

MARKETS IN FOCUS

Don't sleep on small caps

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We can all admit that we have trust issues with the small-cap segment of the equity market. Despite brief spikes along the way, we are now in the 14th cumulative year of large-cap outperformance.

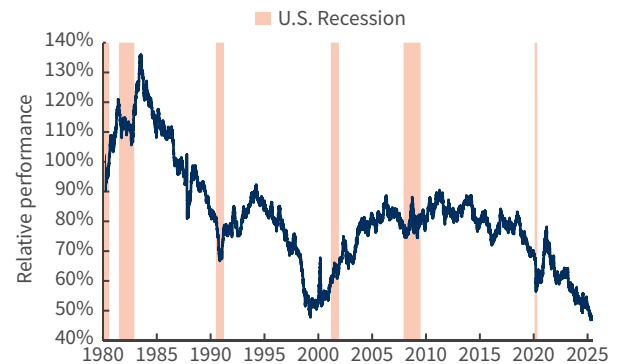
What once was empirical is now mythical: The Fama French Three-Factor Model's assumption that smaller companies have higher expected returns — that investors should see greater returns for taking on greater risk — just hasn't been the case.

The Russell 2000® Index has been range-bound for years; its last all-time high was November 8, 2021. Meanwhile, the S&P 500 Index has notched more than 80 all-time highs over the same period. Now, however, a confluence of tailwinds could finally start supporting outperformance in small caps. Continued economic resiliency, the prospect of lower interest rates, and a resurgence in earnings growth have finally improved the risk/reward outlook at the smaller end of the market capitalization spectrum. Moreover, performance is starting to get on the right track.

It's no secret that small caps are favorably priced, especially compared to large caps. In fact, right now the Russell 2000 Index excluding companies that are not profitable* is trading at a price-to-earnings multiple that's about 10 percentage points cheaper than the S&P 500 Index. Apart from 2021, this is the cheapest that small caps have traded relative to large caps since the aftermath of the dot-com bubble. It comes down to the fact that the fundamentals of small caps have markedly trailed those of large caps.

Relative underperformance is at a 45-year low

Relative performance of the Russell 2000 Index vs. Russell 1000 Index since 1980



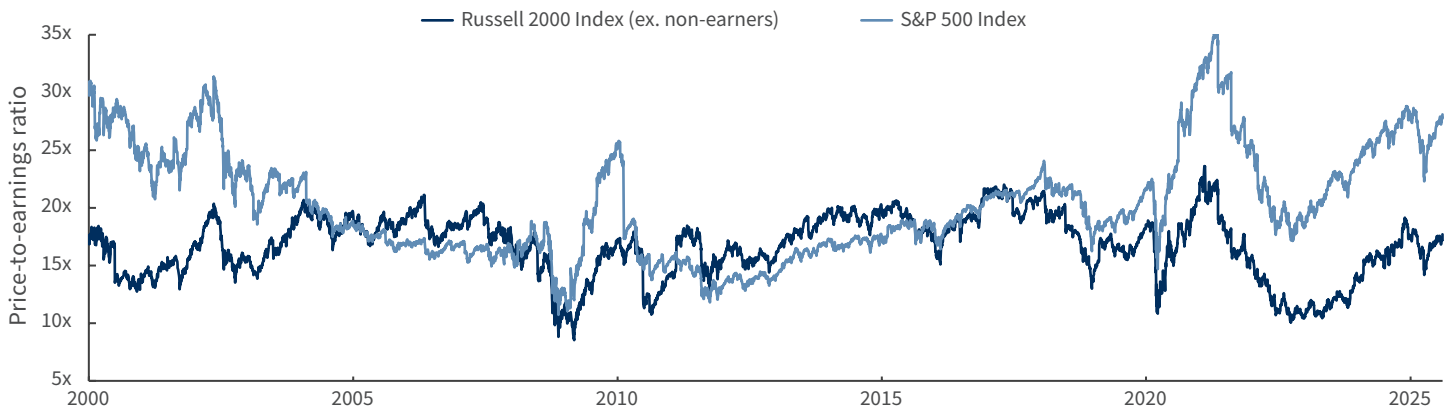
Source: Bloomberg, as of 8/12/2025.

However, the case for small caps is based on more than valuations alone. Investors are generally overallocated to large-cap companies, which have been plagued by concerns about narrow market breadth and lofty valuations. The low relative valuations of small-cap companies can offer better risk mitigation during periods of volatility, providing insulation when selling pressure picks up.

Look at Liberation Day: Tariff announcements triggered a drawdown across the market, but small-cap companies were able to exit their drawdown faster than their large-cap counterparts,

Small caps are trading at their widest discount in the last 20 years

Last 12 months price-to-earnings ratios



Source: FactSet, as of 8/12/2025.

