

U.S. Small Cap Equities: A Strategic and Tactical Opportunity

U.S. small cap stocks play a strategic role in portfolios. They offer investors the potential for strong returns, diversification, and—through skilled active managers—long-term outperformance. In addition to these structural advantages, the current market environment appears to be especially favorable to small cap equities. Valuations remain at historic levels and rising IPO and deal activity should be supportive of prices going forward. Small caps are also under-owned after lagging U.S. large cap equities for virtually the entire past decade. Finally, we note that factor performance indicates markets have substantially neglected quality. In past cycles, investor favor has ultimately shifted—an evolution that favors an active, long-term approach. As we detail below, we believe these strategic and tactical reasons make small cap equities a compelling opportunity for investors.

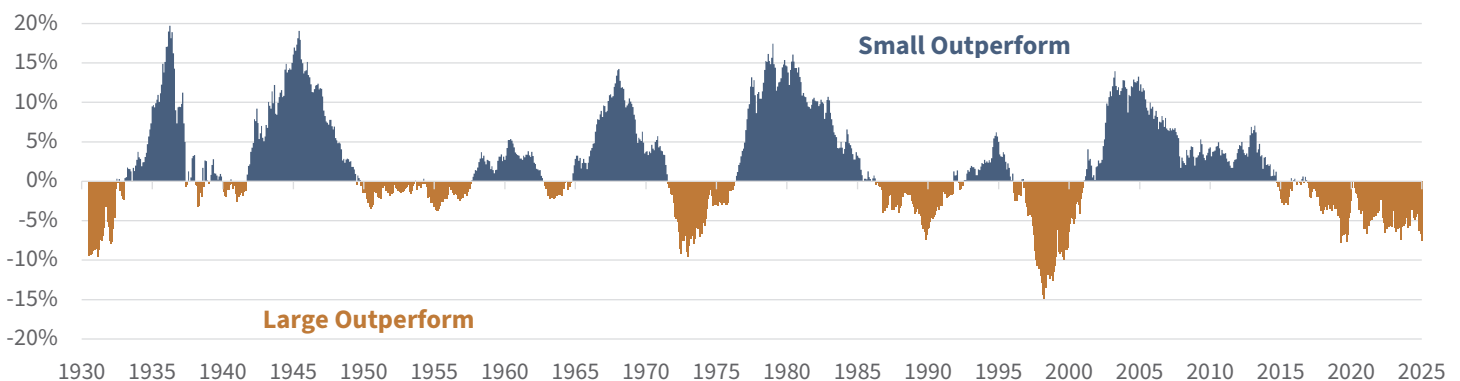
Small Caps: A More Favorable Environment

U.S. small cap stocks have generated strong performance over the past year. Since hitting a low in early 2025, small cap equities have risen sharply and are near multiyear highs.¹

U.S. small cap stocks, however, continue to underperform U.S. large cap stocks over the long term, a pattern that dates back more than 10 years. Over a multi-decade timeframe, small and large cap companies have alternated market leadership (**Exhibit 1**).

Exhibit 1: Small Caps and Large Caps Have Traded Market Leadership Over Time

Small Versus Large Cap Equities (Value-Weighted) 5-Year Monthly Rolling Excess Returns



As of 12/31/2025

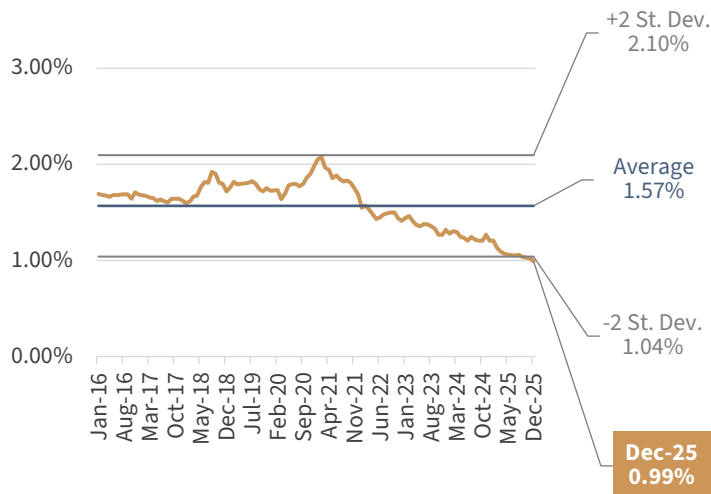
Source: Kenneth French's Data Library (portfolios formed on size, value-weighted)

Note: Small Caps are represented by the returns of the Med 40 portfolio, and large caps are represented by the returns of Hi 30 portfolio based on their monthly returns for the period July 1926 to December 2025.²

The recent outperformance by U.S. large caps, on a monthly rolling 5-year basis, has been historic, and investor allocations to U.S. small cap growth are at their lowest levels in more than a decade (**Exhibit 2**).

