

US Small Caps – Where Has the Alpha Gone?

November 2025

- In Q3 2025, the median US small cap manager underperformed the Russell 2000 Index by the widest margin in over 20 years
- Higher interest rates and a proliferation of private equity are two factors contributing to the underperformance
- Opportunities remain in small cap for patient investors with a long-term approach to the asset class

Background

"Successful investing" is often relative, and, over the past decade, most major public equity indexes have produced historically-strong returns. US small cap equity, as measured by the Russell 2000 index, has generated solid absolute returns (+9.4% annualized over 10 years) but has underwhelmed in the shadow of US large cap dominance (+14.6% annualized over the same period). Of further concern among small cap investors has been manager alpha, or lack thereof, as roughly 75% of active managers have underperformed their benchmark year-to-date in 2025 by an average of 3-4%.

Small Cap Active Managers have Broadly Underperformed

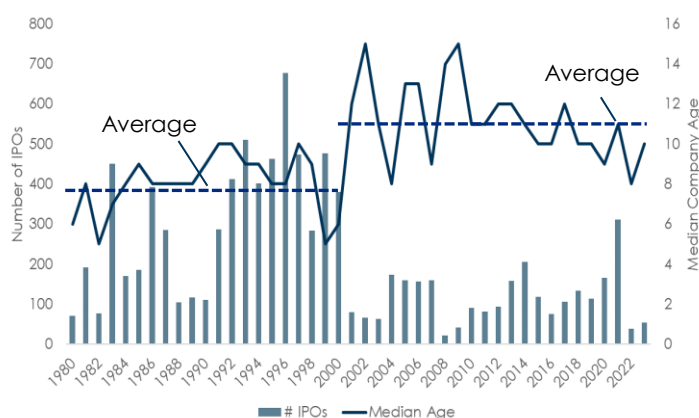
Asset Class	% Underperforming	Median Excess Return
Small Cap Value	77%	-3.4%
Small Cap Core	72%	-3.2%
Small Cap Growth	75%	-4.6%

Source: eVestment, year-to-date through 9/30/2025

Evolution of the Small Cap Opportunity Set

Historically, active managers have benefitted from several tail winds in US small cap, including a wider universe of companies to select from (2000 companies in small cap vs. 500 in large cap), a lack of analyst coverage which leads to more companies being mispriced, and finally, a steady stream of new public companies (IPOs), that continuously refresh the small cap opportunity set.

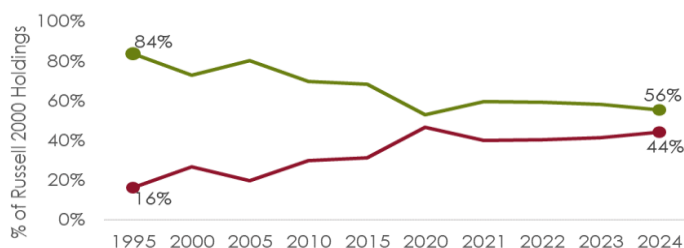
Private Equity Growth has Hurt the IPO Market



Source: Jay Ritter, University of Florida IPO Report

Over the past two decades, flows into private equity funds have grown. Easier access to capital has enabled smaller private companies to defer or delay public listing via IPO. As companies remain private for longer, and ultimately list as mid-cap or large-cap companies, the universe of smaller public companies for active managers to select from has shrunk.

44% of Russell 2000 Companies are Non-Earners



Source: Bloomberg — Earners % — Non-Earners %

By design, the Russell 2000 comprises roughly 2,000 stocks. Successful, profitable companies may grow too large for inclusion in the small cap index while declining companies may be reclassified down from large cap to small cap. This dynamic, coupled with lower IPO issuance, has led to an increased weight of non-earning (unprofitable) Russell 2000 constituents.

Where Has the Alpha Gone?

"High quality" generally refers to financially-healthy companies with proven business models and high return on equity. Active managers that focus on these fundamentals have not been rewarded of late. Rather, small cap market momentum has been squarely behind lower-quality, more speculative companies, particularly in industries poised to benefit from AI-related investments (e.g. data center construction, utilities, energy, etc.), and those that may be supported by lower interest rates. AI-exuberance, driven more by lofty expectations than profits, has drawn comparisons to the 1999 dotcom bubble.

Russell 2000 Non-Earners have Outperformed Significantly

Sector	Earners	Non-Earners	Difference
Comm Services	-9.5%	41.5%	51.0%
Info Tech	8.6%	51.3%	42.7%
Materials	22.1%	62.7%	40.6%
Energy	-4.1%	20.2%	24.3%
Industrials	19.9%	37.1%	17.2%
Financials	5.5%	22.5%	17.0%
Utilities	10.8%	27.4%	16.6%
Real Estate	-0.2%	7.4%	7.6%
Con. Staples	0.2%	6.5%	6.3%
Health Care	4.9%	10.0%	5.1%
Con. Disc.	4.1%	-4.4%	-8.5%

Source: FactSet, Russell, Jefferies, year-to-date through 9/30/2025

ACG's Position

The pursuit of success can be difficult in the short run, and it appears the alpha has been channeled toward non-earners in small cap. Over the long-run, however, the market tends to reward growth and profitability and managers with clearly defined, repeatable processes, and patience, should be best positioned to outperform.

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Alpha is a measure of an investment's performance that indicates its ability to generate returns in excess of its benchmark.

Vintage year assets refer to the assets of a private equity fund that were acquired during the year when the fund made its first significant investment. This year is crucial for evaluating the fund's performance, as it is the benchmark for comparing returns among funds launched in the same market conditions.

Median US small cap manager return based on Nasdaq eVestment data.

Median Excess Returns are returns achieved above and beyond the return of representation of the stock market.

The Russell 2000 Index tracks performance of 2,000 smaller companies offering a comprehensive view of the small-cap sector.

Small-cap value stocks are shares of smaller U.S. companies that the market perceives as underpriced.

Small-cap core refers to stocks of small companies that combine characteristics of both value and growth investing.

Small-cap growth measures the performance of the faster-growing small-cap U.S. companies.

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