

# When Quality Isn't Enough: A Multi-Dimensional Lens for Small Cap Investing

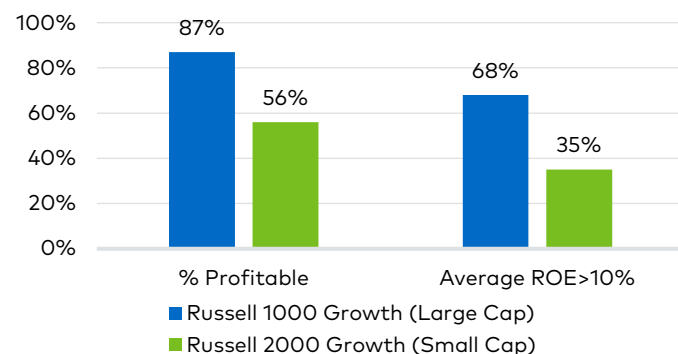
What works for large caps may not always work for small caps. In this paper, we explore why trusted quality metrics can break down in the small cap universe.

## We address:

- Why traditional quality metrics don't fit small caps.
- The pitfalls of relying only on patience and conviction.
- How combining thematic and technical analysis can drive better outcomes.

Quality isn't one size fits all. In large caps, it can mean durable advantages, strong returns, high profitability, solid return on equity (ROE), stable margins, and steady growth. Few small caps meet these benchmarks. For example, as of October 2025, less than 60% of Russell 2000 Growth companies are consistently profitable, and average ROE is much lower. Small caps are typically less mature, riskier, and face uncertain funding. Yet these challenges can also create unique opportunities for transformation.

**Figure 1: Profitability and Average ROE in Large Caps vs. Small Caps**



**Source:** Bloomberg. As of 10/31/2025. "% Profitable" measured using trailing 12-month GAAP earnings per share. "ROE" refers to return on equity, a measure of how effectively a company generates profits from its base of shareholder's equity. A 10% cost of capital is used as a general proxy for the typical company's cost of capital.

In small cap investing, quality is not about perfection today. It is about identifying companies with the potential to become tomorrow's high-quality leaders as they scale and mature.

## When Quality Is Not Enough

We want to believe any small cap could be the next Chipotle, Visa, or Mastercard. Just pick one that checks the large cap quality boxes and hold tight. These success stories fuel the hunt for the next big winner, tempting us to expect history to repeat itself.

In reality, most small caps aren't quality businesses yet. Few ever make that leap. Applying large cap frameworks can lead to disappointing results, as the link between quality and returns is more tenuous in small caps. Strong unit economics don't always scale, and appealing margins may hide risks like customer concentration or intense competition. What seems like a unique product can quickly lose its edge if a larger player moves in.

In small caps, quality is unpredictable and easily disrupted. We believe rigorous, ongoing scrutiny is essential because what works for large caps rarely fits small ones. Figure 2 shows that even when the quality factor excess return was low or negative, the index itself often delivered strong performance. This demonstrates that high quality doesn't always translate to outperformance.

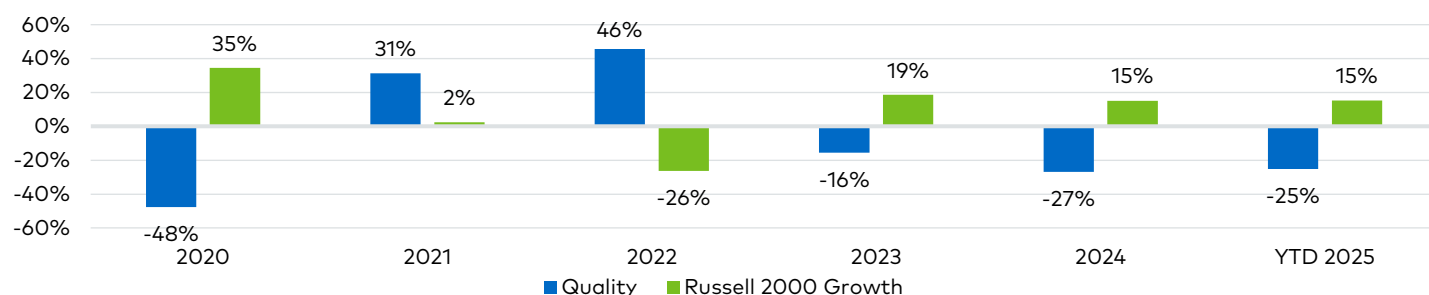
## When Conviction Becomes Costly

Quality and long-term investing often go together, especially in large caps, where paying for attributes like strong balance sheets and consistent earnings can support attractive returns. However, even in large caps, relying too heavily on traditional quality metrics comes with risks, particularly when results disappoint and conviction is not tempered with adaptability.

