RBC Global Asset Management

Quality Headwinds:

Recent outperformance of low-quality companies sets the stage for high-quality opportunities

Rich Drage
Senior Portfolio Manager
RBC Global Asset Management

Andy Topps
Portfolio Manager
RBC Global Asset Management

Scott Chandler
Institutional Portfolio Manager
RBC Global Asset Management

Introduction

Looking solely at index-level returns, U.S. small cap stocks have delivered a relatively positive year. The Russell 2000 Index returned +13.5% through November, a strong return that aligns with historical annualized trends. However, beneath the surface, active management has struggled due to a concurrent 'junk rally' that has penalized high-quality companies. Junk rallies lead to significant underperformance of quality characteristics, such as low debt levels, high return on equity, and consistency in earnings year over year - qualities that active managers tend to seek in companies they own. This environment, marked by speculative trading and policy uncertainty, has led to unusual index concentration and underperformance of quality-focused strategies.

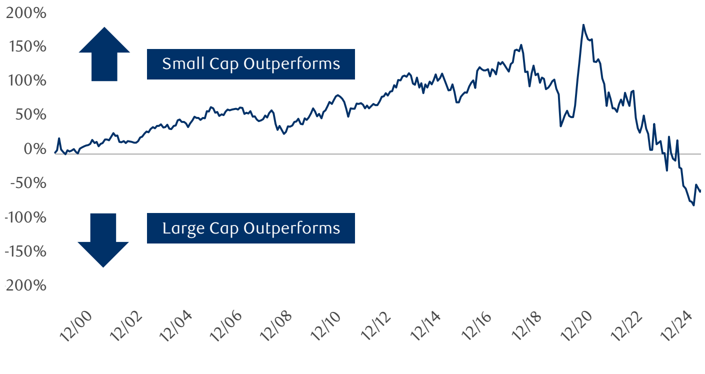
Despite the recent experience, we believe current market conditions are set up to deliver strong future total returns in small cap equities and, in our view, are particularly attractive for active portfolio managers.

- Macro backdrop favorable for small cap – rate cuts have immediate impact on interest expense for small companies; tariff-related inflation from imports has been lagged but kicking in in coming months
- Attractive valuations: small caps are at a historically wide discount to large cap; profitable companies with quality traits are trading at a discount compared to the broader index
- Inefficiencies persist: active management historically adds value in small cap given lower analyst coverage; active managers tend to rebound and outperform after periods of strong underperformance

Small Caps have performed well historically

U.S. small cap equities have previously provided compelling long-term returns to investors, both in absolute terms as well as relative to U.S. large cap equities. Since the turn of the century in 2000, small cap equities had cumulatively outperformed larger companies significantly for most of the last 25 years. Even with the last decade's focus on mega-cap companies driving U.S. equity markets, the cumulative outperformance of small caps persisted up until 2023, and it remains competitive.

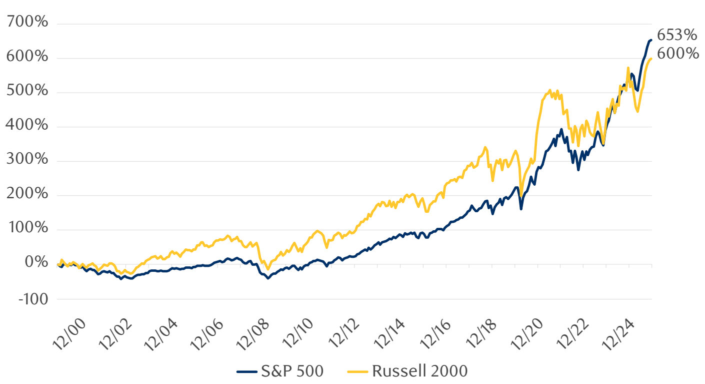
Figure 1: Relative Return



Source: Factset as of November 30, 2025. Date range: January 2000 – November 2025. Cumulative returns of Russell 2000 index minus S&P 500 index at each monthly period.

Total returns for both small and large cap companies have both been attractive too, with the S&P 500 returning +8.1% and the Russell 2000 returning +7.8% over the almost 25 year period through the end of November, on an annualized basis.

Figure 2: Cumulative Return



Source: Factset as of November 30, 2025. Date Range: January 2000 – November 2025.

What's going on in the U.S. down the capitalization spectrum?

Small cap markets have been uncharacteristically choppy in 2025. The Russell 2000 generated negative returns in the first quarter (as did all US equity markets) followed by an extremely sharp but narrow rally in the subsequent months following the market bottom that quickly followed the "Liberation Day" tariff announcements. Even with the sharp selloff in the first few months of the year, small cap returns are now outperforming their long-term annualized average, returning +13.5% YTD through November.

Year-to-date index returns in the small cap space have mainly been driven by a handful of companies. And while this narrowness of index returns has also been a headwind in the large cap space, the difference down the cap spectrum is that these handful of "winning" companies are not proven and profitable companies, but rather tend to be speculative growth companies without established business models, profits/earnings, and – at times – barely any sales. In one instance, a company's stock generated returns of +1000% over the last year despite no expectations for positive cash flow or earnings until 2030 (and even that was an estimate!).

