

## Investment Perspectives

March 2026

# The Case for U.S. Small Caps

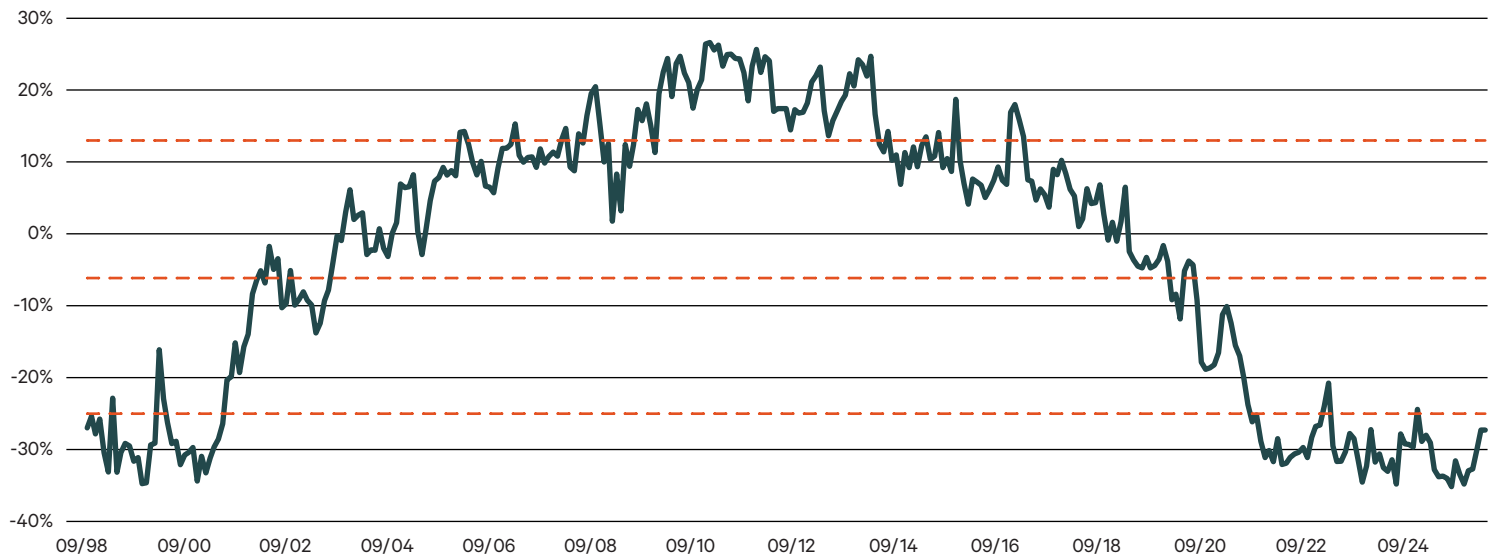
## U.S. Large Cap Versus U.S. Small Cap Valuation Gap

U.S. large capitalization stocks have now outperformed small capitalization stocks for more than a decade. Differences in performance between them have been driven by fundamental composition. Large caps have benefitted from a higher concentration of businesses with stronger earnings growth as well as multiple expansion.

While this period of relative outperformance by U.S. large caps has provided attractive returns to investors, it has also brought increased future expectations. As charted below, valuation of small cap companies relative to large caps (S&P 600 vs. S&P 500) has swung from a greater than one standard deviation premium at the end of the last decade in 2010 to a greater than one standard deviation discount, the lowest it's been since the late 1990s.

