Equity Insights
December 2024

Exploring Opportunities for Global Small- and Mid-Cap Stocks in the Next Cycle

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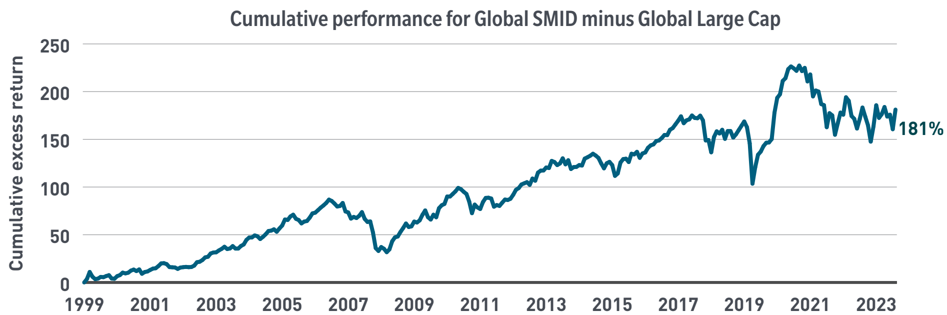
Why consider investing in global small- and midcap stocks: The Base Case

The global small- and midcap asset class has strongly outperformed large-cap stocks over the long term (Exhibit 1), and while market leadership ebbs and flows over shorter periods of time, we feel the asset class appears well positioned to potentially assume a leadership role in the next rotation.

Exhibit 1: Global Small/Mid-Cap Stocks Have Strongly Outperformed Large Caps Over Time

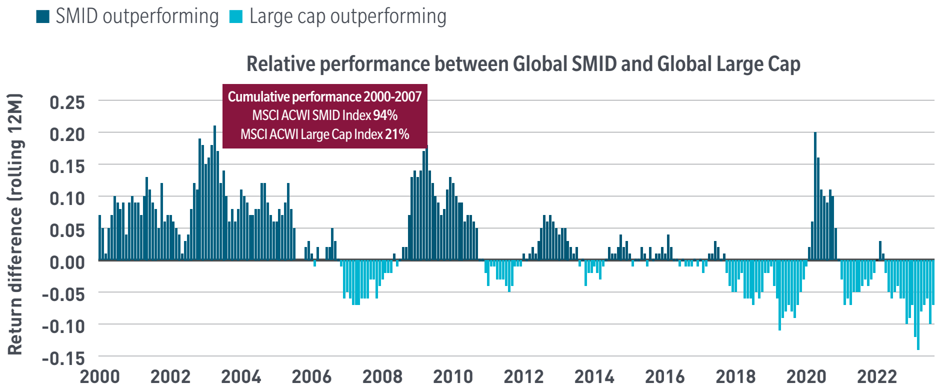


Source: FactSet. Monthly data as of 31 December 1999 to 31 July 2024. Series shows the cumulative excess returns for MSCI All-Country World SMID Index (ACWI SMID) minus MSCI ACWI Large Cap Index (ACWI Large). Total returns are net and in US dollars. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Why consider investing in small and mid-caps?

In our view, the opportunity set for global small- and midcaps appears particularly attractive. As noted, while leadership has tended to rotate every few years, we witnessed a sustained period of global small- and midcap outperformance during the eight-year period (2000 – 2007) coming out of the dot-com era, up until the Global Financial Crisis (GFC), with the MSCI ACWI SMID Index returning 94% versus the MSCI ACWI Large Cap Index return of just 21% (Exhibit 2). And while no two periods are alike, there are a number of parallels one could draw between that period in the early 2000s to the market environment as of July 31, 2024.

