

Investment Commentary: Small Cap Q4 2025

Quality Small Caps Underperformed in 2025; Poised for a Comeback?

Executive Summary

In a year that bucked recent trends, the small-cap universe delivered differentiated performance that confounded some traditional quality tilts. After years where quality names dominated, pockets of risk-oriented small caps staged an outsized rally in 2025, driven by speculative themes and cyclical re-engagement.

High Beta Small Caps Surpassed High-Quality Names

Across the small-cap landscape, higher-risk, higher-beta names generally outpaced their high-quality peers in 2025. This effect was particularly pronounced in risk-on segments like microcaps, speculative growth, and areas tied to nascent trends such as early-stage tech and thematic exposures.

Factor data showed that high-risk stocks outperformed low-risk and high-quality stocks in both the small-cap Russell 2000 and other indexes over much of the year, a pattern more typical of speculative rallies than disciplined quality rotations. Low-quality small caps—often with less stable earnings and weaker balance sheets—benefited from broadening risk appetite and liquidity dynamics that lifted volatility-linked strategies.

This speculative tilt translated into short-term gains for certain higher-beta cohorts, but it also raised questions about sustainability given their structural risk profiles. Was this a “catch-up” for beaten up names, or a speculative “overshoot?”

Liberation Day “Risk-On” Trade

This trend was most pronounced during the months following Trump’s “Tariff Liberation Day,” particularly June-October.

Here are some eye-opening stats we shared in our Q3 commentary:

- **High Beta Surge.** According to LPL, the highest beta small caps returned 75% in Q3, versus 13% for the lowest beta names.
- **Value Destroyers Lead.** The small caps with the lowest Cash Flow ROIs (“value destroyers” with a median ROI of -15%) dominated the last 6 months (+33% relative performance over the Russell).
- **Leverage Pays (Temporarily).** The highest levered companies (“zombies”) also outperformed the Russell. The shareholder return for the highest levered quintile of the Russell was +26% for the last 6 months. The 10-year return for this same group is -36%!
- **Profitability Penalty.** The S&P 600 small cap index, which requires companies be profitable for inclusion in the index, has underperformed the Russell 2000 by nearly 1000 basis points YTD.

Another interesting datapoint: Microcaps outperformed small caps by 10.2% for the full year and 21.1% since the April lows. Microcaps (typically below \$300 million market cap) are amongst the most risky of small cap investments.

Why Quality Underperformed in 2025

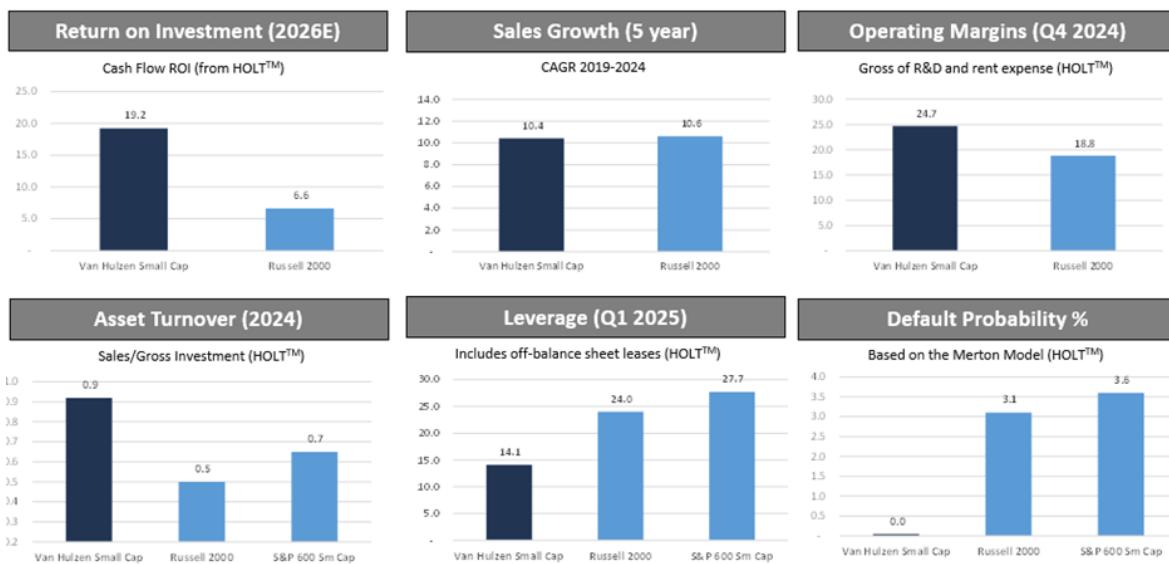
High-quality small caps lagged for a few key reasons:

