Market Review – 3Q 2026

Small caps gave back a strong first half as a surprise Fed hike hit the most rate-sensitive names hardest

A genuine rally, then a shock. The Russell 2000 was up as much as 20% YTD by early September before the FOMC raised rates 25bp on 9/16 — its first hike since 2023 — after hot August CPI. Small caps are disproportionately exposed: ~32% of R2000 constituents carry floating-rate debt vs. ~6% for the S&P 500.

Worst margin since 2020. Small caps underperformed large caps by the widest margin since 2020; Tech and Industrials — together the most overweight sectors across active small-cap managers — posted their worst quarterly relative return since the early 2000s.

Market got concentrated again. The top five S&P 500 names are now 6x the market cap of the entire Russell 2000 and trade at 10.6x sales vs. 2.2x for small caps. 3Q26 was the third-worst relative quarter for small vs. large since 1979, behind only 1990 and 1998.

A valuation reset, not an earnings problem. Aggregate R2000 fundamentals improved even as prices fell (EPS +19.5%, FCF/share +11.2%). Valuations have reset meaningfully — the R2000's forward P/E fell back under 20x for the first time since July 2025, while earnings-revision ratios stayed above 1.0 for a 17th straight month.

3Q26 AT A GLANCE

-7.2%	-9.4%	6th	-53bp	19.7x
Russell 2000	Russell 2000 Growth	straight qtr avg. core mgr lagged the index	avg. small-cap growth mgr shortfall vs. R2G, 3Q26	R2000 forward P/E — first time under 20x since Jul '25

Portfolio Review & Outlook – 3Q 2026

Portfolio Review

- SCQG fell -12.15% in 3Q26 vs. -9.39% for the R2G, a -2.76% shortfall (-0.64% allocation, -2.12% selection). Trailing year: +8.68% vs. +11.52% (-2.85% shortfall).
- Style factors were a +2.06% tailwind this quarter — the low-beta, high-quality tilt worked exactly as designed — but a -3.07% industry/sub-industry drag more than offset it, net -1.01%.
- Damage was concentrated: Technology (-1.00%) and Industrials (-0.61%) selection, led by aged positions (MYRG, GVA, STRL, SNEX, AEIS, AROC, ATEN) caught in the momentum reversal.
- The shortfall was larger than the peer average. The momentum reversal hit more heavily-weighted, longer-held positions, whose model scores and fundamentals had remained intact through the prior rally. The result was higher exposure to the sharp reversal than the typical small-cap growth book.
- Over the trailing year, Health Care selection (-6.25%) — the structural Biotechnology underweight missing a +34.7% benchmark rally (we avoid loss-makers) — is the single largest driver, offset by a standout Financials selection effect (+4.50%).
- 3Q26 ranks among the handful of true tail absolute performance quarters in SCQG's 16-year life (down -12% or more), behind only 1Q20 (COVID), 3Q11 (debt-ceiling/eurozone), 4Q18 (Dec selloff), and 2Q22 (rate-hike/inflation shock). Of these, 3Q26 was also the only time that the portfolio did not cushion the drawdown.

Outlook

- We remain constructive on small caps heading into Q4 — this looks far more like a valuation reset than a fundamentals problem and sell-offs this sharp have historically set up above-average recoveries.
- Q4 has historically bounced back hard after quarters this bad (avg. +8.4% gain, ahead of large caps) — the rolling 10-year relative return is still historically in the trough, which is exactly where the opportunity sits.
- The macro backdrop still favors cyclical, domestically-levered small caps: capex accelerating, unemployment below 5% for 61 months, productivity above 2% for 12 straight quarters, 30-year-low high-yield spreads, strong small-cap M&A.
- Russell 2000 fundamentals (sales, FCF, EPS) all improved in 3Q26 even as prices fell. We read that as a valuation reset, not earnings deterioration, and see small-cap leadership continuing.
- Our bias toward safer, higher-quality stocks cost us a little in most months this year, when the market was rewarding riskier names. That positioning protected the portfolio when the September shock hit. Over a full market cycle, that trade-off — small, steady costs in exchange for real protection when things go wrong — is exactly why we built this strategy
- 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.