

The Small Idea: Who Took Away the Punchbowl?

You think the party is just getting started, and then poof!

After a 20%-plus run for small caps concentrated in the second quarter, the elation fizzled in the third quarter. The Russell 2000 Index fell more than 7% as investor preference swung back to large cap growth, particularly those companies associated with the artificial intelligence (AI) buildout; the NYSE FANG+ Index rose 13% in the quarter.[1]

The usual suspects squelched the joy.

Persistent inflation and ballooning government debt triggered a Fed rate hike in September, and Treasury yields spiked to multidecade highs.[2] With that hike came fears of higher-for-longer rates, a rapid turnaround given that markets were discounting an accommodative Fed earlier this year. Fear of higher rates ignited concerns about a possible recession, though—thankfully—activity has remained quite resilient thanks to robust business and consumer spending. Macroeconomic and geopolitical uncertainty further weighed, increasing investor appetite for defensive cash buffers of magnitudes impossible for small caps to match.

The hardest hit sectors during the third quarter included "growthy" small cap names in technology and industrials—including smaller data-center construction and supply-chain firms—as capital expenditures were concentrated among the hyperscalers. Similarly, yet-to-be profitable/early-stage businesses with long duration prospects—including biotech—suffered as higher discount rates muted projected cash flows.[3]

Although rising interest rates and crowding out—by hyperscalers and the US Treasury—curtailed easy access to capital and dampened hopes for speculative mergers and acquisitions premiums, strategic acquisitions of small caps continued apace.

Color us stubborn, but we're hanging in for another round.

1. Source: Bloomberg; data as of September 30, 2026.
2. Source: Bloomberg; data as of September 17, 2026.
3. Source: Bloomberg; data as of September 30, 2026.

This edition of *The Small Idea* was written by Bill Hench, head of the Small Cap team and portfolio manager.

While punishing to heavily indebted companies of any market cap, protractedly high rates may sound only a selective death knell and may not, by definition, be a bad thing overall. Approximately one-third of companies in the Russell 2000 Index have more cash than debt, with half of the index's total debt is concentrated in just 12% of market cap.[4] Thus, nimble stock pickers in the small cap space may be able to avoid leveraged laggards, instead focusing on self-financing, cash-flow positive names.

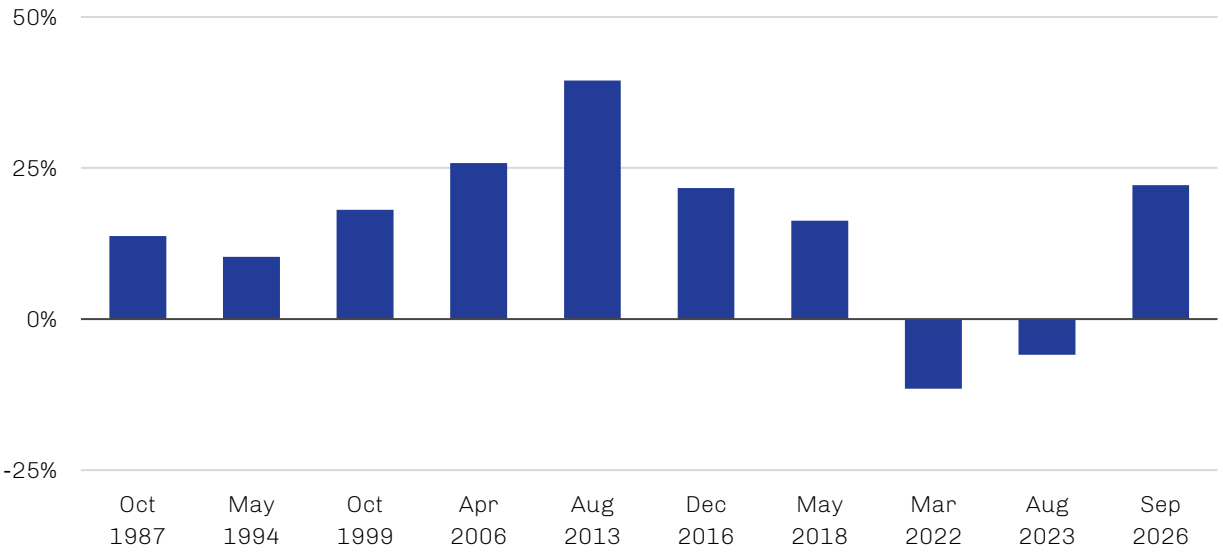
> Higher rates, by definition, may not be a bad thing overall.