- With the market weightings dominated by mega-cap leaders, early 2025 flows favored risk assets and lower cost-of-capital names, leaving quality-oriented small caps in the second tier of investor focus.
- Persistent macro uncertainty—especially around interest rates and global growth—led investors to chase momentum rather than fundamentals in smaller names. That dynamic tends to favor high beta issues with volatile price action over stable, quality firms.
- Some quality indices, like the S&P SmallCap 600, require consistent earnings to qualify. This exclusion of unprofitable but fast-moving small caps muted the index's exposure to the rally. The lower quality Russell 2000 outperformed the S&P 600 by 6.8%.

In essence, 2025 looked like a risk premium year in the small-cap space: investors were rewarded near-term for chasing growth and volatility rather than classic quality characteristics. This performance pattern echoes earlier factor regimes where speculative segments can temporarily overshadow fundamentals.

How We Define Quality

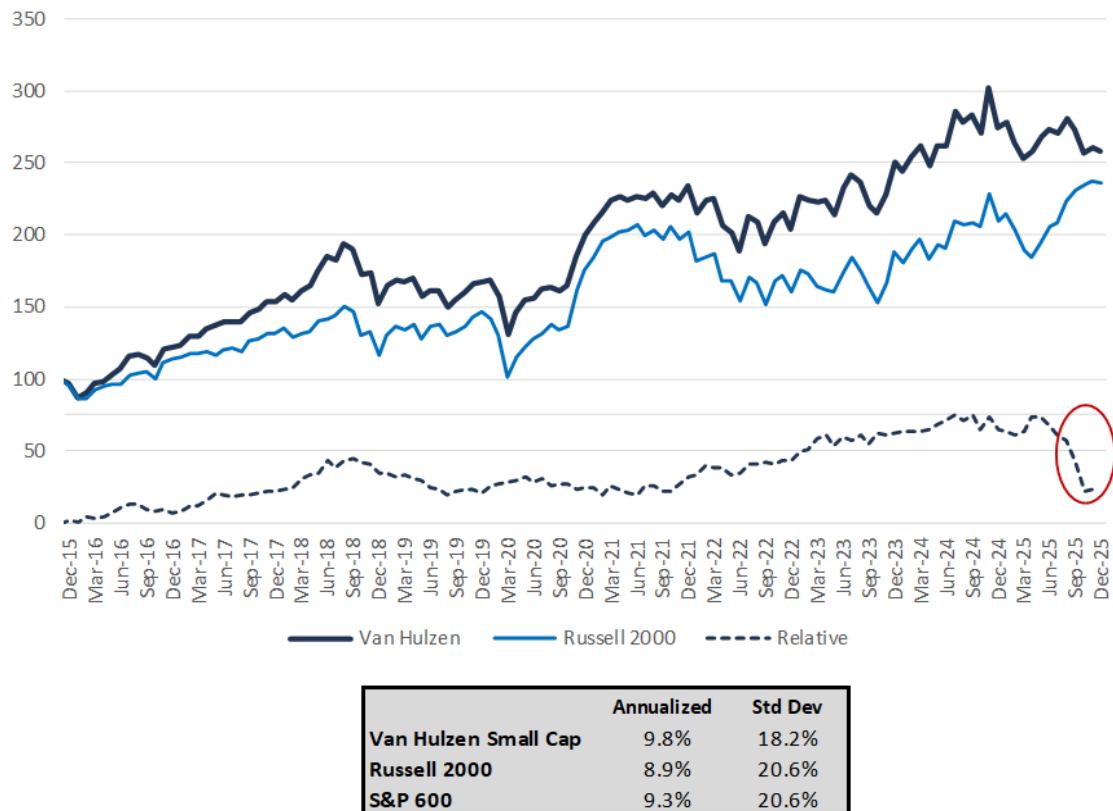
Our holdings are leaders in today's most relevant industries, with strong ROIs, margins, asset efficiency and sales growth. We do not speculate. Our holdings have low leverage, and we do not tolerate default risk. These characteristics were not a formula for outperformance in 2025, but they have been in 7 of the 10 years since inception.



The average Cash Flow ROI of the stocks in our portfolio is 19.2%, versus 6.6% for the Russell 2000. Our average leverage is 14.1% (versus 24%) and default probability is 0% (versus 3.1%).

Van Hulzen Small Cap Strategy

The second half of 2025 was tough on our strategy, which focuses on established, profitable small caps with strong cashflows and low debt. In fact, it was the worst 6-month stretch (from a relative standpoint) for the strategy in its 10-year history. Nothing has changed in our approach or the profile of our holdings. Only short-term market preferences have changed. See relative performance chart below.



