POINT OF VIEW

Re-Thinking Volatility in Small Cap

Shifting Perspectives

When many investors think about U.S. small cap growth stocks, volatility often comes to mind. Over the past decade in particular, to say this volatility has not consistently translated into strong performance would be an understatement.

We believe these negative associations—while understandable—miss the bigger picture. The opportunity is not about investing in small cap growth as a broad asset class, but in the underlying companies and innovations that define it. This requires a mindset shift. We believe U.S. small cap growth is the bleeding edge of innovation, which in turn creates significant dispersion between winners and losers. The resulting volatility is not a flaw, but rather a byproduct of this dynamism as these emerging companies scale and find their product-market fit.

To an extent not seen anywhere else, this has historically created significant dispersion in the opportunity set. In this paper, we show how a volatile asset class with historically poor risk-adjusted returns can present a differentiated opportunity set for skilled managers. More importantly, we aim to show that many of the best managers in the asset class have processes to harness volatility to their advantage, enabling them to generate attractive risk-adjusted returns.

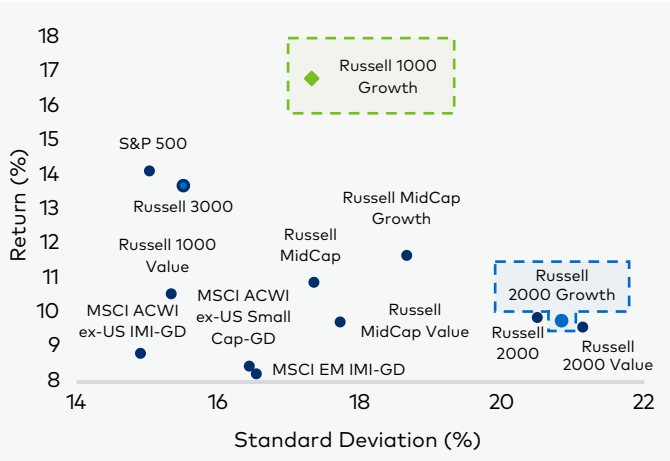
The "Asset Class" Perspective

It seems small caps have generally suffered from a reputation of being highly volatile, with none of the returns to show for it. Over the past decade, a quick comparison of U.S. small cap growth against its large cap counterpart reveals -700bps of annualized underperformance with 20% greater volatility[1]. Why is this? By their nature, many of these small cap businesses are earlier in their life cycles, less proven, and in some cases, still trying to find their product-market fit. Growth is usually not linear. Many companies are not profitable and dependent on external financing. More constrained liquidity can amplify price reactions to the upside and the downside. All the while, along this journey investors struggle to assign the appropriate valuation for businesses at the vanguard of new markets that can go from disruptors to disrupted in a very short period of time. Biotech—the largest standalone industry in the Russell 2000 Growth—is a great illustration of this "boom-bust" dynamic.

The issue here is that when you think of U.S. small cap growth as an asset class, you accept everything—the good with the bad. And when you think about the dynamics of the asset class, it doesn't have the same concentration and quality features of large cap, meaning overall asset class returns reflect the experience of the average company—unprofitable (or marginally profitable), economically sensitive, unproven business model, and no imminent competitive advantage. Confronted with these realities, one could be easily forgiven for deciding to forego an allocation or take a more tactical approach that uses the asset class as a vehicle to add risk based on interest rate and economic growth cycles.

As we'll see in the next section, there may be a better way to approach investing in U.S. small cap growth. In our view, the asset class only perspective can obscure important differences within the opportunity set, and at worst, can lead to an "in or out" mindset using the asset class as a vehicle to tactically increase/decrease risk.

Figure 1: Returns and Risk by Equity Asset Class, Trailing 25 Years



Source: eVestment. As of 03-31-2026. Shows annualized returns and standard deviation (as a measure of volatility) for a group of selected equity asset classes. Chart is presented lowest to highest based on standard deviation. While this is by no means an exhaustive analysis of all asset classes, it is intended to cover most of the potential investable universe.