*Note: The price-to-earnings ratio of Russell 2000 Index companies excluding non-earners provides a more consistent comparison with the S&P 500, where most constituents are profitable.

mainly because they weren't as widely owned and weren't as expensive as large-cap favorites.

Much of the valuation discrepancies come down to earnings. The S&P 500's largest seven companies by market capitalization have driven large-cap earnings, posting earnings growth of 37%, but the remaining 493 companies in the index have also out-earned the Russell 2000 by 5% to -17%.

Large-cap companies have spent years posting robust earnings growth by leveraging their international footprints and economies of scale, leaving small caps with no reply. Now, analysts broadly expect the earnings growth of small-cap companies to exceed that of large caps in 2025 and 2026. Despite the upgrade, small-cap earnings are still coming in nearly 900 basis points better than analysts' expectations. Critically, revision ratios for earnings and sales are moving higher — and guidance isn't deteriorating like it has done in the past.

We increasingly believe that this is the year we could see small-cap earnings growth outpace large-cap earnings growth, reverting to the mean of their relative valuation gap. The massive amount of capital expenditures (capex) from large caps could trickle down to small caps, providing an upside to earnings in the future.

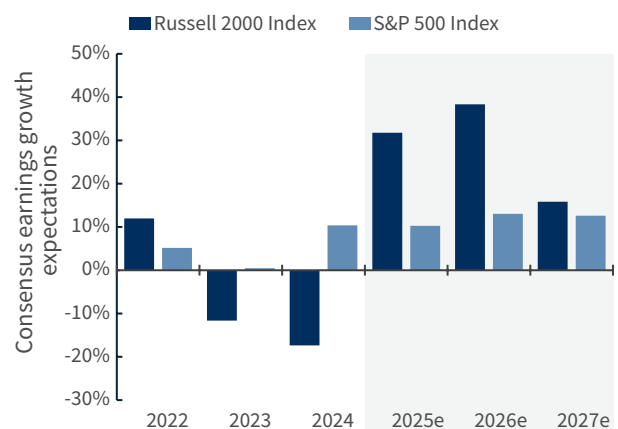
The notable uptick in capital markets activity could also be a tail-

wind for small caps: There are plenty of strong acquisition targets in healthcare, larger companies are flush with cash, and patent cliffs are on the horizon. In financial services, regional banks may see their fragmented market consolidate while they broker deals.

There's finally light at the end of the tunnel.

Optimism for small caps this year

FactSet consensus earnings growth expectations



Source: FactSet, as of 8/12/2025.

Enthusiasm for small caps ticked up around the election, when investors were optimistic about deregulation and accelerating growth. We may finally see those benefits at the same time that recession fears are waning and broader sentiment is improving. We believe deregulation is likely to be the Trump administration's upcoming economic focus, which could complement other growth-oriented policies:

- Easing the regulatory reporting and reserve burdens on small and mid-sized banks could unlock mergers and acquisitions (M&A) activity;
- Small industrial and tech companies could be helped by the increased manufacturing tax credits and ability to expense domestic research and development (R&D) spending that were included in the One Big Beautiful Bill Act; and
- The extension of the Tax Cuts and Jobs Act could be a tailwind for earnings growth in small-cap companies that are more domestically focused and less able to exploit international tax advantages.

Small-cap companies are more sensitive to interest rates than large caps, less because of their credit profile and more because they are a riskier stratum of equities. The U.S. Federal Reserve could begin cutting rates as soon as September, and falling rates have historically been positive for market breadth and small-cap companies, which further supports the case for investing down the market cap spectrum.