Of course, we make no claims of “tracking” the small cap index. The Russell 2000 is a strange animal, loaded with unprofitable early-stage companies and over-levered “zombies.” We have outperformed the Russell by 21.7% since inception, which combined with our lower standard deviation results in a very strong 2.3% Alpha. And we have seen similar periods of relative underperformance at times in our 10- year history. For example, the strategy saw similar (albeit more gradual) underperformance in the 12 months from September 2018-August 2019. Relative performance then stabilized and went sideways for more than a year before outperforming by 55% over the three years beginning in mid-2021.

2025 Biggest Winners & Losers

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
BWXT	BWX Technologies	72.9%	Nuclear components for Navy	-
STRL	Sterling Infrastructure	72.6%	Engineering & Construction	<i>Trimmed in Q4</i>
MLI	Mueller Industries	46.3%	Water management systems	-
DGII	Digi International	43.2%	Open source business apps	-
YOU	Clear Secure Systems	35.1%	Security systems	<i>Add in Q4</i>

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
CORT	Corcept Therapeutics	-53.6%	Treatments for cushings syndrome	-
SPSC	SPS Commerce	-50.4%	Supply chain software	<i>Added in Q3</i>
SMPL	Simply Good Foods	-48.3%	Food	-
BWIN	Baldwin Insurance	-38.2%	Insurance brokerage	<i>Sold</i>
JJSF	J&J Snack Foods	-38.1%	Snack foods	<i>Sold</i>

Outlook for Small Caps Heading into 2026

As we pivot toward 2026, the narrative around small caps is shifting from risk-of-the-moment to earnings and valuation fundamentals. We have already seen a return to quality in the early weeks of January, and our strategy is up 4.8% for 2026 as of this writing.

Bullish Structural Tailwinds

- Earnings acceleration: Consensus forecasts show expected earnings growth for small caps outpacing large caps in 2026, with analysts pointing to stronger profit momentum in the S&P SmallCap 600 and Russell 2000 equities. See chart below.
- Valuation discounts: Small caps overall trade at notable discounts relative to large caps on forward P/E ratios, indicating a valuation buffer that could support upside if earnings materialize.
- Monetary policy tailwinds: Market expectations for easing by the Federal Reserve could reduce financing costs for smaller firms, which tend to be more rate-sensitive due to higher leverage.

These factors support a broad cyclical rebound thesis for small caps in 2026, especially if real economic growth and corporate profit cycles strengthen.

Cautionary and Nuanced Views

Not all forecasts are uniform:

- Some strategists highlight that the 2025 rally was concentrated in speculative pockets and may not be durable without underlying manufacturing or real-economy acceleration.
- Relative underperformance in prior years has left small caps historically cheap, but cheap does not always mean guaranteed outperformance; risks in liquidity and fundamentals remain.
- Rotation into higher-quality small caps is expected by many active managers in 2026 as the speculative beta rally

Small-Cap's Estimated Earnings Growth is Expected to Be Higher Than Large-Cap's in 2026

One-Year EPS Growth



Past performance is not guarantee of future results.

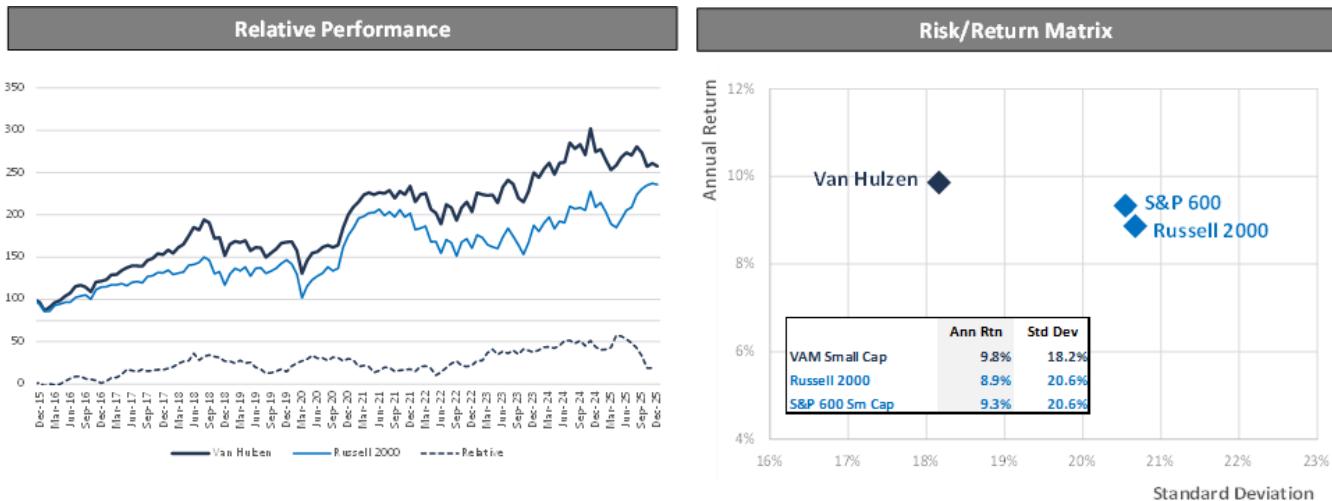
Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The EPS Growth Estimates are the pre-calculated mean two-year EPS growth rate estimates by brokerage analysts. Estimates are the average of those provided by analysts working for brokerage firms who provide research coverage on each individual security as reported by FactSet. All non-equity securities, investment companies, and companies without brokerage analyst coverage are excluded. Source: FactSet.

