- Underperformed for much of the Global Financial Crisis of 2007–2009, then outperformed afterward.
- Outperformed in the early COVID-19 years (2020 and 2021), before once again lagging global large caps.

Exhibit 7: Rolling one-year performance, global small caps minus large caps in developed markets



Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indices are unmanaged. Index performance not meant to represent any Fidelity product. S&P EPAC SmallCap Index is a regional, developed-market small cap equity benchmark and a subset of the S&P EPAC BMI, designed to measure small caps in Europe and the Asia-Pacific region. Performance compared vs. the S&P EPAC LargeMidCap Index. Source: FactSet, as of 3/31/26.

By understanding these cyclical trends and applying tactical overweight and underweight positions, active portfolio managers may be able to take advantage of another source of potential alpha.

Accessing the opportunity

Institutional investors who appreciate the diversification, risk-reward, valuation, and security selection arguments for owning global small caps may still contemplate what changes they should make to their investment portfolio and how best to implement them.

The most obvious approach may be to add a dedicated small cap mandate.

Adding a specialized global small cap manager with a proven track record may have several advantages. This approach benefits from the global small cap expertise of the manager and their trading expertise in the more liquidity-constrained markets for small cap stocks.

A standalone global small cap portfolio also enables the establishment of more specific portfolio-level risk and return targets. For example, an institutional investor might wish to allocate a higher-risk target to the global small cap portfolio, given the relative inefficiency of the asset class.

Conclusion

Global small cap equities represent more than a diversification tool—they are a structurally underutilized source of return within global portfolios. They offer access to a broader and less efficient opportunity set, with return drivers that differ meaningfully from large cap equities. Over time, this has translated into attractive long-term returns, delivered in cyclical patterns relative to broader markets.

Starting valuations that are below both large caps and historical norms and quantitative measures that reflect security selection opportunities also support the asset class.

For portfolios that aim to reflect the breadth of the global economy—and to reduce reliance on a narrow set of large-cap drivers—closing the "small cap gap" may be an important part of the solution.

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Nick serves as a member of the investment management team, assisting portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations and contributing to investment thought leadership through global equity-focused research. Additionally, he is the principal liaison for the portfolio management team to current and prospective clients and internal partners, providing detailed portfolio reviews and serving as a key conduit of client objectives, requirements, and marketplace insight to the investment team.

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MSCI ACWI (All Country World Index) is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed and emerging markets.

MSCI ACWI (All Country World) Small Cap Index is a global equity index that is designed to measure the investable equity market performance for global investors of small cap stocks in developed and emerging markets.

S&P Developed SmallCap Index is a global equity index that tracks small-capitalization companies in developed markets.

S&P Developed LargeCap Index is a global equity index that tracks large-capitalization companies in developed markets.

S&P EPAC LargeMidCap Index seeks to measure the developed markets within the Europe and Asia Pacific regions, comprising the stocks representing the highest 85% of float-adjusted market cap in each developed country.

S&P EPAC SmallCap Index seeks to measure the developed markets within the Europe and Asia Pacific regions, comprising the stocks representing the lowest 15% of float-adjusted market cap in each developed country.

S&P EPAC BMI (Broad Market) Index is a comprehensive index that seeks to track all investable stocks in developed Europe and Asia-Pacific markets.

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