**FIGURE 1: SMALL FORWARD P/E PREMIUM/DISCOUNT**

S&P 600® Index vs. S&P 500® Index Price-to-Earnings Ratio, FY2

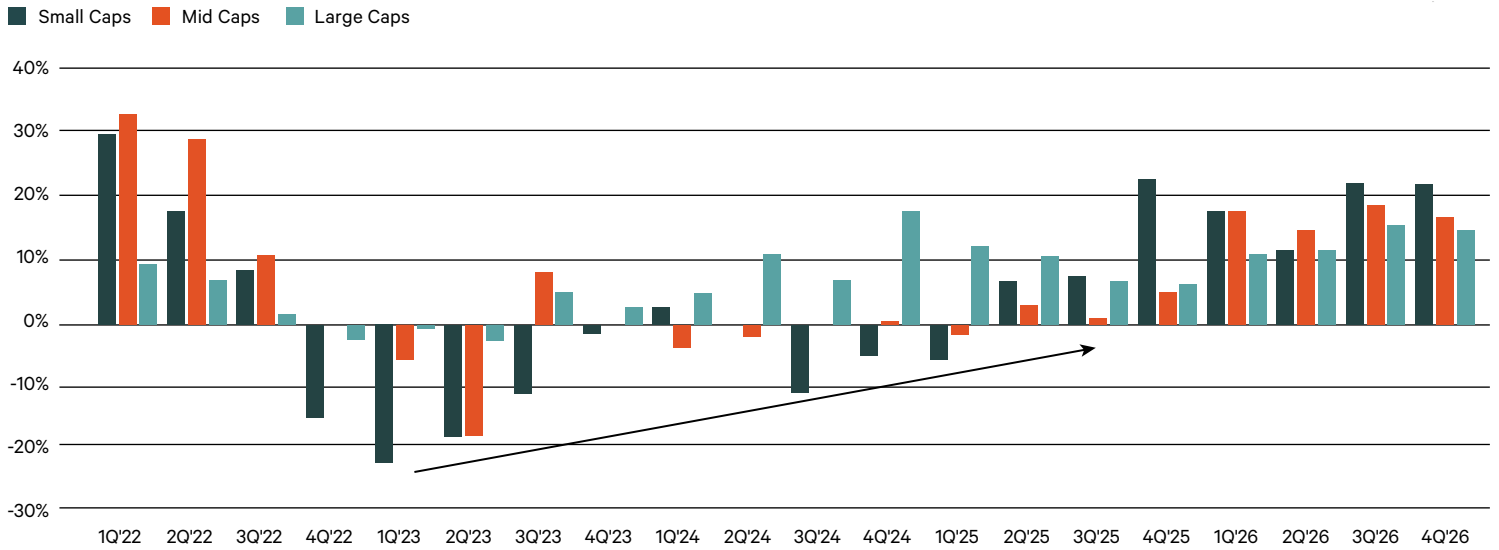


Data as of March 31, 2026. Source: FactSet. Please see the end of this paper for information regarding the indices. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

## 2026 Earnings Estimates Favor U.S. Small Caps

When looking at future earnings estimates in the chart on the next page, it is noteworthy that small (S&P 600) and mid-caps (S&P 400) are expected to overtake their larger counterpart, the S&P 500, with faster earnings growth through 2026. This would represent a marked change from the past few years and may be the catalyst for outperformance.

**FIGURE 2: EARNINGS GROWTH ESTIMATES FOR SMALL, MID AND LARGE CAP STOCKS**

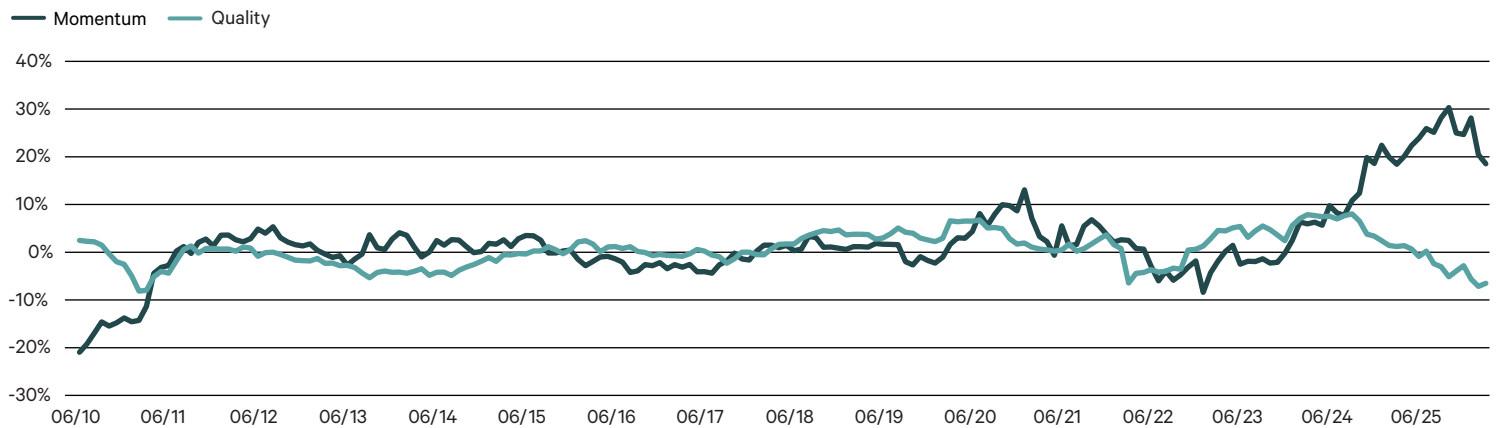


Data as of December 2, 2025. Source: FactSet, BofA U.S. Equity & U.S. Quant Strategy. Please see the end of this paper for information regarding the indices. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

