TD Asset Management

Investor Knowledge 10 Minutes

Focusing on an **overlooked asset class**

At a glance

- **The U.S. small and mid-capitalization (cap) asset class may be an incubator for tomorrow's biggest companies and has historically rewarded investors for the additional risk taken relative to U.S. large caps.**
- **Within U.S. equity markets there is a concentrated group of mega-cap stocks that can dominate market performance, both to the upside and downside. Investors can consider an allocation in less concentrated U.S. small-and mid-cap stocks where they may benefit from an improved risk-adjusted return profile.**
- **To harness the opportunity in the space, TD Q U.S. Small-Mid-Cap Equity ETF ("TQSM", the "ETF") aims to provide exposure to a diversified portfolio of small- and mid-cap U.S. companies. By using a quantitative multi-factor approach, which seeks to optimize exposure to stocks that are expected to outperform the market by emphasizing style factors, TQSM aims to provide strong performance.**

U.S. small and mid-cap equities offer investors a dynamic opportunity set of companies that span from emerging small-cap stocks to former large-cap stocks that have stumbled back to mid-cap land. While many U.S. small and mid-cap stocks may not be household names in Canada, today's largest and most recognizable stocks were once small and mid-cap companies. Apple, Amazon, NVIDIA, and Tesla were all squarely in the U.S. small and mid-cap asset class at one point.

We recognize that U.S. small and mid-caps are not as well represented in investor portfolios in Canada, but an allocation based on an investor's risk profile and goals may be appropriate given the attractive risk-adjusted return profile the asset class historically has provided. Coupled with the wide variety of U.S. small and mid-cap funds out there, this paper will discuss the "why, what and how" when it comes to investing in U.S. small and mid-cap equities.

Why invest in U.S. small and mid-cap equities?

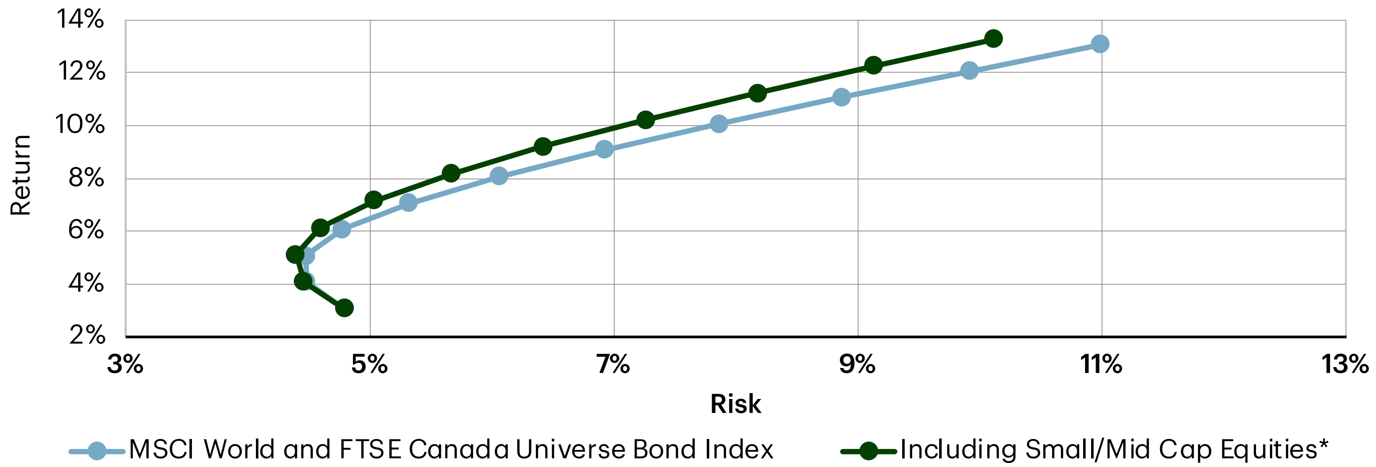
Smaller U.S. companies are the lifeblood of the U.S. economy. While they don't get the same sort of media exposure as an Apple or Microsoft, these companies span the gamut from agricultural and construction machinery to airplane parts to specialty chemicals and everything in between. These companies also have a bias toward the strong U.S. economy, and they should benefit from the "onshoring"/"reshoring" of U.S. industries.

What are the key considerations when investing in small and mid-cap stocks?

The small and mid-cap indices are much more diversified than the large cap S&P 500 Index. The weight of the largest 1% of companies within the S&P 500 Index is well over 20% of the index, which dwarfs the benchmarks used by TD's small and mid-cap funds. Similarly, from a sector point of view, the S&P 500 Index is more concentrated in a single sector than the small and mid-cap benchmarks – the largest sector (Information Technology) within the S&P 500 Index is more than twice as large as the second-largest sector (Financials). If we include companies like Amazon, Alphabet, Meta and others that were previously classified as Information Technology companies, then the IT sector would be over three times as large as the Financials sector. While the concentration of the S&P 500 Index in just a few companies tends to lead to strong performance when they do well (such as in 2023 with the "magnificent seven"), the index performance can also suffer when they underperform.

Adding small and mid-cap stocks to a diversified portfolio can lead to higher returns and lower risk. The graph below shows the efficient frontier for a portfolio consisting of varying weights of the FTSE Canada Universe Bond Index and the MSCI World Index (blue line). Adding in a small allocation of small and mid-cap stocks to this portfolio leads to higher returns and lower risk (green line).

Adding small and mid-cap equities to a diversified portfolio can lead to higher returns and lower risk



Source: FactSet. Data as of December 4, 2024.
*Taking 5% from the MSCI World Index allocation and adding the allocation to 50% S&P Mid-Cap 400 Index (total return) 50% S&P Small Cap 600 Index (total Return).

How are valuations today compared to historical trends?

Valuations for small and mid-cap equities tend to be attractive. Historically, small and mid-cap equities traded at a premium to large-cap equities reflecting their higher risk/return profile. However, since 2017 the large-cap index has become more expensive and the gap in valuations between large-cap equities and smaller cap stocks has been increasing (chart below), indicating that smaller stocks are attractively valued compared to their larger peers.

S&P 500 Index vs S&P 1000 Index Price/Earnings Ratio

Source: TD Asset Management Inc., FactSet. Data as of December 4, 2024

Solutions from TD Asset Management Inc.

TQSM aims to provide exposure to a diversified portfolio of small and mid-cap U.S. companies through a quantitative multi-factor approach, which seeks to optimize exposure to stocks that are expected to outperform the market by emphasizing style factors like value, quality, sentiment and size. For those who prefer investing in U.S. dollars, TDAM offers TQSM.U. ■

Visit the TD ETFs solutions page for more information.

Opportunity

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