

From our U.S. partners.

The case for owning small cap stocks

Why a combination of valuation and improved earnings have changed the outlook for this differentiated asset class

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Key takeaways

- Since 1929, the performance of large cap U.S. stocks versus small caps has run in cycles lasting about seven years, on average, making the current cycle of U.S. large cap outperformance an outlier.
- What’s changed for small caps vs. recent years includes expectations for improved sales and better earnings.
- Meanwhile, relative valuations (U.S. small caps vs. large caps) are in their cheapest quintile since 1990, which has increased the historical odds of small caps outperforming large caps over the next 5 to 10 years.

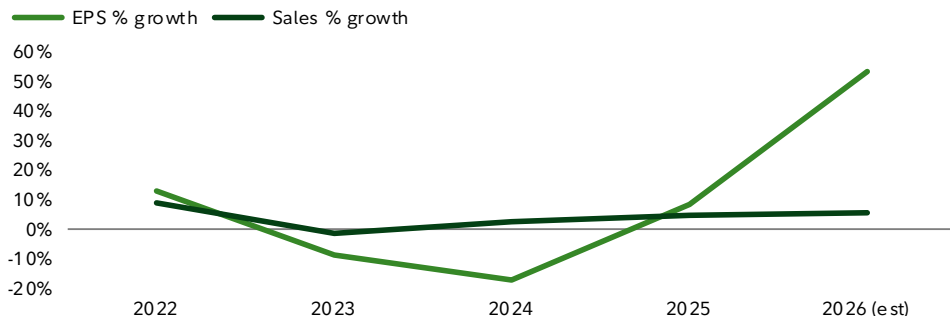
U.S. small cap equities have disappointed investors the past 12 years amid one of the longest stretches of underperformance versus large cap U.S. stocks since the Great Depression.

Could it be a matter of time before the cyclical performance relationship between the large and small stocks once again favors small caps?

This trend could already be underway. Small caps have outperformed large caps for the trailing 12 months ending in March 2026 and in the first quarter of 2026. Extended outperformance remains to be seen amid geopolitical concerns in the Middle East, rising oil prices, and inflationary worries that could stall the current rate-cut cycle and disproportionately hurt small caps.

Yet if small caps can overcome these worries, the narrative on small caps may change meaningfully. Two things have already changed for the better in the small cap equity universe as of the first quarter of 2026: 1) Small caps are now backed by historically attractive relative valuations and 2) the earnings and sales outlooks look far rosier than in recent years (Exhibit 1).

Exhibit 1: Russell 2000® Index earnings-per share and sales growth



Past performance is no guarantee of future results.

EPS = earnings per share. Source: Factset, as of 4/6/26.



What's behind the improved earnings outlook?

Expectations for the fastest small cap earnings growth in four years stem from:

- The U.S economy, which the Fidelity Asset Allocation Research Team says remains in a mid-cycle growth stage as of March 2026.
- A U.S. Federal Reserve rate-cutting cycle, which, in theory, should help small caps, especially ones with a relatively high proportion of floating-rate debt.
- Recent corporate tax cuts have benefited many domestic-oriented small cap firms that utilized the resulting increased cash flow to spend on manufacturing, infrastructure, and technology build-outs.

The large cap vs. small cap cycle

It's important to understand how the relationship between small cap and large cap stocks in the U.S. has ebbed and flowed historically. Exhibit 2 shows six periods of relative outperformance for U.S. small caps since 1929 and seven periods of underperformance. These performance cycles have averaged about seven years.