We believe this challenge becomes even greater in small caps. Traditional quality signals may not offer the same predictive

**Figure 2: In Small Caps, 'Quality' Does Not Always Predict Outperformance**

Quality Factor Excess Return vs. Russell 2000 Growth



**Source:** Bloomberg. As of 10-31-2025. Quality factor is defined using Bloomberg's PORT MAC3 Factor Model, a composite of profitability, leverage, and earnings variability for the constituents of the Russell 2000 Growth Index (used here as a proxy for the small-cap growth universe). Quality factor excess return is calculated as the difference in returns between the top 20% and bottom 20% of stocks in the Russell 2000 Growth Index, ranked by quality score.

power, and setbacks tend to be steeper. For example, from 2011 to 2023, the average downward revision in earnings estimates was about 3.7 percent for large caps, compared to 24 percent for small caps.<sup>1</sup> Conviction in small caps, without a willingness to continually reassess, can quickly lead to greater losses.

For example, consider a situation where an investor identifies a small cap as high quality and buys more shares after a 20 percent drop, dismissing the decline as short-term volatility. If disappointing results continue, losses can escalate. Traditional quality measures may miss hidden risks unique to small caps.

The lesson is that what works for large caps may not always apply to small caps, and relying on a single dimension can leave investors more exposed.

## Beyond the What: When and How Much?

Because of these differences, our process goes beyond fundamentals to incorporate thematic and technical analysis, guiding not just what we own, but also when and how much.

Themes aim to help us spot major world challenges or innovations that can become significant market opportunities. These can be broad, like artificial intelligence or electrification, or more focused and cyclical, such as biotech advances. Though often dismissed as low quality and volatile, biotech has experienced multi-year periods of strong, uncorrelated returns. Anticipating relevant themes lets us prepare to act if they begin to play out in the real world.

Technicals add a vital sense of timing to our process by seeking to capture market psychology. Every investor's view is ultimately reflected in price and volume. Breakouts after consolidation may signal growing interest, while stocks making higher highs and higher lows may suggest rising confidence in the company's future. By leveraging these signals, we try to tap into the collective wisdom of

the market, potentially allowing for more nimble decision-making even when we don't have all the answers ourselves.

Blending these inputs from fundamental, thematic, and technical analysis enables us to guide what we own, how much we own, and when we invest. As a result, turnover is a natural byproduct of our disciplined approach. By integrating multiple perspectives, we seek to manage risk and capture opportunity, ready and willing to act before setbacks escalate.

Referring back to our earlier example, this approach becomes especially important when an investment underperforms despite strong fundamentals. In these situations, technical or thematic indicators such as negative price action or a fading industry trend can serve as early warning signs. These signals prompt us to take a more cautious stance, even when the core fundamentals still look attractive.

If the stock keeps falling, our approach aims to minimize or avoid loss. Even a quality stock can be the wrong investment at the wrong time, especially in small caps, underscoring the need for a responsive, multi-dimensional process.

## A Sharper Set of Lenses for Small Cap Success

In small caps, quality demands a sharper lens. Some companies appear high quality at first but fall short under deeper scrutiny, while others are quietly building the foundation for future strength. Early-stage challenges, like lower margins or moderate debt, can signal smart investments and positioning for growth.

Dismissing companies that don't yet fit a rigid definition of quality risks missing tomorrow's leaders. Many great growth stories began where few expected. In small cap investing, we believe the best opportunities often lie in businesses where quality is just starting to build and fundamentals are steadily improving.

<sup>1</sup> Quality isn't one size fits all. In large caps, it can mean durable advantages, strong returns, high profitability, solid return on equity (ROE), stable margins, and steady growth.

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