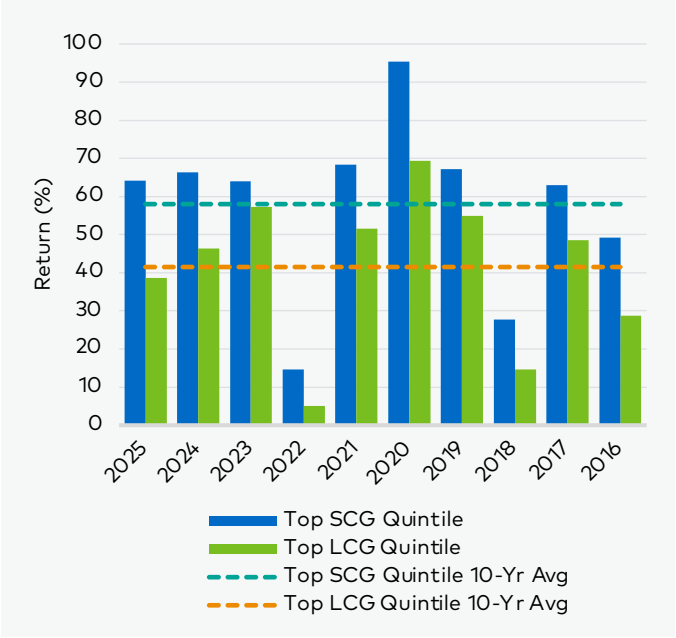
The "Opportunity Set" Perspective

If the asset class perspective boils down to owning everything, the opportunity set perspective reflects a more selective approach. The essence of U.S. small cap growth as an asset class can be disruption and innovation, and with it, outsized winners and losers. This is the lifeblood of active management.

In this sense, we believe volatility isn't something to be categorically avoided, but rather something to be taken advantage of with a robust process.

In Chart 2 below, we compare the top quintile of performance by calendar year for U.S. small cap growth against U.S. large cap growth. The first thing that stands out to us is the consistency of small cap outperformance vs. large cap in the top quintile. Said differently, managers who can identify these top performers are rewarded with more outsized performance than would otherwise be the case in large cap, and this has been true every year over the past decade. The other notable observation is that the top quintile of small cap outperformed its large cap equivalent significantly—on average by +16.5% over this 10-year period.

Figure 2: Comparing the Top Quintile of Returns, US SCG vs. US LCG



Source: Bloomberg. As of 03-31-2026. Chart shows the return associated with the top 20% of stock performers in a given universe in a given calendar year. "US SCG" refers to US Small Cap Growth and the universe is the Russell 2000 Growth Index constituents as of the respective date. "US LCG" refers to US Large Cap Growth and the universe is the Russell 1000 Growth Index constituents. Analysis excludes companies with a market cap <$750M to more accurately reflect the liquid, investable universe for most small cap managers.

Perhaps the more surprising finding came with the bottom quintile analysis. While it is true the bottom quintile of small caps consistently underperforms large caps, the magnitude of this underperformance was much more muted (-4.4% on average) as compared to the magnitude of small cap outperformance in the top quintile (+16.5%). Additionally, there were actually two instances (2022 and 2016) over the past decade where the bottom quintile of small cap stocks outperformed the bottom quintile of large caps.

Figure 3: Comparing the Bottom Quintile of Returns, US SCG vs. US LCG



Source: Bloomberg. As of 03-31-2026. Chart shows the return associated with the bottom 20% of stock performers in a given calendar year. "US SCG" refers to US Small Cap Growth and the universe is the Russell 2000 Growth Index constituents as of the respective date. "US LCG" refers to US Large Cap Growth and the universe is the Russell 1000 Growth Index constituents. Analysis excludes companies with a market cap <$750M to more accurately reflect the liquid, investable universe for most small cap managers.