Exhibit 2: The cyclical performance of U.S. small caps vs. large caps over time

Period	Ibbotson Associates U.S. Small Stock Index	Ibbotson Associates U.S. Large Stock Index	Difference	Years
Jan. 1929 to Dec. 1931	-84.9	-61.0	-23.9	3
Jan. 1932 to Mar. 1937	701.3	189.5	511.8	5.3
Apr. 1937 to Mar. 1939	-68.0	-31.9	-36.1	2
Apr. 1939 to May 1946	1037.6	163.2	874.4	7.2
Jun. 1946 to Dec. 1957	106.0	296.1	-190.1	11.6
Jan. 1958 to Dec. 1968	984.6	272.0	712.6	11
Jan. 1969 to Jun. 1973	-45.7	15.8	-61.5	4.5
Jul. 1973 to Jul. 1983	1101.0	153.7	947.3	10.1
Aug. 1983 to Dec. 1990	16.3	168.8	-152.5	7.4
Jan. 1991 to May 1996	271.1	136.3	134.8	5.4
Jun. 1996 to Mar. 1999	-0.6	101.8	-102.4	2.8
Apr. 1999 to Nov. 2013	454.9	84.5	370.4	14.7
Dec. 2013 to Dec. 2025	170.2	370.3	-200.5	12.1
Average small cap bull market (vs. large cap)	758.4	166.5		8.9
Average small cap bear market (vs. large cap)	13.3	122.9		6.2

Past performance is no guarantee of future results. Index comparisons are for illustrative purposes only. Indices are not investments, are not professionally managed, and do not reflect deductions for fees or expenses. Time periods for the respective averages of the market cycles correspond to an average for the periods above. Rows in which small caps outperform large caps (green text), i.e., where the "Difference" column value is positive = bull markets (for small caps). Rows in which small caps underperform large caps, i.e. where the "Difference" column value is negative = bear markets. Bull market "Difference" values in dark green denote the larger difference values vs. bear markets. Outperformance and underperformance periods determined by visual chart trend analysis. Source: Fidelity Investments and Morningstar, as of 3/9/26.

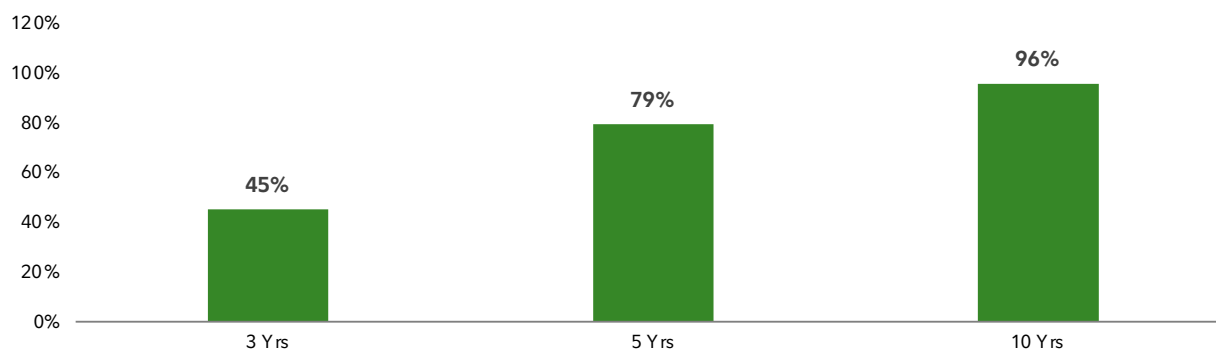
Valuations matter

It's impossible to say whether the cyclical trend is starting to shift in favor of small caps, since timing asset class rotations is inherently difficult. Persistent inflation trends, the impact of U.S. tariffs on costs and supply chains, and the degree of economic uncertainty complicates the trend analysis further.

What's very clear, however, is the valuation advantage.

As of March 2026, U.S. small caps were in their cheapest quintile vs. large caps since 1990 (Exhibit 3). In the near term (three years or less), relative valuation has not been a great predictor of the relative performance of small caps, but as we look over longer periods, the historical odds for small cap outperformance become more compelling. When U.S. small caps reached the cheapest quintile over the past 35 years, small caps tended to outperform, especially in subsequent 5- and 10-year periods.

Exhibit 3: Historical frequency of outperformance when U.S. small caps were in their cheapest quintile



Past performance is no guarantee of future results. Diversification does not ensure a profit or guarantee against a loss. It is not possible to invest directly in an index. All indices are unmanaged. Source: FactSet, as of 3/9/26.

Market concentration trends may be in favor of small caps as well. As of March 2026, small caps account for about 4% of the overall U.S. market cap. This compares with a long-term average of about 9%. We believe, over time, if small cap stocks revert to their long-term average concentration, it may support performance vs. large caps.