And remember that high interest rates often coincide with robust economic activity, providing an environment conducive to corporate earnings growth. This tailwind may be especially impactful for smaller companies; given the relatively high operating leverage of such companies, even a modest uptick in revenues can flow disproportionally to the bottom line.

Earnings ultimately drive equity returns. When strong fundamentals outweigh the headwind of higher borrowing costs, positive returns can coexist alongside rising yields, as they have for small cap stocks in eight of the ten rising-rate periods since 1987, as shown in Exhibit 1.

Exhibit 1. Rising Treasury Yields Have Not Been a Death Knell for Small Caps

Russell 2000 Index Trailing-Year Returns During Periods of Rising 10-Year Treasury Yields



Note: Period of rising yield is defined as a minimum 95 basis point increase in 10-year Treasury yields.
Source: Furey Research Partners, FactSet; data as of September 14, 2026.

Beyond the tailwind from a still-strong economy, the domestic orientation of small caps provides both a shield and a boost in the current policy environment. Tariffs and onshoring benefit small cap industrials, heavy-equipment suppliers and engineering firms that also may be seeing a structural boost from new tax rules allowing 100% year-one depreciation on certain property.

All of these catalysts can coalesce into higher earnings—historically a strong tonic for returns. Earnings growth for small companies in the Russell 2000 Index is projected to exceed the S&P 500 Index into the fourth quarter and through 2028—with room, still, for multiple expansion.[5] Based on forward projections, and excluding negative earners, the Russell 2000 Index trades at a 19% price-earning multiple discount to the S&P 500 Index.[6]

4. Source: Furey Research Partners; data as of September 30, 2026.
5. Source: LSEG I/B/E/S; data as of September 30, 2026.
6. Source: Bloomberg; data as of October 29, 2026.

Opportunity Beckons

With small cap earnings inflecting higher and still-noteworthy valuation discrepancies, we continue to perceive opportunity.

Some small cap energy companies remain at single-digit earnings multiples while benefiting from rapid growth in power consumption—including consumption by AI data centers—higher commodity-price floors and strong cash-flow generation. Geopolitical conflicts and tight petroleum/gas supplies continue to support global commodity export markets, boosting cash flows for upstream and midstream operators.

> With earnings inflecting higher and persistent valuation discrepancies, we continue to perceive opportunity in small caps.

And despite recent fallout, AI can remain both an opportunity and a tool for some small cap companies. Even as hyperscalers dominate headlines, data center/infrastructure buildouts require substantial physical input from small providers of specialized hardware, HVAC equipment and industrial components. At the same time, integrating AI tools to automate overhead can trigger margin expansion for smaller companies previously unavailable even through scale.

We also continue to seek opportunity in non-biotech healthcare. Valuations remain compressed even as cost structures normalize, operations strengthen and earnings accelerate. After long underperformance, investor focus may shift to—and reward—fundamentals over the speculative narratives propelling some other sectors.

The recent downdraft in small cap stocks may present ample opportunity to acquire positions in small companies at prices we believe are unmoored from underlying financial strength. We believe the headwinds weighing on these stocks are likely to moderate at some point. In our view, inflation eventually will abate, the interest-rate cycle will improve and geopolitical tensions will ease. Investor attention could return to fundamental value—to the potential benefit of a range of currently undervalued small companies.

Meanwhile and always, we position ourselves to potentially maximize upside. We remain focused on targeting good companies while managing the one variable we control—the price we pay. Unable to predict which names will disproportionately contribute, we spread our bets and diversify the portfolio, exercising price discipline to slowly build positions.

So, take away the punch bowl. I don't even need ice. Just give me dibs at whatever behind the bar looks enticing. Here's to good times.

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10-year Treasury yield is the interest rate paid on a US Treasury bond with a maturity of 10 years upon issuance.

NYSE FANG+ Index is an equal-weighted equity benchmark designed to track the performance of 10 highly traded growth stocks of technology and tech-enabled companies in the technology, media & communications and consumer discretionary sectors.

Russell 2000® Index (Gross/Total) measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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