



Attractive Japanese Small- and Mid-Cap Stocks

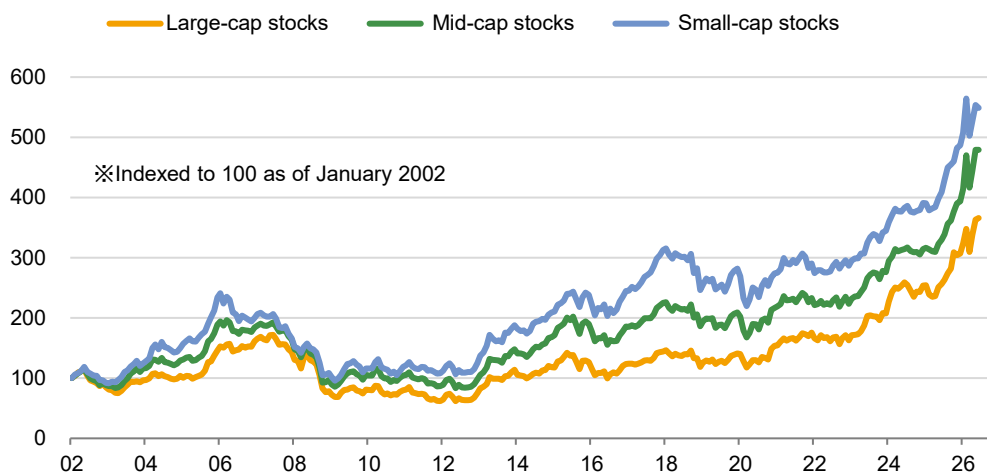
Reasons to Focus on Small and Mid-Cap Stocks Now

👉 Key Points to Note

- The small- and mid-cap universe contains numerous high-growth, undervalued hidden gems
- Careful stock selection can yield investment returns that outperform large-cap stocks
- Corporate Governance: The focus of reform is shifting toward Small- and Mid-cap stocks
- Attention on small- and mid-cap stocks is growing due to accelerating domestic demand growth and a shift toward a strong Yen

In the Japanese stock market recently, the strong performance of mega-cap AI and semiconductor stocks—which have been driving the Nikkei 225's sharp rise—has been particularly noticeable, and small- and mid-cap stocks rarely make the headlines. Looking back at the bull market since 2023, the main drivers have been large-cap stocks, which have attracted concentrated buying from foreign investors. However, Japanese small- and mid-cap stocks are an attractive asset class. Expanding your search beyond well-known large corporations (large-cap stocks) to include hidden gems known only to insiders (small- and mid-cap stocks) is beneficial both for enhancing investment returns and for managing overall portfolio risk. In this report, we will examine the appeal of small- and mid-cap stocks and why they deserve attention right now.

Small- and Mid-Cap Stocks Have Outperformed Large Caps over the Long Term



※ Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap Indexes; latest figures as of June 5, 2026

Source: Russell/Nomura and Bloomberg; Compiled by Daiwa Asset Management

Many High-Growth Companies Not Found Among Large Caps

One characteristic of small- and mid-cap stocks is that, precisely because the companies are smaller, they can experience rapid earnings growth once their businesses enter a growth trajectory. Many small- and mid-cap companies actively introduce new technologies, products, and innovative services, creating the potential for significant growth in overall revenue and other metrics through initiatives such as acquiring new customers. In contrast, large-cap companies tend to have a large business scale and are more prone to diversification, so the impact of a single initiative on the company's overall performance is often relatively small.

In the case of small- and mid-cap stocks, it is also common to see founding entrepreneurs leading the company with strong leadership. Since the management themselves are major shareholders, they tend to manage the company with a focus on stock prices, and their interests are often aligned with those of investors (shareholders).

Often Left Undervalued

Another characteristic is that high-quality companies with proprietary technologies and strong competitiveness tend to remain undervalued. Compared to large-cap stocks, which are frequently featured in newspapers and other media, these companies receive less attention from investors. Furthermore, since many are not covered by analysts, their corporate value is often overlooked. In addition, because there is less information disclosed in English compared to large-cap stocks, awareness among foreign investors remains low. This makes them particularly attractive given the current situation where indices such as the Nikkei 225 continue to rise significantly, leading to a perception that large-cap stocks are overvalued.

