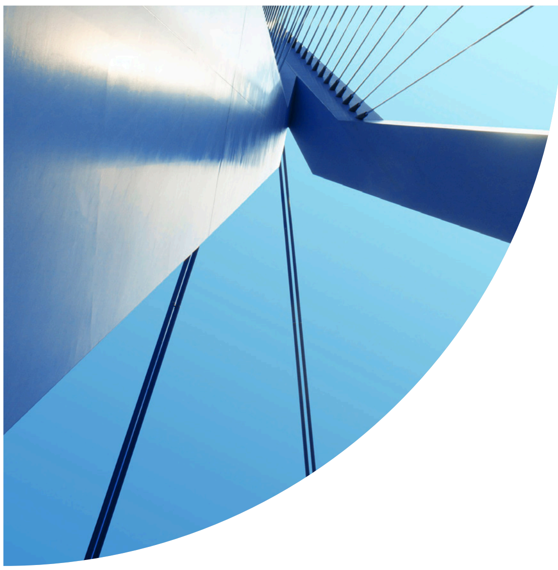
Historic Extremes Create Extreme Opportunities



Why small- and mid-growth companies may be the next sweet spot

A narrow group of mega-cap growth stocks, the so-called Magnificent 7 (Mag 7), is responsible for the vast majority of positive equity market performance to date in 2023. As shown in Figure 1, as of September 30, the Mag 7 were up 55% on average while the remaining 493 stocks in the S&P 500 Index gained just 3%. By some measures, market breadth has fallen to its lowest levels in over 20 years. While the fundamentals of some of the Mag 7 are indeed impressive, we believe that concentration has reached levels that are both extreme and historically unsustainable. Therefore, we strongly believe investors should position for a broadening out of equity market leadership. In particular, we think that small- and mid-cap growth stocks could deliver compelling returns.

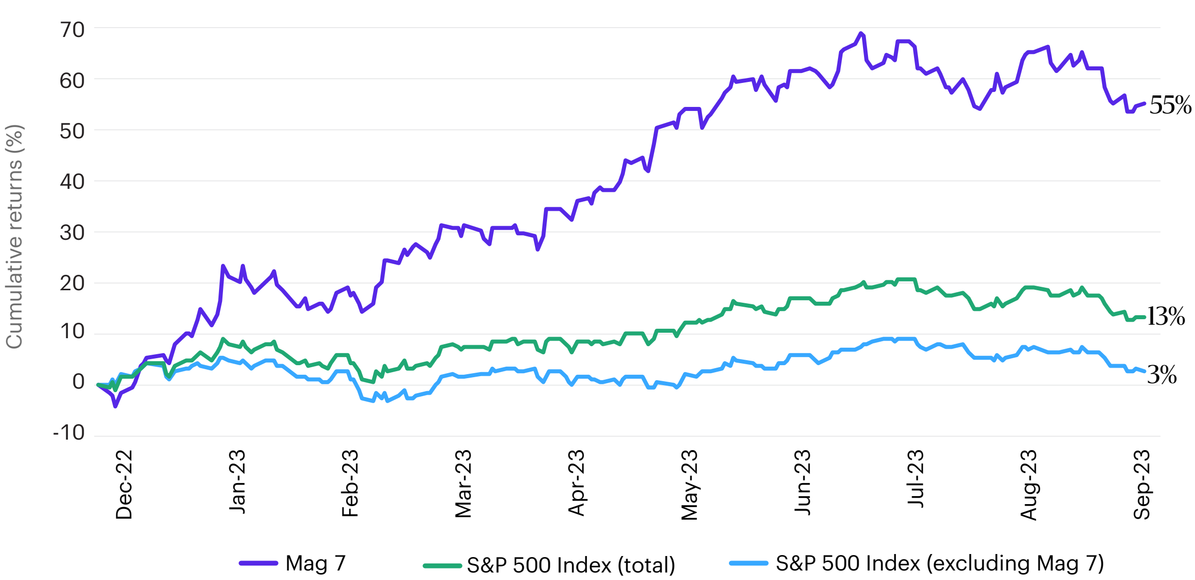
MIKE SMITH, CFA

+ Managing Director, Senior Portfolio Manager, Discovery Growth Equity Team

OZO JACULEWICZ, CFA

+ Associate Portfolio Manager, Senior Portfolio Specialist, Discovery Growth Equity Team