After an extended period of dominance by large multinational corporations, favored partly because of their strong industry positions and strong fundamentals, we believe a different backdrop for inflation, geopolitics, and monetary policy could result in a broader range of potential winners and losers across multiple investment categories. This, too, could benefit U.S. small caps.

Trends favoring small caps

Looking ahead, several fundamental trends could work in favor of U.S. small caps in the coming years, including:

- A continuation of healthy overall U.S. fundamentals based on leading economic indicators.¹
- A potential move lower for interest rates, which could disproportionately help small caps, due to their collectively lower ratio of earnings to net interest expense versus large caps.
- Potential for more small cap acquisitions, driven by valuation discounts and efforts to reshore and localize U.S.-based supply chains.
- Small caps have tended to be more U.S.-focused than large caps, which means that some small caps could be less affected by potential earnings degradation associated with international currency fluctuations, political posturing, or military maneuvers.

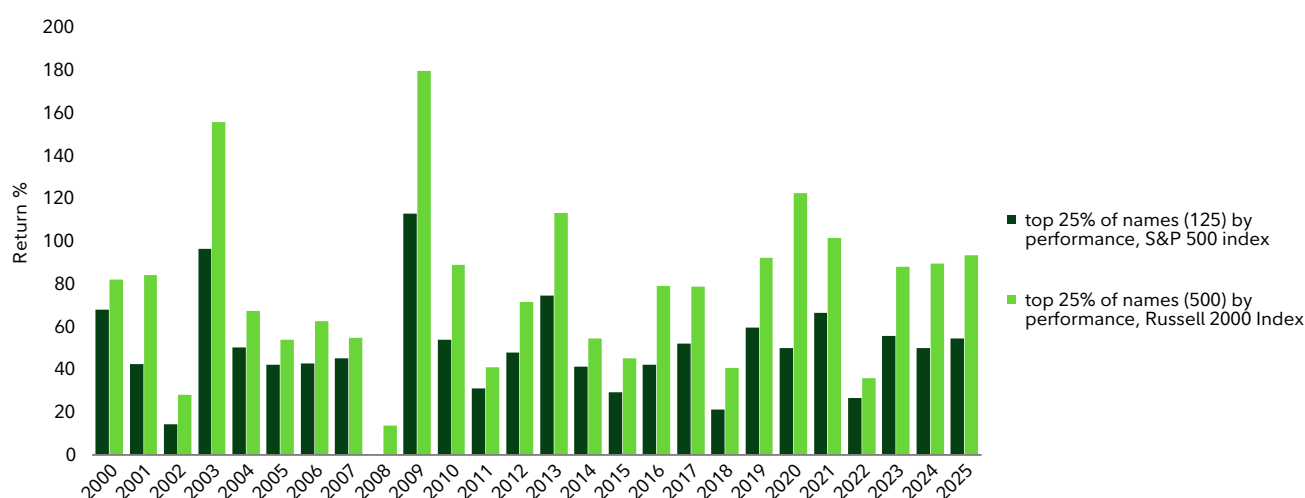
¹ Based on the Organisation for Economic Co-Operation and Development (OECD) Composite Leading Indicator, which has remained above the long-term average reading of 100 in January and February 2026.

Not all small caps are equal

From a fundamental perspective, the quality of small caps has varied greatly. As of early 2026, about 41% of the small cap Russell 2000® Index components did not generate earnings. This partly reflects the number of growth-oriented, early-stage companies in the index.

Yet over time—regardless of economic regime, market performance, or style bias—there has been the opportunity to find strong performing companies over time within the small cap universe. Exhibit 4 shows that in each of the last 25 calendar years, the average of best-performing stocks (among the top 500 securities—or roughly top 25%—based on returns within the Russell 2000® index) outperformed the average of the top stocks (among the top 125 securities—or roughly top 25%—based on returns) in the S&P 500.