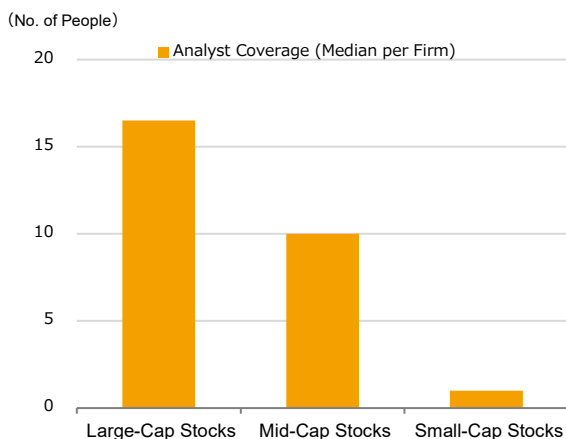
High Growth Driven by Small Company Size



※ Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura JapanTop, Mid, and Small Cap indices, as of June 5, 2026

Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

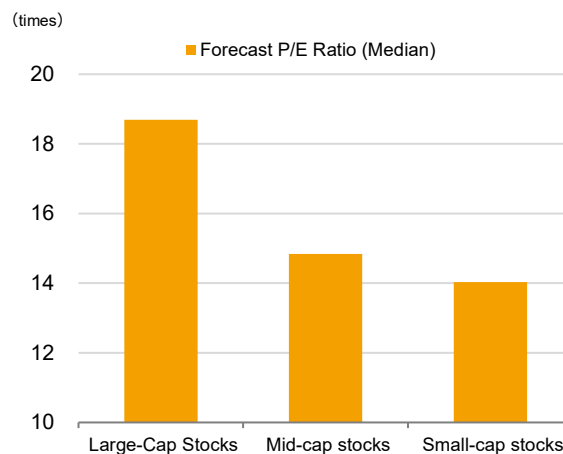
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Stock Selection Can Deliver Returns Above Large-cap Stocks

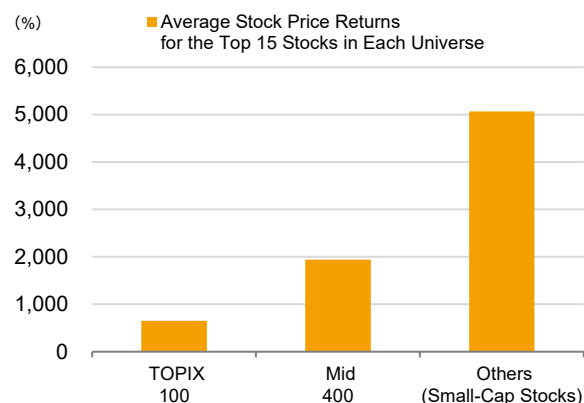
Due to characteristics such as high earnings growth and the fact that high-quality companies are often undervalued, small- and mid-cap stocks offer opportunities to identify stocks with dramatic price increases. As earnings expand and stock prices rise, public attention grows, analyst coverage begins or expands, and these stocks come onto the radar of foreign investors. At each of these stages, further acceleration of financial inflows is expected.

In fact, comparing the average returns of the top 15 stocks in each size-based universe over the past decade or so, starting from early 2015, the TOPIX 100 (large-cap stocks) returned +650%, while the TOPIX Mid 400 (mid-cap stocks) returned +1,950% and the “Others” (small-cap stocks) reached +5,070%. Furthermore, as shown in the chart below, when comparing the number of stocks that saw their prices increase fivefold versus those that increased tenfold by market capitalization over the same period, the difference is clear. While the significant difference in the number of stocks comprising each universe is one factor, it can be said that looking toward the small- and mid-cap universes, which contain a larger number of stocks, is a useful strategy for those seeking higher stock price returns.

Returns for small- and mid-cap stocks cannot be judged by indices alone. Compared to large-cap stocks, stock prices tend to be more strongly influenced by individual company factors; even when small- and mid-cap indices underperform large-cap indices, there are many cases where individual small- and mid-cap stocks see larger gains. For example, while the small-cap index has underperformed the large-cap index since 2018, a comparison of the average stock price returns of the top 15 stocks in each size-based universe over the same period shows that while the TOPIX 100 returned +500%, the “Other” (small-cap) category returned +1,820%—meaning small-cap stocks outperformed large-caps, contrary to the index trend.