FIGURE 1: YEAR-TO-DATE CUMULATIVE RETURNS OF MAG 7 VERSUS REMAINING S&P 500 INDEX CONSTITUENTS

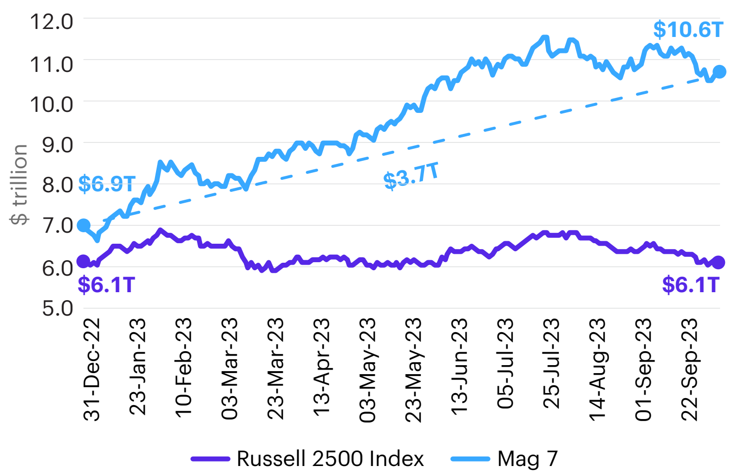


Source: FactSet, data presented from December 31, 2022, through September 30, 2023. **Past performance is not a reliable indicator of future results.**

Just how dominant have mega-cap tech stocks become?

To demonstrate the extreme levels of concentration we see today, we compared the growth in market capitalization of the Mag 7 with that of the Russell 2500 Index, which captures the entire small- and mid-cap universe of U.S. stocks (the SMID-cap equity universe). As recently as four years ago, the combined market cap of the Mag 7 equated to 83% of the Russell 2500 Index. Recently, this ballooned to 174%. As shown in Figure 2, the total value of these seven stocks has grown by $3.7 trillion this year alone, which amounts to more than half of the entire market cap of the SMID-cap universe. Put another way, for the combined cost of buying the Mag 7, an investor could buy the entire SMID-cap equity universe with $4.5 trillion to spare!

FIGURE 2: GROWTH IN MARKET CAPITALIZATION OF THE MAG 7 HAS BEEN EXPLOSIVE



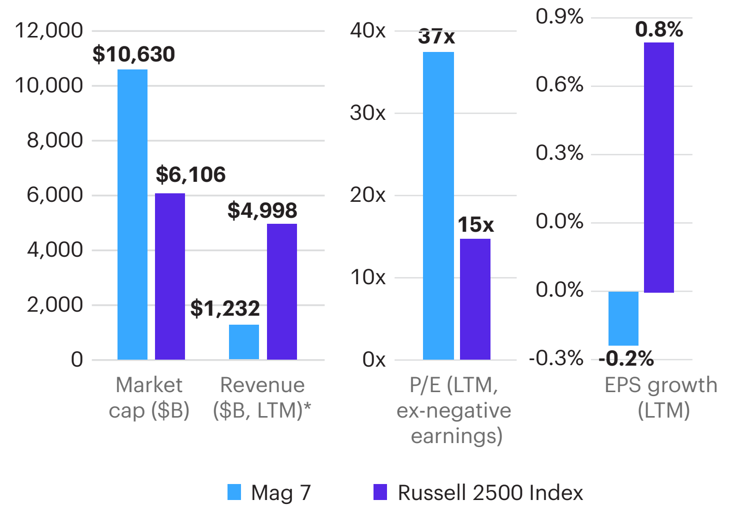
Source: FactSet; data presented from December 31, 2022, through September 30, 2023

Healthy fundamentals for small and mid caps

This raises an important question: "*Are investors getting good value for crowding into the Mag 7?*" To find out, we looked at the revenue, earnings-per-share growth, and valuations of the Mag 7 versus those of the Russell 2500 Index. The results, shown in Figure 3, are astounding. In the past year, SMID-cap stocks produced nearly 4x higher revenues while trading at less than half the price/earnings multiple of the Mag 7. Investors in the Mag 7 are achieving lower growth rates and are paying a much higher price for each dollar of earnings. In short, investors in the Mag 7 are **not** getting good value for their money.