Exhibit 2: U.S. Small-Cap Growth Stocks Are Under-Owned

Percentage of U.S. Equity³ Assets Allocated to Small Cap Growth Over Past 10 Years



As of 12/31/2025

Source: Morningstar Direct. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

We believe, however, that investors should reconsider small cap equities. Not only can they play a crucial role in portfolios strategically, but several fundamental factors in the current environment appear favorable to U.S. small cap stocks, including:

Relatively Attractive Valuations: Because smaller cap equities are often seen as offering more upside potential than large cap companies, they have traditionally commanded a higher premium. Since 2021, however, large-cap stocks have had higher valuations and are now near their highest levels of the past 20 years relative to small-cap growth stocks (**Exhibit 3**).

IPO and Deal Flow Expected to Rise: Rising business activity and brighter growth prospects are creating a favorable environment for mergers, acquisitions, and IPOs among U.S. small businesses. In 2025, IPO activity surged with 216 new issues⁴ and raised nearly \$48 billion. This was a substantial increase from previous years (176 IPOs in 2024 and 127 in 2023).⁵ Moreover, private equity remains a key driver of U.S. small cap deal activity and, according to PitchBook, U.S. private equity

firms hold about \$1 trillion in dry powder. In 2025, private equity deal value reached \$1.2 trillion, the highest annual total since 2021.⁶ With substantial capital available and dealmaking momentum building, U.S. small cap valuations should remain resilient. However, it is important to note that many individual IPOs do not succeed, making skilled active management an important component of small cap investing.

The Active Management Edge in U.S. Small Cap Investing

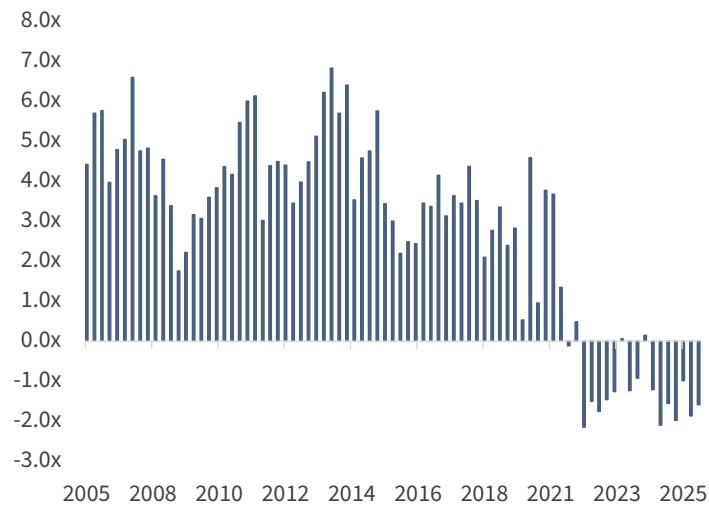
Active managers have more opportunities to identify market mispricings in U.S. small cap equity markets because they are less researched and have a wider range of characteristics than large cap. Investors can partner with an experienced active manager to add growth potential to their portfolios.

Limited Analyst Coverage Creates Market Inefficiencies

Smaller cap stocks do not have much coverage by Wall Street analysts—and some of them none at all—which makes deep, independent research even more critical.⁷

Exhibit 3: U.S. Small Caps Trade at a Discount

Difference in Forward Price-to-Earnings Ratios: Russell 2000 Growth Minus S&P 500 Index



As of 12/31/2025

Source: FTSE Russell

Note: Large caps are represented by the Russell 1000 Index; small caps are represented by the Russell 2000 Growth Index. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

U.S. Small Cap Universe Drives Wide Dispersion

With over 2,000 companies represented across indexes, U.S. small cap equities exhibit greater dispersion of returns than U.S. large cap equities (**Exhibit 4**). The dispersion is the result of the characteristics of small cap companies, which tend to be more influenced by company-specific factors rather than broader market trends. In addition, they typically have lower liquidity and less differentiation within sectors. Large caps, which are more mature businesses, are generally characterized by lower risk and lower upside potential.