Exhibit 2: While Leadership Has Tended to Rotate Every Few Years, Small/Mid-Cap Outperformed During Much of the 2000s

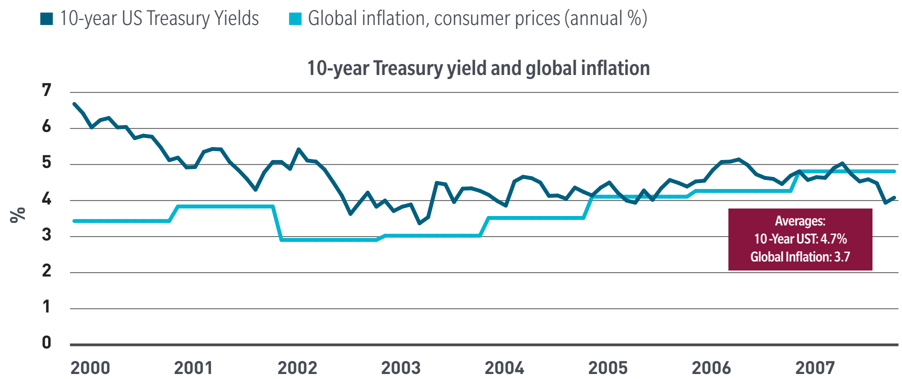


Source: FactSet. Monthly data as of 31 December 1999 to 31 July 2024. Series shows the rolling 12-month excess returns for MSCI All-Country World SMID Index (SMID) relative to MSCI All-Country World Large Cap Index (Large Cap). Values shown in call-out are cumulative returns, calculated from 31 December 1999 to 31 December 2007. Total returns are net and in US dollars. Past performance is no guarantee of future results. It is not possible to invest in an index.

The parallels are as follows:

Inflation and interest rates – Directionally, the path of interest rates was much different during the start of the 2000s, with interest rates moving lower, versus what we witnessed in 2022 where rates moved sharply higher. However, over that eight-year period, interest rates and inflation were quite stable (Exhibit 3). In fact, over that eight-year period, 10-year treasuries averaged 4.7% and global inflation 3.7% (approximately 1% real rates), which is much more aligned with today's reality — and the market backdrop we are likely to face moving forward — versus a world of zero inflation and the zero/negative interest rate environment that categorized the decade post the GFC. And while rates may in fact trend a bit lower over the near term (historically a positive for small- and midcap stocks), I think we'd all agree that the prospects of going back to a world of ZIRP (Zero Interest Rate Policy), benefiting higher multiple, long-duration large-growth stocks, is highly unlikely. In this context it makes sense that asset classes with more exposure to cyclical areas of the market (*i.e.*, small- and midcaps) did quite well during this period as these have tended to be areas of the market that have benefited most from "healthy" inflation and higher rates. In fact, this trend started to play out, beginning in October 2022. Once the initial rise in rates was absorbed by the market, from October of 2022 through the early part of 2023, we witnessed a strong rotation from US large-cap growth stocks to small- and midcap stocks. . . and then what happened? Well, early in 2023, Generative AI swept in and "saved the day" for the Magnificent 7. But if not for Gen AI (I know, it's hard to say that with a straight face), we would be looking at a very different market environment today.

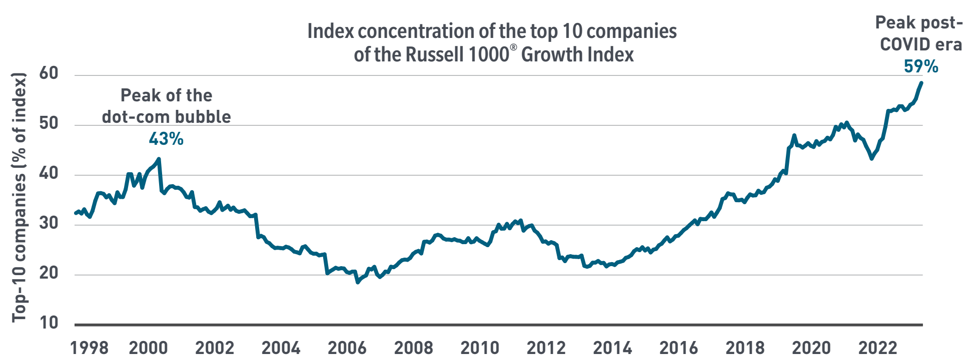
Exhibit 3: Inflation and Interest Rates Now More Aligned With Those of the Mid-2000's



Source: FactSet for 10-year US Treasury Yield. Monthly data as of 31 January 2000 to 31 December 2007. Global Inflation, consumer prices (annual %) - World Development Indicators. Data from database: World Development Indicators. Annual data from 2000 – 2007.