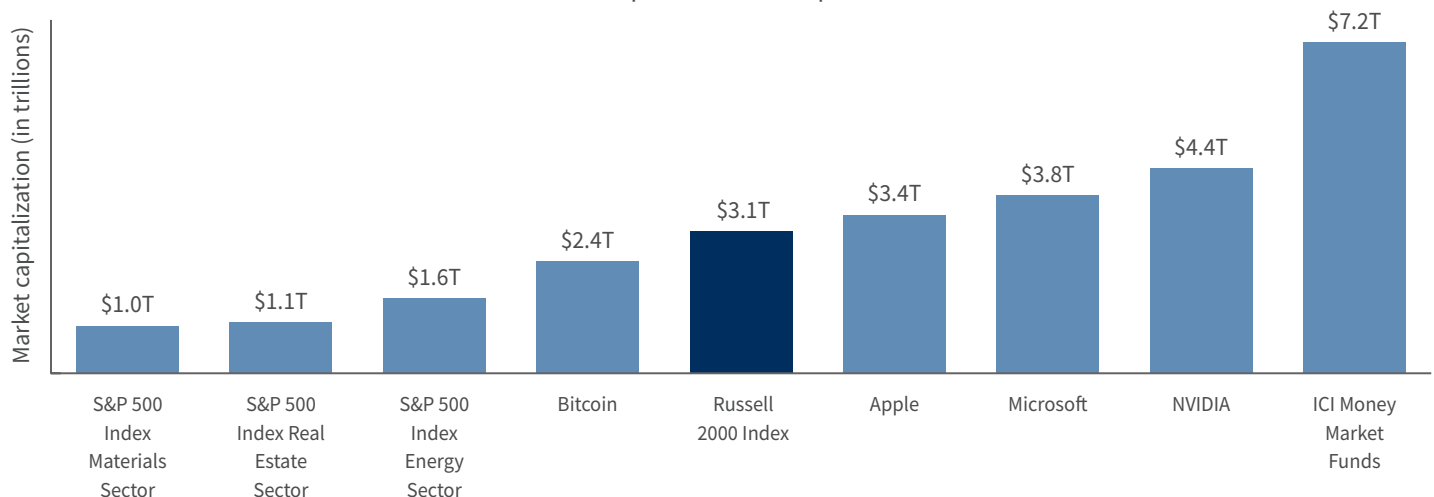
If you don't think the United States will fall into a recession, and you expect that interest rates will fall, then small caps deserve serious consideration.

Despite these reasons for optimism, investors have continued taking money out of small caps. As of August 12, about 6% of the assets in small-cap exchange-traded funds (ETFs) have left the asset class year to date. If earnings growth picks up and flows return to the space, small caps can benefit from multiple expansion.

We think investors would do well to reconsider their allocations down market cap while these companies remain attractively priced. When everyone expects consistent, constant disappointment, it can increase the magnitude and velocity of the price action that follows surprises. Small caps remain serially under-owned and could move quickly when sentiment inflects higher.

Fading uncertainty, falling recession risk, stimulative fiscal policy, the prospect of lower interest rates, and promising price action are all good reasons to consider owning small caps — and an allocation to small caps is part of a properly diversified portfolio. The S&P 500 Index's biggest names by market capitalization each eclipse the entire Russell 2000 Index's market cap on their own, which means lower-capitalization companies won't need the same amount of funds flowing into the space to generate outsized returns.

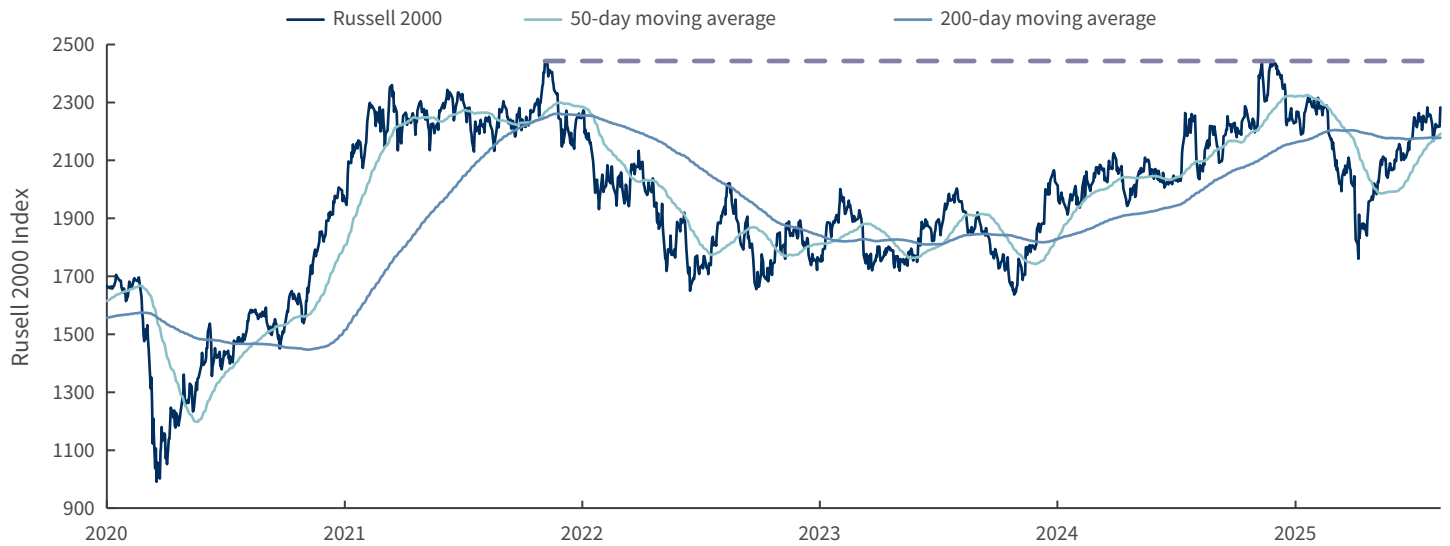
Small caps aren't asking for much... Market capitalization comparisons



Note: Specific companies are included for reference only; this is not a recommendation to purchase or sell specific companies or investment products.