A Negative Environment for High Quality

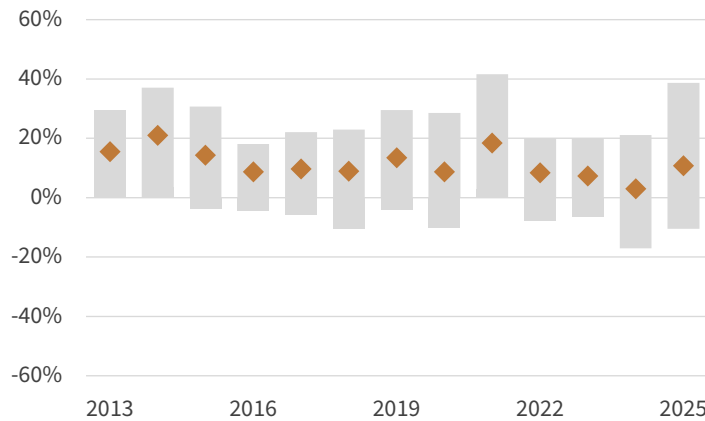
Small cap stocks have rallied since early 2025, but the performance within the asset class has been dramatically uneven. Factor performance indicates that many investors have been neglecting quality. In addition, and even more unusual, the performance of multiple factors hit extreme levels simultaneously. We have rarely seen such stark disparities in factor performance.

In the second half of 2025, the **MSCI Barra Earnings Quality** factor recorded its lowest six-month return in its 50 years—a history that includes low-quality episodes such as the technology bubble of the late 1990s and the COVID-era meme stock frenzy (**Exhibit 5**).

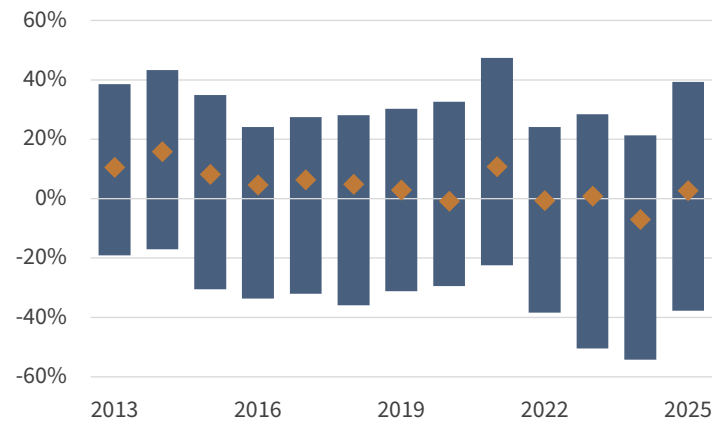
Exhibit 4: Wider Dispersion Offers Active Managers More Opportunities

Rolling Dispersion of 3-Year Annualized Returns (12/31/2013 to 12/31/2025)

Large Caps



Small Caps



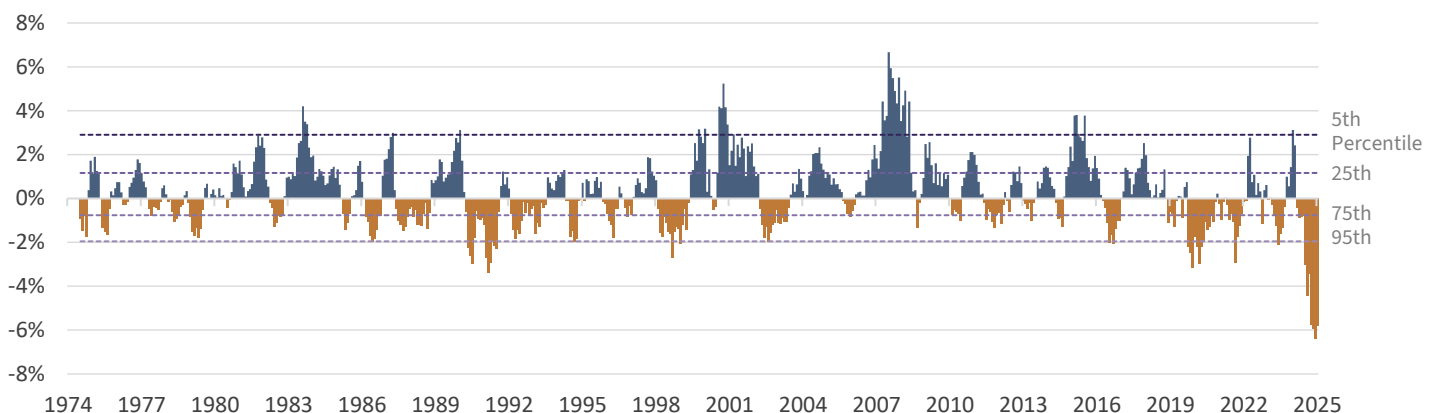
◆ Median

Sources: FactSet and FTSE Russell

Note: Large-caps are represented by the Russell Top 200 Index; small-caps are represented by the Russell 2000 Index. Dispersion is measured as the difference between the returns at the 10th and 90th percentiles.