Another characteristic is that, due to the low ownership ratio by foreign investors, these stocks are less susceptible to the influence of global macroeconomic trends and foreign investor sentiment. They also have low correlation with global stock markets and indices such as the TOPIX and Nikkei 225, making them a good choice for portfolio diversification.

Sharp Share Price Gains Among Top-performing stocks

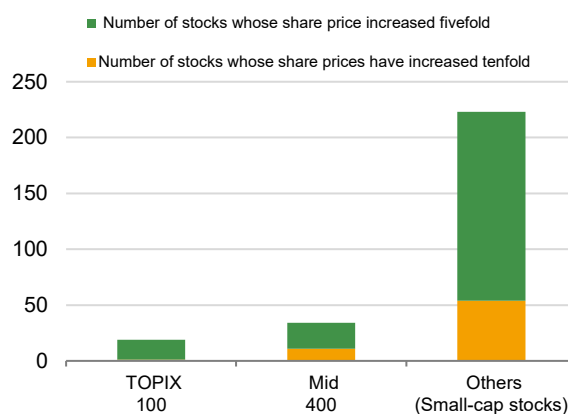


※ Stock price returns from the beginning of 2015 through June 5, 2026

Covers all listed stocks (common shares) for which stock returns can be calculated.

Source: FactSet; Compiled by Daiwa Asset Management

Exploring Small- and Mid-Cap Universes Can Enhance Return Potential

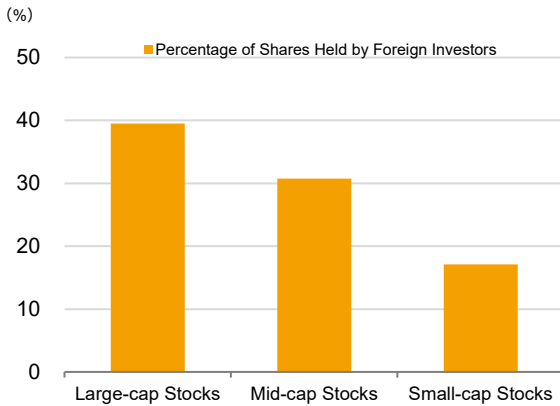


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Source: FactSet; Compiled by Daiwa Asset Management

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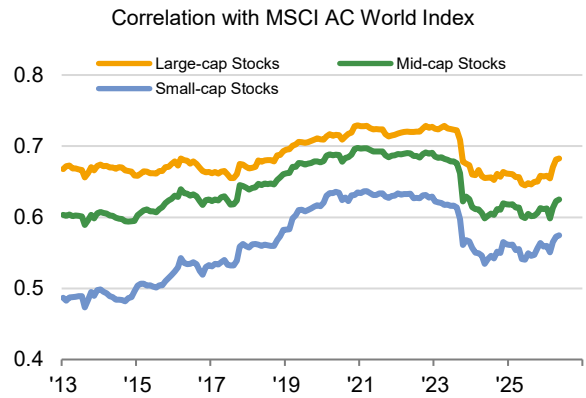
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※Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap indices, as of June 5, 2026

Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

...Given their low correlation with global stock markets, diversification benefits can be expected



※Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap indices, as of end of May 2026

Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

Why Small and Mid-Cap Stocks Now?

While the Japanese stock market has seen a continued large-cap bias since 2018, with small- and mid-cap stocks underperforming, their price performance relative to large-caps has stabilized over the past two years. In addition to their appeal as an asset class, we believe there are compelling reasons to focus on small- and mid-cap stocks right now. We expect investor interest in small- and mid-cap stocks to increase going forward, supported by further progress in corporate governance reforms, a shift toward an inflationary economic regime underpinned by a return to positive real wage growth, accelerating domestic demand in the “second phase” of this transition, and a projected shift toward a stronger-Yen trend.