Long Term Performance

Since inception, our strategy has delivered an annualized return of 10.8%, versus 8.9% for the Russell 2000, producing 3.2% annualized alpha.

While the market backdrop remains uncertain, we continue to advocate patience with small caps. The era of large-cap dominance is showing signs of fatigue, and although low-quality, highly levered companies may lead in the early stages of a rebound, quality tends to win in the end. Today's disciplined small caps are the likely large cap leaders of tomorrow.

Relative Performance Since Inception



Alpha

$$\alpha = R_p - [R_f + (R_m - R_f) \beta]$$

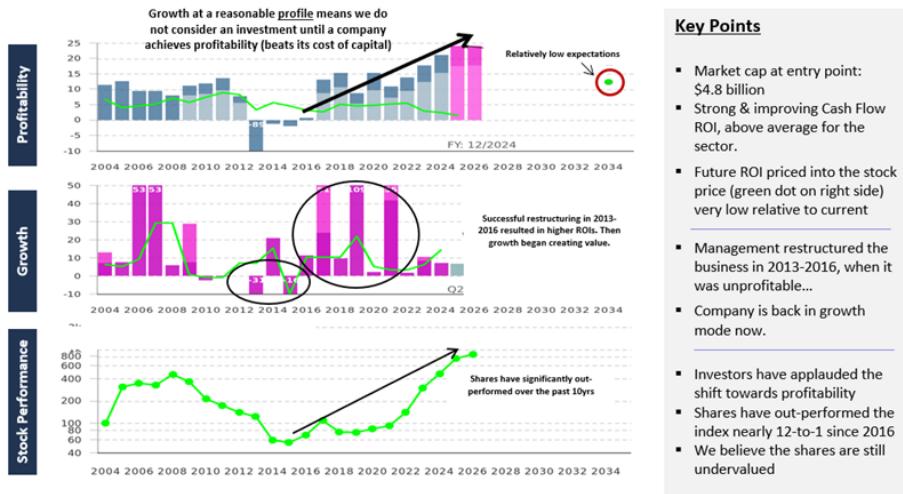
Rp = Realized return of portfolio
Rm = Market return
Rf = risk-free rate
β = Beta
Alpha (relative to RUT)

Russell 2000	S&P 600
9.8%	9.8%
8.9%	9.3%
2.0%	2.0%
0.81	0.81
2.3%	2.0%

Investment Process

Investment Process

Fundamental Analysis: Sterling Infrastructure (STRL)



STRL is an engineering and construction company that provides e-infrastructure, transportation, and building solutions in the United States. It is a high growth company with great momentum and plenty of room for further upside.

Note: There is no assurance that the Strategy will achieve its investment objectives.

Top 10 Holdings

Company	Business description	Weight	Mkt Cap (\$mm)
Qualys (QLYS)	Cyber security	5.1%	4,800
Hamilton Lane (HLNE)	Investment banking	5.0%	8,500
Sterling Infrastructure (STRL)	Engineering & construction	4.4%	10,700
Progress Software (PRGS)	Open source business apps	4.1%	1,700
Applied Industrial (AIT)	Motion/fluid/power control	4.0%	10,600
Merit Medical (MMSI)	Medical supplies	4.0%	4,900
Viper Energy (VNOM)	Oil & natural gas	3.8%	3,800
Addus HomeCare (ADUS)	Personal home care & Hospice	3.7%	1,900
American States Water (AWR)	Water Utility	3.5%	2,900
SPS Commerce (SPSC)	Supply chain software	3.5%	3,400



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