Exhibit 5: The Earnings Quality Factor Has Recently Hit Historic Lows

6-Month Rolling Returns



As of 12/31/2025

Source: FactSet and MSCI Barra USSLOW Factor Model

Another record-breaking data point was recorded by the Beta factor, which posted a six-month return of 11.4% in the second half of 2025 (**Exhibit 6**). This performance ranks in the 1st percentile of six-month rolling returns for the factor since 1975. Beta has rarely been more in favor.

Finally, Momentum posted a six-month return of 5.5% in the second half of 2025 (**Exhibit 7**). This performance ranks in the 6th percentile of six-month rolling returns for the factor since 1975.

These factors illustrate that investors have been neglecting quality in recent markets, especially in 2025. It is also notable that daily trading volume in the stock market has been dominated by algorithmic /quantitative traders, short-term oriented hedge funds, and passive ETF inflows/outflows. The first two market participants tend to favor momentum (i.e., they typically chase winners and sell losers), while the third is buying or selling based on the underlying index or basket the ETF is constructed to mirror. These dynamics can cause many stocks to become divorced from the underlying fundamentals,

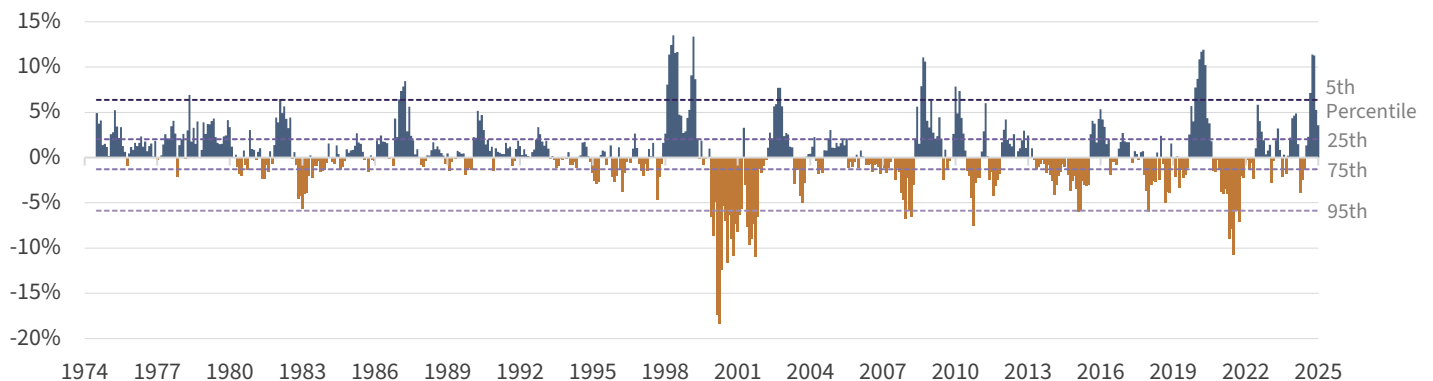
both to the upside and to the downside, over the short-to-medium term.

Low quality rallies are challenging for active managers because fundamentals are less rewarded and indices rise broadly, leaving fewer winners and losers on which to capitalize. High-quality rallies, however, tend to reward companies on a fundamental basis, thus making it a more favorable environment for skilled active managers with a fundamental, long-term approach.

As extreme as the factor performance has been, it has never been sustainable. Markets typically transition from speculative, momentum-driven phases—where low-quality, high-beta, or narrow leadership in the market is rewarded—to environments where fundamentals, balance sheet strength, and cash flow sustainability reassert themselves. Markets can favor high-beta, story-driven, or cyclical names but, when volatility rises, liquidity often tightens, or earnings dispersion widens, high-quality earners should begin to outperform as investors seek durability, transparency, and reliability.