Stabilizing Relative Performance of Small Caps vs. Large Caps



※ Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap indices

Latest figures as of June 5, 2026

Source: Russell/Nomura and Bloomberg; Compiled by Daiwa Asset Management

Corporate Governance: Focus of Reform Shifting to Small and Mid-Cap Stocks

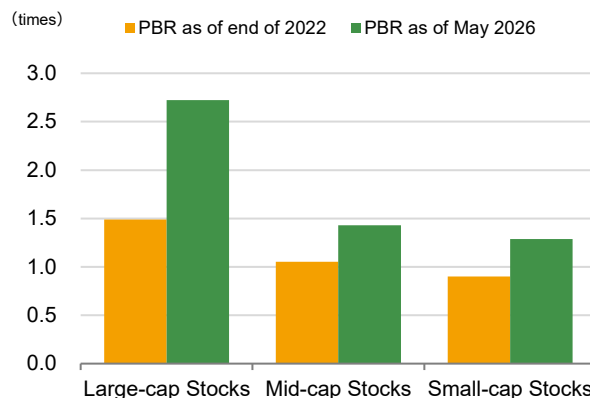
While significant progress has been made in corporate governance reform in the Japanese stock market, large-cap stocks—which have abundant resources and are more susceptible to pressure from foreign investors—are leading the way, while small- and mid-cap stocks are lagging behind. According to data released by the Tokyo Stock Exchange in April 2026, 94% of companies listed on the Prime Market have already disclosed measures to “realize management that takes capital costs and stock prices into account” (in response to the “TSE Request”), whereas only 54% of companies listed on the Standard Market have done so. Reflecting this situation, improvements in PBR are also lagging among small and mid-cap stocks.

However, as reforms take root in the Japanese stock market, the focus of regulators and investors is shifting toward small- and mid-cap stocks, and these reforms are expected to gain momentum going forward. At the Tokyo Stock Exchange’s Expert Panel, discussions have centered on measures for small- and mid-cap stocks—such as the Standard Market and Growth Market—since 2025. As reforms progress further, measures for small- and mid-cap stocks are expected to advance, leading to a reassessment of stock prices and valuations.

This year marks the first revision of the Corporate Governance Code in five years. The draft revision was published on April 10, and a public comment period ran through May 15. Notable in this revision are new provisions regarding the “appropriate allocation of management resources” and the “promotion of growth investments.” The code states that companies should “continuously verify” whether they are “effectively utilizing management resources, such as financial assets (cash and deposits) and tangible assets, for growth investments and other purposes.” Additionally, the reference materials state that “when allocating management resources,” companies “need to consider a resource allocation strategy that includes diverse investment opportunities and shareholder returns.”

The issue of “cash hoarding”—the accumulation of excessive cash and deposits that are not being effectively utilized—is a problem across the entire Japanese corporate sector. However, since many small- and mid-cap companies are cash-rich, the pressure for reform may intensify further among these firms.

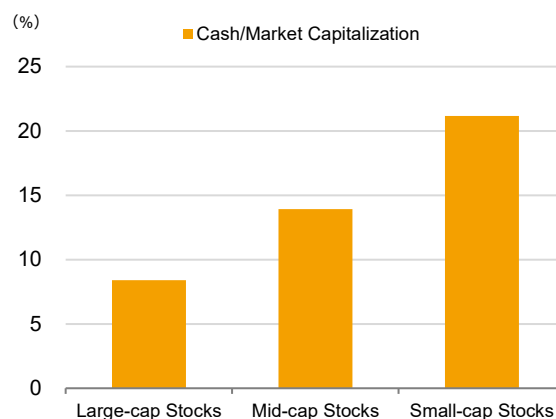
Degree of Improvement in PBR Compared to the End of 2022



※Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap indices, as of end of May 2026

Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

Growing Reform Pressure on Cash-Rich Small- and Mid-Cap Stocks



※Large-cap, mid-cap, and small-cap stocks are represented by the Russell/Nomura Japan Top, Mid, and Small Cap indices, as of June 5, 2026