While these dynamics are favorable and perhaps even surprising to some, it ignores a key element. In small cap, the likelihood a company will remain in the top quartile of returns from one year to the next can be low vs. large cap where there is more persistence one year to the next.

What does this mean? If you intend to fully take advantage of this dispersion, we believe you need a dynamic approach that matches the dynamism of the opportunity set.

From Volatility to Value Add

Over the past 25 years, the median active manager in U.S. Small Cap Growth[2] has outperformed the Russell 2000 Growth by nearly +2.2% gross of fees. But how managers deliver that excess return can vary considerably. Many managers approach the asset class with a "win by not losing" quality-first approach, seeking to avoid the long tail of unprofitable businesses with more cyclical growth and external financing needs. On that dimension alone, they may mitigate the risk of dilution, and at worst, avoid companies with a higher likelihood of ceasing to exist as going concerns. Understandably, this can result in improvement to risk-adjusted returns—in part because of an improvement to the numerator (returns) but often having more to do with the vast improvement from cutting off tail risks (the denominator).

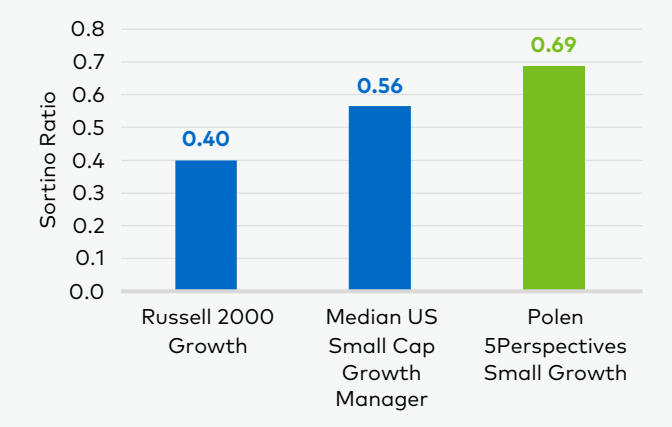
We take a different approach. Instead of first and foremost orienting around what we should avoid, we instead seek to harness the dynamism of the opportunity set to our advantage. We seek to identify the stocks in our universe at a given point in time that are experiencing some inflection in their business that the market has yet to fully appreciate. If we can get as close as possible to that inflection, it stands to reason we can get the benefit of both 1) accelerating earnings growth and 2) the valuation multiple expanding at the same time—and this is where outsized returns live.

Through our experience, we realized that identifying these inflection points in a business is very hard. Sometimes the inflection point presents itself in the form of a fundamental change, but it's also possible that it first comes in the form of price, or via the emergence of a timely thematic tailwind. By complementing this bottom-up fundamental discipline with thematic and technical disciplines, we aim to improve the odds of observing more of these inflection points, sooner in the growth curve.

An equally important and underappreciated element of investing in small caps is having a way to disengage quickly when emerging growth is no longer emerging. For every business that reaches escape velocity to mid and large cap, there's a long tail of small caps that return to earth or never truly emerge in a sustained way. For us, having the thematic and technical elements of our process introduce a timeliness dimension that we believe better positions us to disengage sooner than would otherwise be possible on the merit of fundamentals alone.

Let's bring this back to the discussion on whether the returns in small cap justify the risk via the lens of the Sortino Ratio. Unlike the better-known Sharpe Ratio which penalizes all volatility, the Sortino Ratio only penalizes downside volatility. Clearly stated, it's the return for each unit of downside risk.

Figure 4: Sortino Ratio, Trailing 25 Years



Source: eVestment US Small Cap Growth manager universe. Period shown is trailing 25 years as 03-31-2026.

In terms of how to improve the ratio, there are two ways: 1) increase returns, or 2) reduce risk. For many quality-first investors, the aim is to narrow the range of potential outcomes (ie volatility) by emphasizing businesses with established business models and strong competitive advantages. By simply avoiding unprofitable and highly cyclical businesses, these managers can mitigate risk in the denominator and drive their Sortino Ratio higher.

