Small Cap Quality Growth Portfolio Review – 2Q26

Market Review

- Small-caps just turned in one of their strongest quarters in decades. The Russell 2000 (R2) climbed 21.5% in 2Q26 - its best showing since 4Q20 and the eighth-strongest quarter out of 190 dating back to 1978. On a relative basis versus the S&P 500, it ranked 23rd and notably outpaced the large-cap benchmark on most trading days for the first time in four years. Growth stocks did the heavy lifting within the index, with Russell 2000 Growth (R2G) returning 25.7% versus 17.2% for Value (R2V) - though the R2V still holds the edge over one-, three-, and five-year windows. Micro-caps outdid everyone, with the Russell Microcap Index up 25.6%, while the Russell 1000 (R1) managed 15.1% and the mega-cap Russell Top 50 trailed at 10.7%. The Nasdaq, meanwhile, gained 21.6%.
- This wasn't a one-quarter blip. Looking at the 1H26, the R2 is up 22.6% and the Microcap index 27.5%, dwarfing the R1's 10.3% gain. Looking back to the market bottom on April 8, 2025, the numbers get even more dramatic: the R2 has rallied 74.5%, Microcap 108.4% — both comfortably ahead of large-caps and even the Nasdaq's 73.1%.
- High-beta names had their best relative quarter within the R2 in more than ten years, and unprofitable companies actually outperformed profitable ones by upwards of 1200 basis points - extending a streak where loss-makers have now led in four of the last five quarters. Quality-oriented stocks, by contrast, kept lagging. On the sector side, Technology was the standout, surging roughly 47% for its best quarter ever and dragging Industrials, Health Care, and Financials along with it. Semiconductor names in particular had a record-shattering run, roughly doubling in price. Energy was the lone sector in the red.
- Importantly, this isn't purely a sentiment-driven move - earnings are backing it up. Over 60% of both the trailing-year and year-to-date gains in the R2 can be traced to actual EPS growth rather than multiple expansion, and small-cap earnings estimates for 2026 and 2027 are now projected to outpace those of large-caps, with margins beginning to turn higher as well.
- On valuation, small-caps still look cheap relative to large-caps - EV/EBIT ratios versus the R1 sit near 25-year lows, suggesting there's room left to run even after this year's surge. Put together — reasonable valuations, improving earnings, and a level of volatility we'd argue works in favor of patient, selective investors rather than against them — the setup still favors small-caps holding the leadership mantle in the months ahead.

Portfolio Review:

- SCQG returned +22.6% (gross) in 2Q26, underperforming the R2G return of +25.7% by approximately 3.1 percentage points.
- Security selection detracted from relative performance with a -2.4% effect; allocation effect was also negative at -0.6%, producing a total relative underperformance of -2.9%. Positive drivers included Financials (+1.65% total effect; selection +1.78 bp impact); Industrials (+1.10% total effect; selection +0.77);and Materials (+0.92% total effect; selection +1.30). Health Care detracted (-5.16% total effect; selection –5.49) and Technology detracted (–2.26% total effect; selection –1.99).
- Overall active factor impact was negative at –2.69%.Favored factors were distributed and not supportive of outperformance this quarter. Market Sensitivity (–3.54% impact; active exposure –0.57, i.e., lower beta than benchmark). Profitability (+1.38% impact; active exposure +0.45 overweight), with smaller positives from Liquidity, Medium-Term Momentum, Size, Volatility, and Value. Growth and Earnings Yield were modest detractors.
- The quarter was explosive: 8 of the 10 largest positive contributors delivered 50%+ quarterly returns - 3 of those names exceeded 90% - and 7 of the top ten delivered greater than 100bp of contribution to return. Technology placed five stocks in the top ten. Average holding period in the top ten was 15 months. The standout contributor was StoneX Group (SNEX) which registered 226bp of contribution. SNEX has consistently delivered record operating revenues, strong growth in client engagement, increased transaction volumes, and higher interest and fee income on client balances. Notable detractors were Phibro Animal Health (PAHC) and Artivion (AORT).

Outlook:

- We posit the “small-cap decade” has begun. The long-running linchpins for the large to small switch all contributed to small cap relative return **depreciation.** These are the **valuation** discount of small to large, the **concentration** of mega-caps as a percent of the total equity market, and the **duration** of the large cap leadership cycle.
- The rubber band of the “linchpins” has most likely snapped. In the next 3, 5, even 10 years, history has demonstrated, small caps are likely to generate historical **appreciation**. Sawgrass’ risk-conscious Small Cap Quality Growth strategy generates portfolios exhibiting lower price volatility; stable, consistent growth; and attractive valuations. It is built for this market.