Concentration risk – Speaking of Gen AI, extreme concentration risk in US tech (Exhibit 4) is also reminiscent of the period leading up to the early 2000s (dot-com bubble ring a bell?). With that said, the mega-cap technology companies of today are clearly high-quality businesses and not analogous with the Pets.com or the eToys of the dot-com era. However, if earnings expectations for these largely concentrated areas of the market were not to live up to the lofty expectations embedded in their stock prices, and multiples derate, the relative value opportunity for small- and midcap stocks could be tremendous.

Exhibit 4: A Handful of Large-Cap Stocks Dominated Performance Then and Now



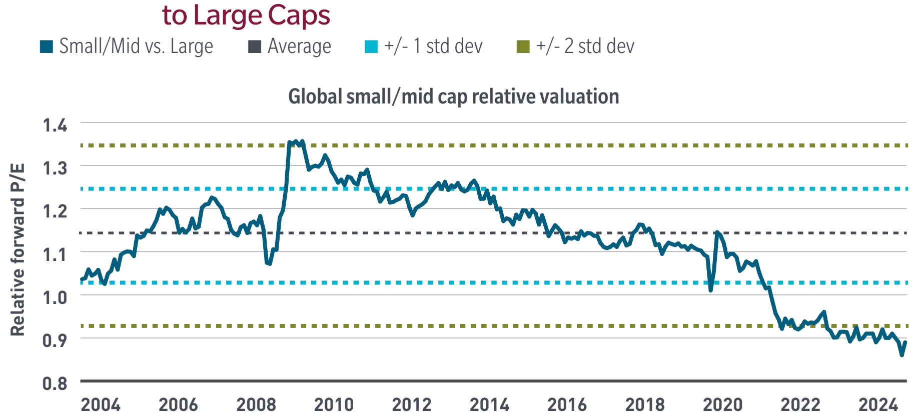
Source: FactSet. Monthly data as of 31 December 1998 to 28 June 2024. Securities are rolled to the issuer level and issuer weights within the index are summed monthly.

Low return environment for US stocks – Following the bursting of the dot-com bubble in the early 2000s, we witnessed a period of low returns for US equities. In fact, over that eight-year period, while global small- and midcap equities, as measured by the MSCI ACWI SMID Index, were up 94.5% (8.7% annualized), the S&P 500 was up just 14% (1.7% annualized) and the tech-heavy Russell 1000® Growth was down 21.2% (-2.9% annualized). So if, or perhaps more likely when, the euphoria around Generative AI becomes fully baked into these mega-cap tech stocks that dominate today's US benchmarks, we could be potentially setting ourselves up for an extended period of low absolute returns, which would also certainly rhyme with what we witnessed from 2000 to 2007.

Name	Cumulative Return 2000-01-01 to 2007-12-31 USD	Annualized Return 2000-01-01 to 2007-12-31 USD
MSCI ACWI SMID NR USD	94.48	8.67
S&P 500 TR USD	14.09	1.66
Russell 1000® Growth TR USD	-21.17	-2.93

Valuations – I left valuations last on the list of parallels as this has been the "base case" for investing in many asset classes outside of US Large Cap Growth over the last decade. Unfortunately, as we've come to find out, valuation alone is not an investment thesis and things can stay "cheap" for a long time without a catalyst. However, in our view, you would once again have to go back to the early 2000s to find a buying opportunity as attractive as it stands today as global small- and midcap stocks have traded at two standard deviations "cheap" relative to their large-cap counterparts (Exhibit 5). Additionally, while lofty valuations didn't matter much in a world of zero inflation, zero interest rates and access to essentially "free" capital, in world of higher rates, higher inflation and less liquidity, they matter greatly.

Exhibit 5: Global Small/Midcap Valuation at Multi-Decade Lows Relative to Large Caps



Source: FactSet. Monthly data as of 30 July 2004 to 31 July 2024. Series shows the relative forward price-to-earnings (next-twelve-months) for MSCI All-Country World SMID Index (ACWI SMID) relative to MSCI All-Country World Large Cap Index (ACWI Large).