## Recent Momentum Versus Quality Factor Performance Now Favors High Quality

We have observed increased investor interest in lower quality and non profitable small-cap companies during recent market rallies. This pattern is not unusual and typically occurs during periods of rising risk appetite, when improving sentiment and liquidity lead investors to seek higher beta exposure. Lately, this return differential in more momentum stocks versus quality stocks has been abrupt and at a higher magnitude, potentially providing an interesting entry point for the long-term quality investor. As you can see on the next page, small cap momentum stocks have outperformed quality over the past two years by the largest amount since the style indices were formed.

**FIGURE 3: ROLLING 2-YEAR EXCESS RETURNS VS. MORNINGSTAR U.S. SMALL TARGET MARKET EXPOSURE**



Data as of March 31, 2026. Source: FactSet and Morningstar. Please see the end of this paper for information regarding the indices. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

These phases—sometimes referred to as “junk rallies”—can produce strong short term returns, but they have been historically difficult to sustain without a corresponding improvement in underlying fundamentals. From our perspective,

such periods often reinforce the importance of discipline and provide opportunities to **reposition portfolios toward higher quality businesses** rather than participate in speculative excess.

## The Case for Investing in Quality Small Caps

Large cap indices currently include a higher concentration of profitable, well capitalized businesses—characteristics that do align closely with our quality criteria but with a current catalyst, potential value creation from AI.

By contrast, U.S. small cap indices contain a much broader mix of companies. The top 10 Russell 2000 Index companies represent only 5.6% of the universe, unlike the S&P 500 at 36.5%. While arguably more diverse, the Russell 2000 Index also includes a substantial number of companies with **lower profitability, higher leverage, and/or inconsistent earnings**.

However, **high quality small companies do exist**, and when identified, we believe they can offer compelling opportunities. These businesses often operate in specialized niches, generate strong returns on capital, and benefit from less efficient pricing due to limited analyst coverage. In our view, this makes small caps an area where **active, quality focused research is especially valuable**, even if the broader index faces headwinds.

Thus, you can gain exposure to compelling, competitive investment opportunities, with meaningful earnings growth with diversification from the concentrated return nature of the larger indices.

Notice below the characteristics of the KAR Small Cap Core strategy with return on equity and earnings growth meaningfully greater than the index, while having less balance sheet risk.

**FIGURE 4: KAR SMALL CAP CORE PORTFOLIO CHARACTERISTICS**

As of March 31, 2026

	KAR Small Cap Core	Russell 2000® Index
<b>Quality</b>		
Return on Equity—Past 5 Years	26.0%	8.0%
Debt/EBITDA*	0.6 x	2.2 x
Earnings Variability—Past 10 Years	26.5%	85.4%
<b>Growth</b>		
Earnings Per Share Growth—Past 10 Years	15.7%	9.1%
Dividend Per Share Growth—Past 10 Years	11.6%	5.3%
Capital Generation—[ROE x (1-Payout)]	18.6%	6.8%
<b>Value</b>		
P/E Ratio—Trailing 12 Months	21.0 x	47.7 x
Dividend Yield*	1.5%	1.2%
Free Cash Flow Yield*	4.2%	1.9%
<b>Market Characteristics</b>		
\$ Weighted Average Market Cap—3-Year Average	\$7.8 B	\$3.7 B
Largest Market Cap—3-Year Average	\$21.2 B	\$23.9 B

Data as of March 31, 2026. Source: FactSet Research Systems and BNY Mellon. The statistics presented above are based on a representative portfolio. Actual results may vary. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Please see the end of this paper for information regarding the index. The index is unmanaged, its returns do not reflect any fees, expenses or sales charges, and it is not available for direct investment. Returns may be affected by currency fluctuations. **Past performance is no guarantee of future results.**

\*KAR utilizes the interquartile method when calculating Debt/EBITDA. The interquartile method excludes outliers from an aggregate statistic such as weighted average. The interquartile method does not assume that data from the top or bottom of the distribution are outliers—only the extreme ends are excluded—and that it can be applied consistently as a quantitative method for most fundamental characteristics. Debt/EBITDA utilizes net debt for the calculation.

