

Is the Mega-Cap Era Over? The Case for a Small-Cap Rotation

By Paul Ehrlichman



Bigger isn't always better—especially when market leadership starts to crack. In Q1, the so-called Mag 7 mega-cap stocks posted their worst underperformance on record, dropping nearly 16%. Investors quickly rebranded them the Lag 7, signaling that the era of large-cap dominance may be running out of steam.

While near-term performance in small-cap strategies is mixed, the long-term fundamentals tell a different story. According to research by Professor Kenneth French, over the last 50 years, small-cap stocks—those in the bottom two-thirds of the market by size—outperformed their large-cap counterparts by 300 basis points annually. The recent stretch of mega-cap dominance has flipped that trend, with small caps underperforming by over 500 basis points per year. But today, U.S. small caps trade at a 24% discount to large caps—levels historically tied to major reversals, like those seen from 1974–1981 and 1998–2018.

In other words:
mean reversion is
setting the stage
for small caps to
take the lead.

Beyond valuation, small caps bring something the market desperately needs right now—diversification. In an environment dominated by a handful of names, smaller companies offer access to future leaders, not yesterday's monopolies. As Jim Chanos said, "Monopoly profits are hard to maintain." Small companies aren't facing that wall. They're better positioned to benefit from AI deployment, emerging market consumption, regulatory easing and global stimulus.



They're also acquisition targets in slower-growth environments and have more room to expand margins.

International small caps are even more compelling. Under-owned, under-analyzed, and fundamentally attractive, they're trading at just 10x earnings, at book value, and yielding over 4%. While U.S. small caps are still lagging, their global counterparts in China, Europe and key emerging markets are already outperforming.

Our InFlexion platform has surfaced a number of high-quality small-cap funds we believe are well positioned for what's ahead.

- ▶ AQR Large Cap Defensive Style
- ▶ Alger Small Cap Growth
- ▶ Dean Small Cap Value
- ▶ Jackson Square SMID-Cap Growth
- ▶ Lazard International Small Cap
- ▶ Lord Abbett Micro Cap Growth
- ▶ Needham Small Cap Growth
- ▶ Virtus KAR Small-Cap Growth
- ▶ Segall Bryant & Hamill Small Cap Growth
- ▶ William Blair Small Cap Value
- ▶ Wasatch Emerging Markets Small Cap

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It's about *time*.

About the Author

Paul Ehrlichman, Flextion's CEO and CIO, has over four decades of experience in portfolio management, leveraging fundamental and quantitative research to develop investment processes and strategies that enhance client returns and manage risks in volatile markets. He has led equity teams focused on global and international value strategies, serving a diverse client base that includes individuals, pension funds, and endowments at several leading global asset managers.

Flextion is a breakthrough platform for evaluating fund strategy returns, helping investors identify managers at a pivotal turning point—those poised to outperform after a period of underperformance. Designed by seasoned portfolio managers, Flextion bridges the gap between “clock time” and “market time,” empowering investors to unlock long-term value and uncover hidden performance potential.

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