To highlight the level of concentration, consider that of the ~1,100+ companies included in the Russell 2000 Growth Index, the top 10 index names contributed 49% of the overall index return (+5.8%) and the top 20 index names contributed 78% of the index return (+9.1%) year-to-date through the end of October. Similar experience in the Russell 2500 Growth Index (which blends small- and mid-sized companies), where the top ten index names contributed 54% of the index return (+5.4%) and the top twenty index names contributed 82% of the index return (+8.1%). Historically, performance concentration in the small cap space has not been this pronounced.

While tariffs have historically been viewed as potentially a positive for smaller companies, encouraging investment in local manufacturing and reorienting demand from imports towards domestically produced goods, uncertainty is not – at least for institutional investors. Small caps experienced a genuine bear market - that is, a decline of 20% or more from a previous peak - from the Russell 2000's peak on 11/25/24 through 4/8/25, when the index fell -27.5%. But following the small cap bottom in the second week of April, the Russell 2000 advanced +40.8% through the end of October. And although many areas of the small cap market had impressive returns, the highest returns off the small cap low came from stocks with no earnings, no cashflows, and a consistent need to raise capital to fund future growth by issuing new equity or convertible bonds. This kind of low-quality rally is consistent with previous small cap rebounds following corrections.

This environment has proved to be a significant headwind for active management in the small cap space through October, with over two-thirds of the active managers underperforming the benchmark year to date.

The 2025 Quality Collapse: Reflecting on the "Junk Rally"

A junk rally is a performance burst led by the weakest corner of the market. Factors like quality, low-volatility, and ESG tilts are out of favor, while markets are typically driven by stocks with lower-quality attributes such as:

- Weak balance sheets
- Inconsistent sales
- Negative earnings
- High beta
- Heavy short interest

Junk rallies are typically short lived, and while they can be unsettling, disciplined investors have benefited from sticking with higher-quality positioning. Investing in small cap stocks often requires patience. Markets tend to overreact to short-term events, leading to exaggerated price swings. These movements can present potential opportunities for disciplined investors who can distinguish between temporary market noise and durable business fundamentals.

One side effect of the strong rally in a very limited number of companies is that index concentration can lead to concerns beyond the lack of diversification. With market valuations moving so significantly, several companies in the index no longer met the criteria of what we would consider "small cap". For instance, within the Russell 2000 Growth Index at the end of October, there were a number of companies with market caps of over $20 billion and even a few with valuations in excess of $30 billion dollars (far from being a traditional small cap). This was also significantly higher than the largest market cap stock ($7.4 billion) as of "rank day" just a few months earlier on April 30th, when Russell announces which stocks are entering and leaving the index.

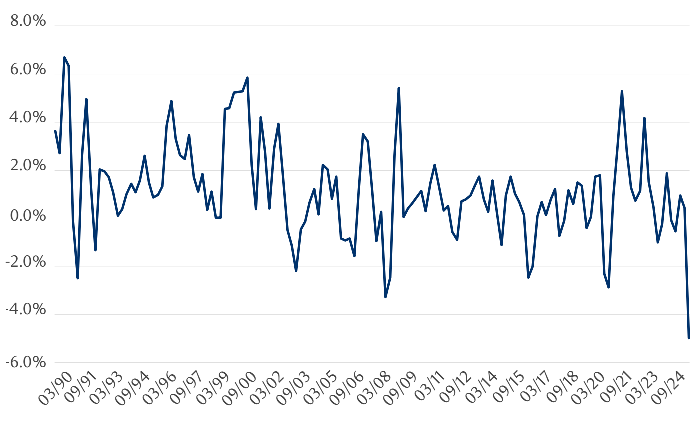
Owning high-quality companies (i.e., profitable firms, consistent cash flows, low debt levels, etc.) have typically rewarded investors over time, but they will tend to struggle during junk rallies – and this year has been no exception. But in periods like we've seen this year, we stick to our process, we do not adjust our portfolio to follow trends or chase performance of speculative companies (even if the benchmark does...). We invest in companies to be long term owners based on their proven, repeatable, and growing business.

Actively Staying Active

Historically, active management has been particularly effective in small cap markets, with professional investors adding value for clients. Over both the trailing 15-year and 20-year periods ending Q3 2025, the median manager within the eVestment US Small Cap Equity universe has generated excess returns of +1.6% above the benchmark gross of fees (which is inclusive of this year's active management challenges!). This is due to inherent inefficiencies, including less analyst coverage, single-business-line companies, and greater return dispersion compared to large cap stocks. These factors create opportunities for skilled managers to identify mispriced securities and avoid pitfalls. This can be achieved through traditional bottom-up stock selection, involving in-depth fundamental research to find attractively valued, high-quality companies. In a world of passive management, small caps have retained a strong claim to the benefits of active management.