Cash refers to “cash, deposits, and short-term securities” , excluding financial

Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

Domestic Demand Acceleration and a Stronger Yen Shift

Structural changes in the Japanese economy as it transitions to inflation will also provide a tailwind. While high nominal GDP growth is boosting corporate earnings through sales expansion, real wages—which have been negative for a long time—are expected to turn positive this year. They have already been positive year-on-year for four consecutive months since January 2026, and if real wages remain steadily positive, not only will consumption recover in a virtuous cycle, but consumers are also likely to become more accepting of price increases than ever before. As a result, companies are expected to regain the domestic pricing power lost during the deflationary period, leading to robust profit growth in their domestic operations. Compared to large-cap stocks with global operations, small- and mid-cap stocks have a higher proportion of domestic sales; therefore, as domestic demand growth gains momentum, interest in small- and mid-cap stocks is expected to increase. Middle East tensions pose upside inflation risks, but any impact is likely to be temporary unless the de facto closure of the Strait of Hormuz becomes prolonged.

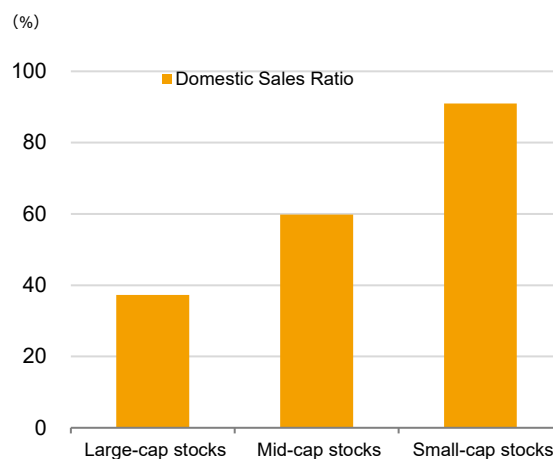
Furthermore, we anticipate that the Yen will appreciate in the foreign exchange market as the situation in the Middle East improves, which will also serve as a tailwind for small- and mid-cap stocks, which have a high proportion of domestic sales and tend to outperform during periods of a strong Yen. The USD/JPY exchange rate, which stood at 103 Yen in early 2021, rose to the 160 Yen range by mid-2024, significantly boosting the profits of large-cap stocks with high overseas sales ratios. Conversely, rising import prices have created headwinds for small-cap stocks with high domestic sales ratios. Currently, while there is strong Yen depreciation due to the deterioration of the situation in the Middle East and high crude oil prices, we expect the Yen to strengthen as crude oil prices fall following the normalization of the situation in the Middle East, driven by an improvement in Japan's terms of trade and a relative rise in real interest rates.

Real Wages Turn Positive YoY



※ Most recent figures are April 2026
 Source: Ministry of Health, Labour and Welfare; Compiled by Daiwa Asset Management

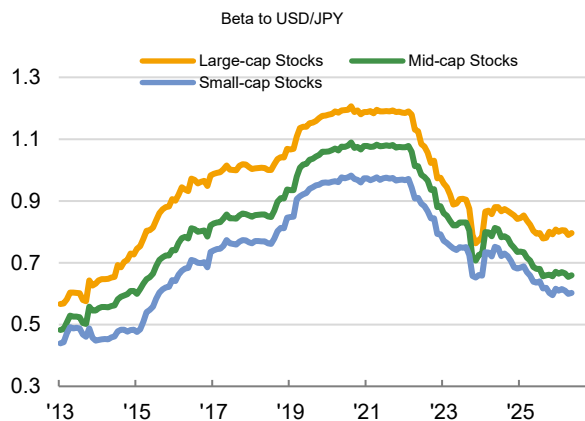
Improving Domestic Demand May Spur Interest in Small- and Mid-Cap Stocks



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Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

Our Expected Yen Strength Provides a Tailwind for Small- and Mid-Cap Stocks



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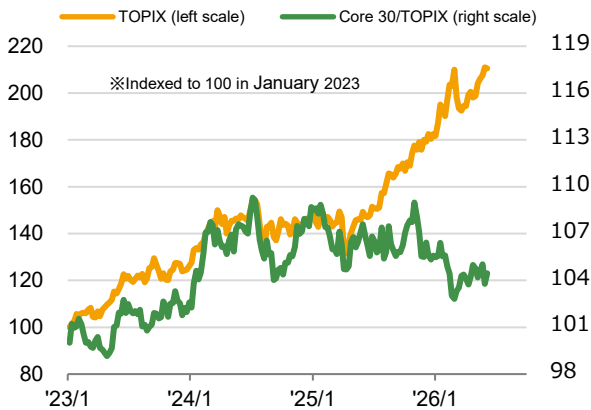
Source: Russell/Nomura and FactSet; Compiled by Daiwa Asset Management