Small caps look primed to retest their 2021 all-time high

Russell 2000 Index since 2020



Source: Bloomberg, as of 8/12/2025.



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Diversification does not ensure a profit or guarantee against loss.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

Definitions

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Breadth describes the relationship between the median and the mean of a market index. When a few data outliers result in a mean that is substantially larger (or smaller) than the median of the full data set, then the performance of the entire index is being driven by a "narrow" selection of companies. An index supported by "broad" market movements is one where the median is

closer to the mean.

Capital expenditures, or capex, are monies used by a company to buy, improve, or maintain physical assets such as real estate, facilities, technology, or equipment, and may include new projects or investments.

Consensus earnings growth expectations forecast the projected earnings growth of a public company, industry, sector, geography, asset class, or other category based on the combined estimates of analysts and other market observers that track the data in question.

The Capital Asset Pricing Model, or CAPM, is used to calculate the expected rate of return for a particular investment. It does so by considering both the expected returns for both the market and for a risk-free asset, plus the investment's beta.

The Fama French Three-Factor Model expands on the CAPM by adding size, risk and value factors to the market risk factor in the CAPM in recognition of the fact that value and small-cap stocks regularly outperform their broader markets. The size premium accounts for small-cap stocks that generate higher returns than the broader market. The Fama French Model was developed by economist Eugene Fama, who later won the Nobel Prize, and his colleague, Kenneth French, in the early 1990s.

Fiscal policy refers to the tax collection and spending a government uses to influence its country's economy.

Guidance refers to statements from the managers of publicly traded companies that indicate whether they expect to realize near-term profits or losses and why.

ICI money market funds refers to money market mutual funds that are sponsored by or members of the Investment Company Institute (ICI), a global association for investment funds.

Last 12 months price-to-earnings ratios calculate price-to-earnings ratios by using data from the past 12 months.

Liberation Day is a term used by President Donald Trump to refer to April 2, 2025, when he announced a wide range of unexpectedly high tariffs on many U.S. trading partners, triggering a global selloff of risk assets.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

Reversion to the mean, or mean reversion, refers to the statistical tendency of data to rise or fall toward its long-term average over time.

Multiple expansion occurs when a stock's multiple rises, in some cases faster than the stock's fundamental value. Multiple expansion creates arbitrage opportunities for investors who have bought the stock at the lower multiple value.

Non-earners are companies that do not report positive operating revenue.

The One Big Beautiful Bill Act, passed and signed into law in July 2025, raised the U.S. debt ceiling by \$5 trillion, made permanent tax cuts created by the Tax Cuts and Jobs Act of 2017, and changed a wide range of other aspects of federal tax policy, made changes to health insurance legislation, phased out or reduced credits for clean energy production or use, and removed tax benefits for illegal immigrants, among other things.

A patent cliff refers to the sharp dropoff in revenue when a company's patent expires, allowing competitors to enter the market. It often refers to patents on drugs produced by the pharmaceutical industry.

Valuations reflect the current or projected worth of investments. Absolute valuations reflect the absolute value of an investment considered singly, and relative valuations consider the value of an investment against comparable investments.

Revision ratios for earnings and sales refers to the ratio of analysts' upgrades to downgrades in each category for a given group of stocks.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

The Tax Cuts and Jobs Act (TCJA) of 2017 was a sweeping revision of the U.S. tax code that reduced taxes for individuals and businesses. The changes for businesses created a single flat corporate tax rate of 21% and also affected deductions, depreciation, expensing, tax credits, and other tax items that affect businesses. The corporate tax cut was permanent. The individual tax cuts were scheduled to expire in 2025 until some of them were made permanent by the passage of the One Big Beautiful Bill Act.

Under-owned is a term used to describe a security or group of securities believed to be trading at a level above its or their intrinsic or fair value.

Moving averages (MAs) are a technical analysis tool that smooths out stock price data by creating a constantly updated average price, often over a specified period of time, such as 15, 30, 50, 100, or 200 days.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividends reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 7% of the total market capitalization of the Russell 3000® Index.

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The Russell 2000® Index excluding non-earners is a measurement of the Russell 2000® Index excluding companies that do not report positive operating revenue.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 98% of the total market capitalization of the Russell 3000® Index.

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