

International Small Cap Equities Are Gaining Momentum

Most portfolios are more U.S.-heavy than investors realize. International small cap is one of the most overlooked gaps—and conditions for closing it are improving.

International small cap equities make up a significant portion of the global market, yet many investors have minimal (or no) exposure to this asset class. However, **many of the challenges international small caps have faced in recent years have abated**, and signs suggest the asset class could be poised to continue the strong performance experienced in 2025.

Challenge	Background	Why it may abate
Macroeconomic pressures	Higher interest rates and inflation and currency volatility increased borrowing costs and reduced profitability for small cap firms. Global trade uncertainty has also disproportionately affected these companies, which tend to have less flexibility than large multinationals to absorb sudden shifts in costs or demand.	A weakening U.S. dollar boosts non-U.S. assets. Central banks around the world have lowered interest rates, which tends to make borrowing easier and support economic activity—conditions that can benefit smaller companies. And because international small cap companies tend to rely more on local customers and domestic supply chains than large multinationals, they may be less exposed to global trade disruptions. That focus on home markets could prove to be an advantage as globalization continues to unwind or be reworked.
Sector composition	International small cap markets are more diversified into cyclical sectors such as industrials, materials, and financials, which underperform during economic downturns. Lack of exposure to high-growth sectors such as technology limits upside potential.	Global economic activity has been expanding, with purchasing managers' index readings above 50 signaling growth in key markets. ¹ That kind of environment tends to favor the cyclical industries (such as industrials, materials, and financials) that make up a significant portion of international small cap indexes. Commodity markets may also provide a tailwind for smaller companies in resource-rich economies. This sector mix also provides a high level of diversification against U.S. large cap indexes.

¹ As of 03/01/26. Source: Bloomberg.

Challenge	Background	Why it may abate
Perceived lower quality relative to large caps	Many investors assume small cap means lower quality: less profitable, more speculative, and more prone to failure. This perception does not reflect the reality of international small cap markets. A significant share of companies in the MSCI EAFE Small Cap Index are profitable across return on equity tiers, suggesting the asset class carries significantly less speculative risk than many investors assume.	As investors look more closely at the fundamentals behind international small cap indexes—rather than applying broad small cap assumptions—the quality profile of the asset class may become better understood and more appropriately valued.
Investor sentiment	Economic concerns in Europe and the U.K., combined with years of large cap outperformance, pushed investors toward the perceived safety of larger, more familiar companies. Capital followed momentum, and international small caps saw sustained outflows that had little to do with the underlying quality of the businesses.	In 2025, investors began rotating out of U.S. equities in favor of foreign assets. As foreign companies show stronger results and small international stocks are still inexpensive, we believe this trend can keep going. ² When an asset class trades at a discount for an extended period, it can attract attention from investors looking for value. Improving economic conditions and the potential for additional policy stimulus could accelerate that shift.

² As of 03/11/26. Source: Bloomberg, FactSet, Voya IM.

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