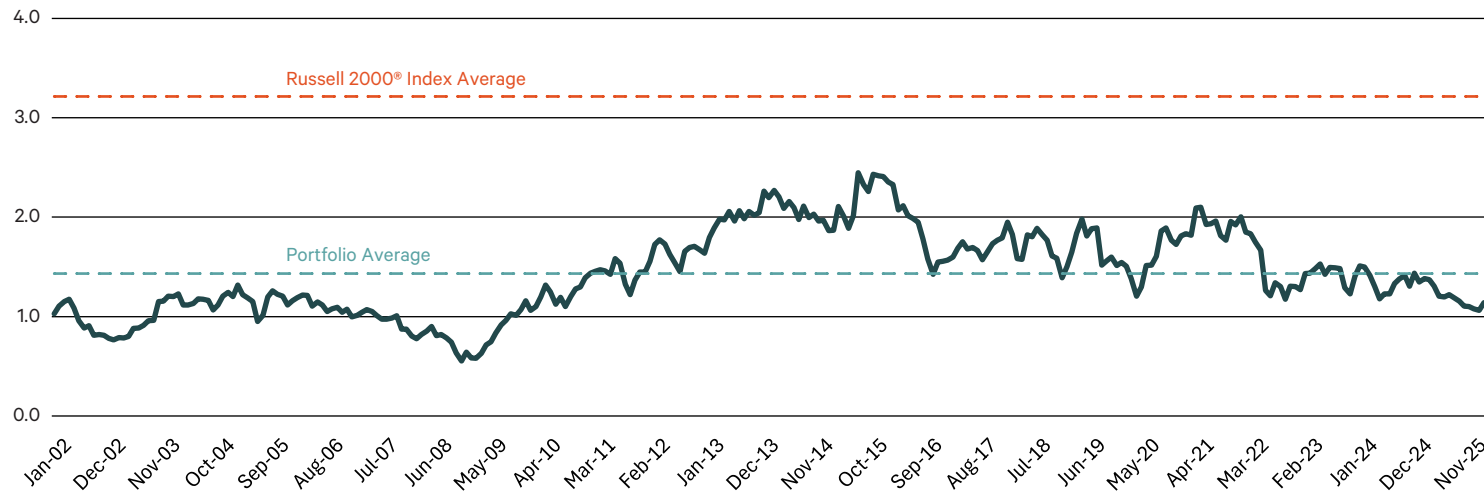
\*Dividend yield is a financial ratio that shows how much companies have paid out in dividends in the most recent year relative to their stock price at the end of such year. Dividend yield is being shown here as a characteristic of the stocks held in the portfolio and not to infer how the stocks have or will perform, as dividends are not the only component of the portfolio's performance. Dividends are subject to change from year-to-year, and the portfolio's dividend yield could be lower or higher in future years.

\*Free cash flow data is as of December 31, 2025. Prices are as of March 31, 2026. Excludes financials.

## In Conclusion

As illustrated in the following graph, when comparing KAR’s Small Cap Core strategy’s P/E to its longer run EPS growth rate, it is notable that it is currently trading in line with its inception-to-date average and below that of the benchmark.

**FIGURE 5: SMALL CAP CORE PORTFOLIO PRICE/EARNINGS-TO-GROWTH RATIO**



Data as of March 31, 2026. Source: FactSet Research Systems and BNY Mellon. The statistics presented above are based on a representative portfolio. Actual results may vary. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Please see the end of this paper for information regarding the index. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. Returns may be affected by currency fluctuations. **Past performance is no guarantee of future results.**

We continue to believe that quality small caps should be part of investors’ portfolio allocation. Given today’s market dynamics, we believe this segment warrants increased attention from long term investors.

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**Index Definitions:** The Russell 2000® Index is a free float-adjusted market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The Morningstar U.S. Small Cap Quality Factor Index is designed to provide efficient, strong exposure to the quality factor, as defined by the Morningstar Risk Model. The Morningstar U.S. Target Momentum Index is designed to provide exposure to stocks from the Morningstar U.S. Market Index with strong price performance as well as strong and improving profitability. The Morningstar U.S. Small Cap Low Volatility Factor Index is designed to provide efficient, strong exposure to the low volatility factor, as defined by the Morningstar Risk Model. The Morningstar U.S. Small Cap Yield Factor Index is designed to provide efficient, strong exposure to the yield factor, as defined by the Morningstar Risk Model. The Morningstar U.S. Small Cap Value Factor Index is designed to provide efficient, strong exposure to the value factor, as defined by the Morningstar Risk Model. The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The S&P Mid Cap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The index is calculated on a total return basis with dividends reinvested. The S&P SmallCap 600® seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The index is calculated on a total return basis with dividends reinvested. The indices are unmanaged, their returns do not reflect any fees, expenses or sales charges, and they are not available for direct investment.