Exhibit 6: The Beta Factor Has Hit Historic Highs

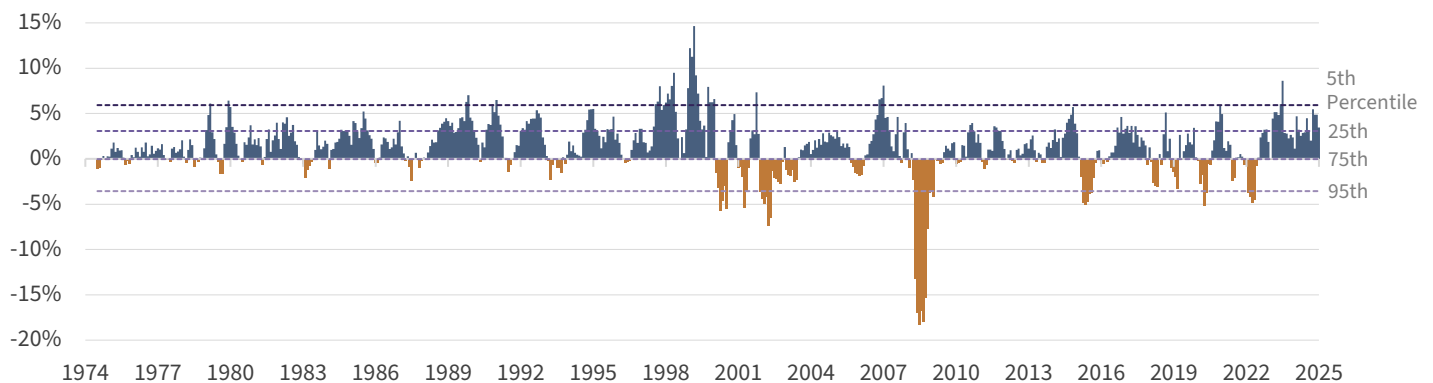
6-Month Rolling Returns



As of 12/31/2025. Source: FactSet and MSCI Barra USSLOW Factor Model

Exhibit 7: The Momentum Factor Has Performed Strongly in Recent Years

6-Month Rolling Returns



As of 12/31/2025. Source: FactSet and MSCI Barra USSLOW Factor Model

U.S. Small Caps: A Strategic Allocation and Tactical Opportunity

U.S. small cap stocks have historically delivered outperformance, diversification, and opportunities for active management. Currently, however, we believe the market backdrop for U.S. small caps is favorable for both short- and long-term reasons. Even after recent strong performance, U.S. small caps are under-owned and offer compelling valuations. We also note that, in past cycles, the outperformance of low-quality companies eventually reverts to higher quality.

Finally, small cap companies represent tomorrow's growth. All successful large cap companies started small, and they can contribute outsized long-term returns to those investors who identify them.

Investors should be aware that small cap investing carries risk. Historically, small caps have been more volatile and have had larger drawdowns than large caps. This makes a long-term investment approach and partnership with a proven active investor, in our view, essential for success.

About Baron Capital

Baron Capital is a premier asset management firm focused exclusively on delivering growth equity investment solutions to institutions, financial advisors, and individual investors. Since its founding in **1982**, Baron Capital has been united under one style of investing with a single objective—to be long-term investors in secular growth businesses with durable competitive advantages, run by great management teams. With **\$48.9 billion** in assets under management (as of 12/31/2025), Baron Capital prides itself on delivering the best solutions and outcomes for clients globally.

To learn more, visit BaronCapitalGroup.com

¹ Russell 2000 Index as of 3/20/2026.

² The "Portfolios Formed on Size" dataset from Kenneth French's data library provides value-weighted (and equal-weighted) returns on portfolios sorted annually on market equity (size). Portfolios are formed at the end of each June using market equity data for that June and NYSE-based breakpoints. The three-group sorts divide stocks into the bottom 30% (smallest firms), middle 40%, and top 30% (largest firms) of the NYSE size distribution. All NYSE, AMEX, and NASDAQ stocks with available market equity data are included in the portfolios (with breakpoints determined exclusively from NYSE firms).

³ U.S. equity includes the following Morningstar defined categories: US Equity, International Equity, Sector Equity, and Nontraditional Equity.

⁴ Does not include special purpose acquisition companies, or SPACs.

⁵ Rachel Gerring and Mark Schwartz, "2025 US IPO activity fuels confidence for 2026," *EY*, as of 1/28/2026.

⁶ PitchBook, as of 1/14/2026. 2025 US PE Breakdown.

⁷ Baron Capital (2025).

Important Information

The performance data quoted represents past performance. Past performance is no guarantee of future results. Current performance may be lower or higher than the performance data quoted.

The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies.

The **Russell 200 Index** measures performance of the top 200 largest US securities based on market cap.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth.

The **Russell 1000® Index** measures the performance of large-sized U.S. companies.

The **Russell 2000® Index** measures the performance of small-sized U.S. companies.

Beta explains common variation in stock returns due to different stock sensitivities to market or systematic risk that cannot be explained by the US Country factor. Positive exposure indicates high beta stock. Negative exposure indicates low beta stock.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered “forward-looking statements.” Actual future results, however, may prove to be different from our expectations. Our views reflect our best judgment at the time and are subject to change at any time based on market and other conditions and Baron Capital has no obligation to update them.

Risks: Diversification does not guarantee a profit or protect against a loss.

Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns.

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