But this has been a particularly difficult period for active managers. How difficult? By some measures, literally the worst period on record. Looking at the eVestment US Small Cap peer group of active managers going back to the beginning of 1990, the six-month period ended September 30, 2025 has been the worst six-month relative performance period on record! The median manager excess return has been -5.0% over those two quarters. Prior to this, the previous low for the median active manager -3.3% excess return in the six-month period ending Q3 2008, during the height (or bottom) of the Global Financial Crisis.

Figure 3: U.S. Small Cap Universe 6-Month Excess Return (%)



Source: Nasdaq eVestment U.S. Small Cap Universe as of September 30, 2025. Date range: January 1990 – September 2025, quarterly data.

While these short-term market events can make it challenging for active managers, history tells us that the environment for active portfolio management in small caps has been very strong after junk rallies. As previously stated, we're coming off a period where the trailing six-month median active manager has underperformed. If we look at what has happened historically following these periods, we find that the median manager excess returns are positive over the subsequent 1-year period 89% of the time! So from that perspective, the path forward looks very good.

Macro Environment

We believe there are many compelling components of the macro backdrop that also make a case for smaller cap stocks to outperform from here. Historically, they have led during periods of improving business conditionsand periods of accelerating economic growth. Small cap equities often move differently than their larger peers, in part because they are more sensitive to shifts in monetary policy and broader economic conditions. With the Federal Reserve having now delivered policy rate reductions three times in 2025, target rates are now 1.5% lower than 18 months ago.[1] Rate cuts can deliver immediate easing of financial conditions for smaller companies, given the much larger exposure to floating rate loans used to fund operations or expansion compared to larger companies.

Additionally, continued clarity around longer-term policy should allow for additional stability and confidence by investors. There are several policies enacted by the current administration that have received a lot less focus compared to tariffs but should be a tailwind for small companies in the coming year: fiscal spending, tax cuts/extension of lower tax rates, deregulation. And while the legality of the current tariff implementation continues to play out in the Supreme Court, any tariffs may continue to make domestic products cheaper for consumers on a relative basis to imported goods in the short term. These conditions have historically triggered an extended period of small cap outperformance relative to large-cap stocks.

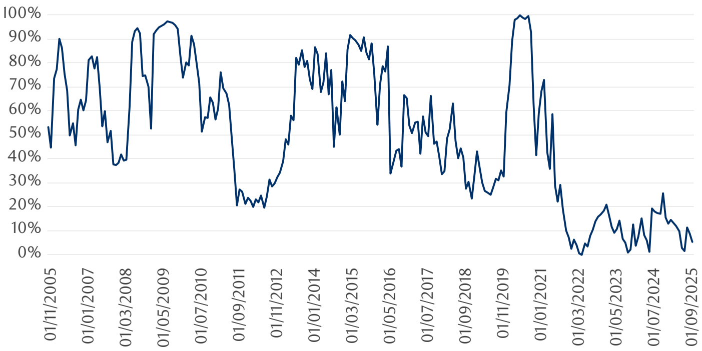
Valuation

Currently, small caps are also benefiting from valuation discounts and look cheap on several different metrics. At the end of the third quarter, the Russell 2000 Index had a forward P/E ratio of 24.8x. This valuation multiple represented a -9% discount compared to the index average over the last 10 years. Compare that to the S&P 500, which ended the same time period with a multiple of 22.9x, which was +21% more expensive than the trailing 10 year average and +40% more expensive than the average over the last 20 years!

While small cap stocks tend to trade at a premium to large cap stocks, that premium is also at one of the lowest levels in two decades as well, ending with a -23% discount to the average over the last 20 years. This discount ranked in the 5th percentile, meaning that based on our analysis, the small cap equities has rarely been cheaper.

Relative Valuation: Forward P/E Ratio (Russell 2000 / S&P 500)

Relative Valuation: Forward P/E Percentile (Russell 2000 / S&P 500)



Source: Factset as of October 31, 2025.
Date range: November 2005 – October 2025

In Summary

While the U.S. equity market is concentrated in mega caps, we believe now is an ideal time to explore opportunities in smaller companies. Recognizing the uncertain and constantly changing environment, smaller cap stocks can still offer growth potential and return diversification to portfolios in a space where skilled managers have proven the ability to add value.

As fundamental investors, our active and selective approach will always be focused on identifying opportunities at the company level with a strong focus on quality—specifically seeking smaller companies with recurring revenues, profitability, and solid growth prospects.

In these times, we make sure to remind ourselves that this time is not different. Buying a stock because it is going up only works for so long. Now is an opportune time to allocate to small caps by leveraging active management's proven ability to identify high-quality companies amid market inefficiencies.

Position for resilience: Favor active strategies focused on quality, recurring revenues, and earnings stability.

[1] Federal Reserve policy rate target change to 3.50%–3.75%, December 2025.

RBC Global Asset Management (U.S.) Inc.
800.553.2143 | rbcgam.com

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