Broadening of Market Participation Beyond Mega-Cap Stocks in a Bull Market

While the relative stock price performance of small- and mid-cap stocks has stabilized, that of mega-cap stocks has slowed. This can be considered one of the typical patterns seen in a bull market. When the Japanese stock market is re-evaluated, foreign investors begin buying Japanese stocks in earnest, and a bull market begins, financial inflows tend to concentrate on globally well-known stocks such as those in the TOPIX Core 30. However, as seen in the bull markets starting in 2003 and 2012, the scope of investor interest tends to gradually expand. As the current bull market continues, we expect this expansion of interest to extend to small- and mid-cap stocks.

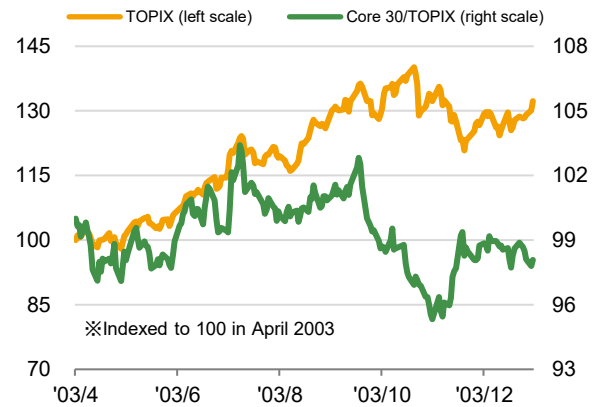
It is also worth noting that the relative price performance of small-cap stocks in the US stock market is improving. While it is true that the drivers behind small-cap stock movements differ between Japan and the US, if global interest in small-cap stocks increases, Japanese small-cap stocks are likely to benefit as well.

Slowing Relative Performance of Mega-Cap Stocks



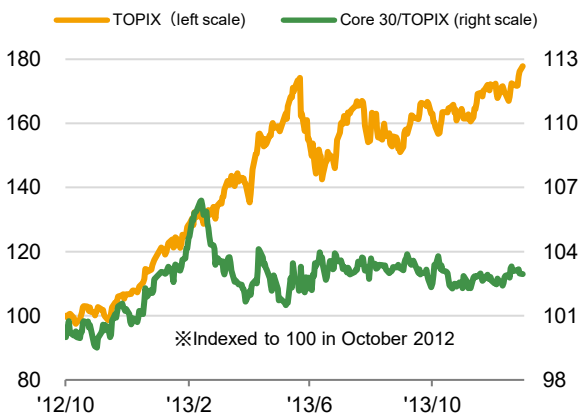
※ Most recent figures as of June 5, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Amid a continuing bull market...



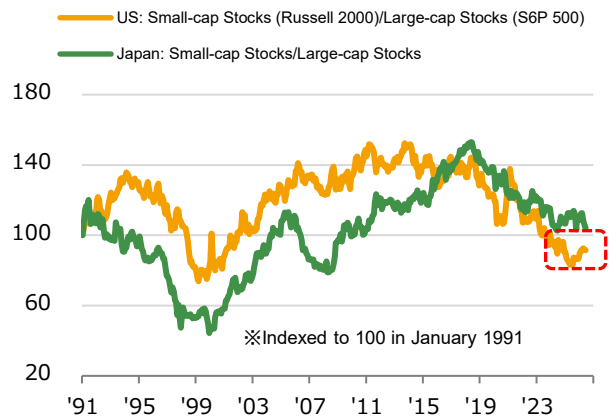
※ April 2003–December 2003
Source: Bloomberg; Compiled by Daiwa Asset Management

...This pattern of broad-based buying has been observed in the past



※ October 2012–December 2013
Source: Bloomberg; Compiled by Daiwa Asset Management

Improved Performance of Small-cap Stocks in the US stock market



※ Japanese large-cap and Small-cap stocks are represented by the Russell/Nomura Japan Equity Index Top Cap and Small Cap indices, respectively; latest figures as of June 5, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

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