Exhibit 4: Top-performing small caps have bested top-performing large caps



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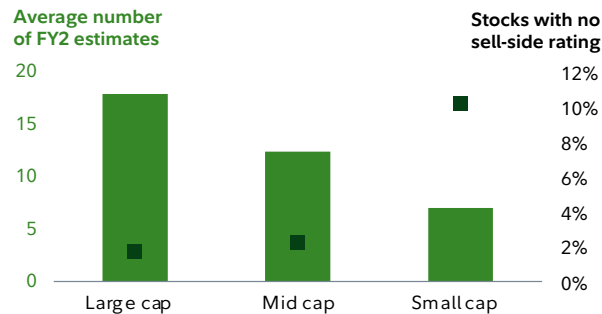
The active advantage

One way to try to take advantage of the breadth of Russell 2000 components is through actively managed small cap products. Stock selection opportunities can be rich in the small cap market, which tends to be less efficient than large caps (Exhibit 5).

Exhibit 5: The opportunity for small caps

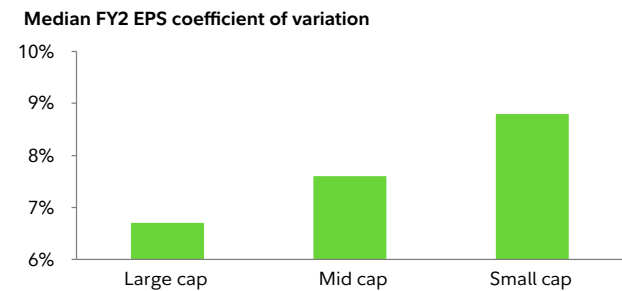
Large opportunity set

Minimal sell-side coverage, may be overlooked by other investors



Long-term investment horizon

Short-term noise creates long-term opportunity, focus on long-term normalized earnings power



Past performance is not a guarantee of future results. Index comparisons are for illustrative purposes only. Indices are not investments, are not professionally managed, and do not reflect deductions for fees or expenses. **LEFT:** Large cap represented by the MSCI ACWI World Index; Mid cap represented by the MSCI ACWI Mid Cap Index. Small cap represented by the MSCI ACWI World Small Cap Index. **RIGHT:** FY2 EPS coefficient of variation divides the standard deviation of the FY2 (Fiscal Year 2) EPS (Earnings Per Share) estimates by the median of those same estimates. It shows the dispersion, or spread, of analysts' FY2 EPS estimates relative to the median estimate. A higher coefficient of variation implies greater uncertainty or disagreement among analysts regarding a company's future earnings. Source: Fidelity Investments, FactSet, as of 12/31/25.

Less coverage can work to the advantage of the analyst teams and managers who conduct their own research to try to identify companies that can generate excess returns and grow from small companies to larger ones over time. Active managers seek to add value versus the Russell 2000 through a combination of additive stock selections and by trying to avoid small caps with the least attractive earnings trends.

Also of note, U.S. small caps can experience more short-term variability, as measured by the coefficient of variation for their median earnings estimates. This could create opportunities for active managers who opportunistically see through the short-term noise and focus on long-term normalized earnings trends.

Conclusion

Market leadership often has rotated between large caps and small caps over the years. We don't know if or when small caps will lead large caps. That said, we believe valuation trends have raised the historical odds for U.S. small cap outperformance, especially over the next 5 to 10 years.

Investors always have choices between active and index-based products. Based on our study, small caps have been one of the asset classes in which stock selection has historically added value.

At Fidelity, our small cap active managers are focused on finding companies they believe are attractive based on fundamental characteristics.

Lastly, our managers tend to also look for strong competitive positions in growing niches, companies with entrepreneurial management teams, and high barriers to entry.

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Ben serves as a member of the investment management team, focusing on U.S. small cap investments. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.



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Index definitions

Ibbotson Associates U.S. Small Stock Index is used to represent the historical performance of small-cap U.S. stocks, based on a subset of small cap stocks traded on the New York Stock Exchange. **Ibbotson Associates U.S. Large Stock Index** is used to represent the historical performance of large cap U.S. stocks, based on a subset of small cap stocks traded on the New York Stock Exchange. **Russell 2000 Index** is a market capitalization-weighted index designed to measure the performance of the small cap segment of the U.S. equity market. It includes approximately 2,000 of the smallest securities in the Russell 3000 Index. **MSCI ACWI World Index** is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed and emerging markets. **MSCI ACWI Mid Cap Index** is a global equity index designed to represent the performance of mid cap stocks across both developed and emerging markets. **MSCI ACWI World Small Cap Index** is a global equity index that captures the performance of small cap companies across both developed and emerging markets.

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