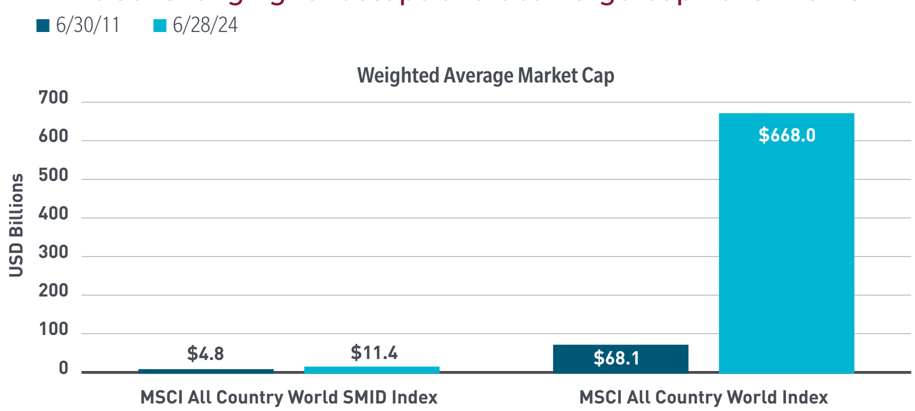
Future trends could benefit a broader range of companies

In addition to the parallels between today's market environment and that of the early 2000s, perhaps more importantly, while technology and artificial intelligence will be an important part of our daily lives, we believe future trends could benefit a wider cohort of sectors and industries outside of just the technology-centric US companies of the past decade. Trends such as increased capex spending (versus opex only), spending to upgrade infrastructure, energy and the energy transition, defense and national security, as well as the reshoring and the localization of supply chains, just to name a few. And while many large-cap companies may stand to benefit from these trends, many small- and midcap companies may stand to benefit as well. And while the US dominates the landscape when it comes to large-cap tech, it would be naïve to assume that all the best companies in the world across a wide subset of sectors and industries reside in a single region or asset class.

The changing landscape of global standard benchmarks

Last, and perhaps most important, we believe the biggest reason for suitable investors to consider a dedicated allocation to the global small- and midcap asset class today is that global investors are significantly less able to gain exposure to small- and midcap stocks through traditional standard global benchmarks. This is primarily due to the strong performance of a handful of US technology stocks during the past decade (and their ensuing increase in market capitalization). In our view, the dominance of the most influential large-cap stocks can be better appreciated when viewed from the perspective of market-capitalization buckets, as illustrated in Exhibit 6, where exposure to companies with a market capitalization greater than $300 billion has gone from just over 2.5% of standard benchmarks in 2011 to over 30% of these same benchmarks. In fact, the weighted average market cap of the MSCI All Country World Index has gone from $68B to an astounding $668B over that same period, leaving many investors under allocated to small- and midcap stocks.

Exhibit 6: Changing Landscape of Global Large-Cap Benchmarks



Source: Bloomberg/MFS Research. Data as of 30 June 2011 and 28 June 2024.

		6/30/2011 Index Weight %	6/28/2024 Index Weight %	% Change	Market Cap Segmentation
Market Cap – MSCI All Country World Index	Up to $30bn	44.70	19.06	-57%	Small-Mid Cap
	$30bn - $300bn	52.76	47.44	-10%	Large Cap
	Over $300bn	2.53	33.50	1224%	Mega Cap

Source: Bloomberg/MFS Research. Data as of 30 June 2011 and 28 June 2024.

Why MFS®?

With our eight investment research offices around the globe and our collaborative global research platform, we can place analysts in local markets, where they perform in-depth company research and cross-border comparisons on a stock-by-stock basis. We believe the breadth and depth of our platform, along with this local expertise, allows us to cover and uncover stocks that others may miss, as we strive to deliver a well-diversified global small- and midcap portfolio.

All told, we believe MFS

- brings significant resources to a relatively inefficient and less-followed asset class on a global basis
- has the ability to leverage the MFS global research platform and our long-term time horizon to potentially identify unique opportunities in the global small- and midcap universe
- has a long history of managing small- and midcap strategies on behalf of clients globally ($55 billion under management in small- and midcap portfolios as of 12/31/23)
- has a seasoned portfolio management team averaging 18 years with MFS and a strong background in managing small- and midcap strategies

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