FIGURE 3: THE MAG 7 OFFER INFERIOR GROWTH PROSPECTS TO THE SMID-CAP GROWTH UNIVERSE

Small- and mid-cap stocks offer significant growth at a substantially lower relative cost

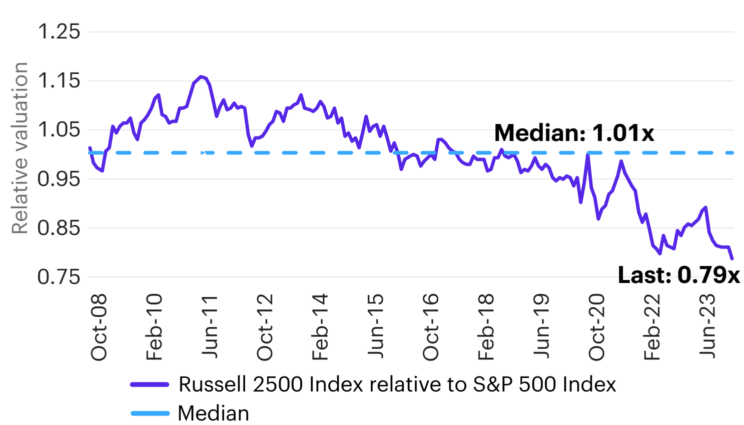


Source: FactSet, as of September 30, 2023
*Market cap and revenue are cumlative. The Mag 7 include Alphabet, Inc.; Amazon.com, Inc.; Apple Inc.; Meta Platforms Corp.; Microsoft Corp.; NVIDIA Corp.; and Tesla, Inc. LTM equals last 12 months.

Small caps and mid caps are trading at attractive relative valuations

In Figure 4, we compare the historical valuations of U.S. large caps, as represented by the S&P 500 Index, with the Russell 2500 Index. Beginning in 2018, small- and mid-cap valuations began lagging large caps—a trend that accelerated since the onset and recovery from the pandemic. From a long-term historical perspective, this has created favorable relative valuations for the smaller segments of the U.S. equity universe. The Russell 2500 Index, which usually trades at a small premium to the S&P 500 Index, is currently trading at a 21% discount. **This is near the lowest relative valuation in two decades and foretells a promising setup for expected returns, should historical relationships return to normal.**

FIGURE 4: RELATIVE VALUATIONS OF SMID VERSUS LARGE CAPS ARE PLUMBING HISTORICAL LOWS



Source: FactSet; data presented from October 31, 2008, through September 30, 2023

Why is now the right time to invest?

Mega-cap technology companies have enjoyed outsized gains in 2023, and this is reflected in their bloated market capitalizations and valuations. We view this narrow leadership to be unsustainable for several reasons.

First, the economy appears to be significantly slowing as persistent inflation and a corresponding rise in interest rates take hold. This is causing uncertainty in the forecasts for consumer and business spending. It has been 18 months since the Federal Reserve started its hiking cycle. A rule of thumb is that it takes 12 to 18 months for the bite of rising rates to be fully felt across the economy, but the impact may be more severe this time as the pace of rate hikes this cycle has been the most rapid on record—and has come off a near-zero starting point.

> *"If something cannot go on forever, it will stop.*
>
> —STEIN'S LAW

Second, elevated valuations for many of the Mag 7 imply sky-high expectations. Should any of these bellwether companies miss or guide down financial results, valuations could compress nearly as fast as they expanded. Indeed, this has happened in the past when groups of stocks traded at valuations that exceeded fundamental reality. Even if their profitability in nominal terms holds up, their extreme valuations may not fare as well as their businesses eventually converge with low-single-digit gross domestic product growth. The writing is on the wall: Now is an excellent time to position for a change in market leadership.

Final thoughts

To reach long-term financial goals, it is critical for investors to benefit from compound returns. In our view, they can more likely achieve this through greater exposure to small- and mid-cap U.S. equities. By targeting smaller companies, investors can own businesses that are more nimble, innovative, and attractively valued. For years, we have described such companies as being on the "right side of change." Whether the economy has a hard or soft landing, our guidance to investors is to avoid crowding into a narrow group of just seven stocks and to lean toward diversifying into small- and mid-cap companies with strong secular earnings growth and attractive relative valuations.

To learn more

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

FOR U.S. INVESTORS ONLY

- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **1-888-701-2575**.
- To reach our institutional investment professionals, contact your existing client relations director, or contact us at **AllspringInstitutional@allspringglobal.com**.
- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **1-800-368-1370**.

FOR INTERNATIONAL INVESTORS ONLY

- To reach our Allspring International team, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspring.com** and **jamie.newton@allspringglobal.com**.

ALL-10182023-7w4y6vdv