We take a different approach that embraces higher volatility as a direct means to drive returns (in the numerator) higher. As described earlier, we don't seek to narrow the range of outcomes—we try to improve our odds of playing in the right tail with the "one-two punch" of 1) orienting around a timely inflection point and 2) disengaging quickly if/when that inflection deteriorates or never truly materializes in a sustainable way. In the end, this has allowed us to deliver a materially higher Sortino Ratio relative to the Russell 2000 Growth Index and even the median peer in the eVestment US Small Cap Growth universe.

Closing Thoughts

When investors dismiss U.S. Small Cap Growth as too volatile, the risk is that they are approaching the issue with the wrong mindset. It's not about the asset class writ large, but rather the opportunity set beneath the surface. We believe managers with a process designed to harness this volatility as a direct source of alpha are well positioned to deliver high and differentiated returns—both attractive features within a broader asset allocation framework.

In this sense, we believe volatility is not something to be avoided, but something to be navigated. It is less a headwind and more a current that, when properly understood, has the potential to carry returns further.

[1] U.S. small cap growth is represented by the Russell 2000 Growth index, and U.S. large cap growth is represented by the Russell 1000 Growth index.
[2] As measured by eVestment US Small Cap Growth manager universe. As of 31-March-2026 for trailing 25-year period. The eVestment US Small Cap Growth universe comprises US equity products that primarily invest in small capitalization stocks that are expected to have an above-average capital appreciation rate relative to the market. Common benchmarks for this universe include the Russell 2000 Growth.

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Sortino Ratio Definition: The Sortino ratio is a downside-risk-adjusted performance measure that evaluates excess return relative to downside volatility. A higher Sortino ratio indicates more return per unit of downside volatility, but the measure is sensitive to the inputs, measurement period, and methodology used.

Index Definitions:

MSCI ACWI ex-US Index – A market capitalization-weighted index designed to measure the performance of large-, mid-, and small-cap companies across developed and emerging markets countries, excluding the United States.

S&P 500 Index – A market capitalization-weighted index of 500 leading U.S. publicly traded companies designed to measure the performance of the large-cap U.S. equity market.

Russell 1000 Value Index – A market capitalization-weighted index measuring the performance of large-cap U.S. companies with lower price-to-book ratios and lower expected growth characteristics.

Russell 3000 Index – A market capitalization-weighted index representing approximately 98% of the investable U.S. equity market, including large-, mid-, and small-cap companies.

MSCI ACWI ex-US Small Cap Index – A market capitalization-weighted index measuring the performance of small-cap companies across developed and emerging markets countries, excluding the United States.

MSCI Emerging Markets Index – A market capitalization-weighted index designed to measure the performance of large-, mid-, and small-cap companies across emerging market countries.

Russell 1000 Growth Index – A market capitalization-weighted index measuring the performance of large-cap U.S. companies with higher price-to-book ratios and higher forecasted growth characteristics.

Russell Midcap Index – A market capitalization-weighted index measuring the performance of the mid-cap segment of the U.S. equity market.

Russell Midcap Value Index – A market capitalization-weighted index measuring the performance of mid-cap U.S. companies with lower price-to-book ratios and lower expected growth characteristics.

Russell Midcap Growth Index – A market capitalization-weighted index measuring the performance of mid-cap U.S. companies with higher price-to-book ratios and higher forecasted growth characteristics.

Russell 2000 Index – A market capitalization-weighted index measuring the performance of approximately 2,000 small-cap U.S. companies.

Russell 2000 Growth Index – A market capitalization-weighted index measuring the performance of small-cap U.S. companies with higher price-to-book ratios and higher forecasted growth characteristics.

Russell 2000 Value Index – A market capitalization-weighted index measuring the performance of small-cap U.S. companies with lower price-to-book ratios and lower expected growth characteristics.

It is impossible to invest directly in an index. The performance of an index does not reflect any transaction costs, management fees, or taxes.

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