

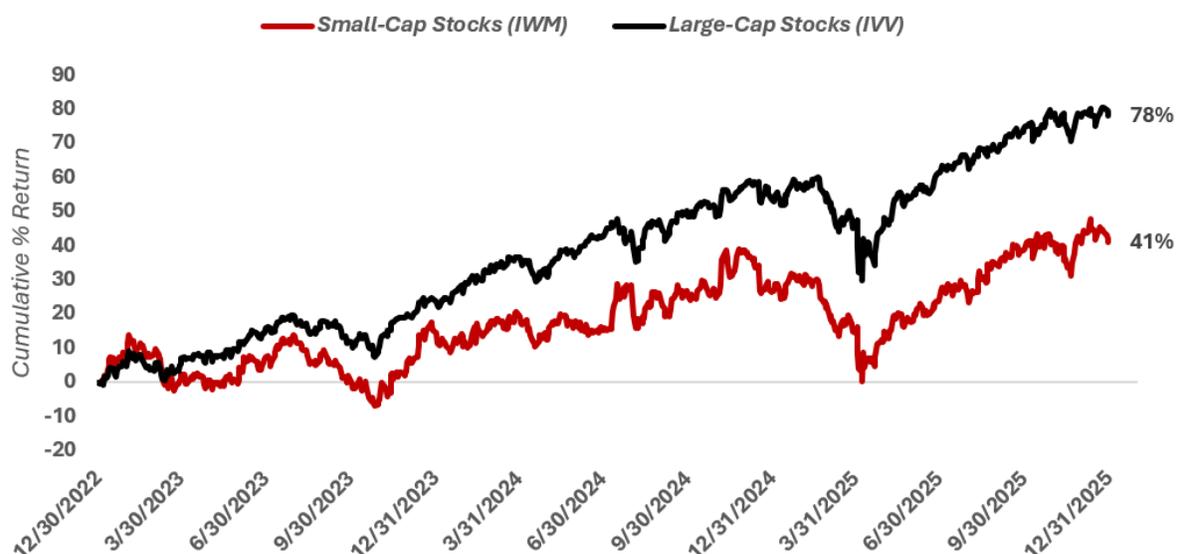
# Key Questions: Small-Caps Outperform in Early 2026 — Will Momentum Continue?

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After several years when the biggest, most well-known companies dominated stock market performance, a new trend has emerged to start 2026: small-cap stocks are showing signs of renewed strength. Small-cap stocks represent smaller U.S. companies — often nimbler, more growth-oriented, and more sensitive to shifts in the economy. These smaller companies, which have spent years lagging the large U.S. names driving the market, are now outpacing their larger peers.

The gap between small-cap and large-cap performance was significant over the last several years, as mega-cap technology companies and firms tied to artificial intelligence (AI) drove markets higher. While small-caps saw periodic spikes in investor interest, those rallies were short-lived and never evolved into a lasting leadership trend.

## Performance Over the Last Three Years



Source: Factset data as of 12/31/25 representing iShares Russell 2000 ETF (IWM) & iShares Core S&P 500 ETF (IVV)

Despite lagging their large-cap peers for years, small-caps have shown a notable shift in the first 45 days of 2026 — rising 6.8% through mid-February while large-caps have remained essentially flat. This reversal has raised a natural question for investors: is now finally the time for an extended period of small-cap outperformance, or just another head fake?

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## Why Small-Caps Are Interesting

In recent years, small-cap stocks have significantly lagged the market's largest companies, as major technology and AI-focused firms drew the bulk of investor interest. However, that stretch of underperformance has left small-caps trading at roughly 19x prior-year earnings, compared with about 27x for large-caps — making them appear “on sale” to many investors relative to the premium valuations of bigger companies. Weak earnings were a major part of the challenge: small-cap earnings per share fell 10% in 2023 and then dropped another 17% in 2024 before rebounding by 13% last year. Looking ahead, consensus expectations call for small-cap earnings to continue expanding in 2026, with some analysts viewing the outlook as one of the strongest in nearly 25 years outside of post-recession rebounds. Historically, when small-cap earnings accelerate faster than those of larger companies, small-caps have often gone on to outperform.

## The Economic Backdrop Could Be a Tailwind

Another reason small-caps may be gaining momentum is the broader economic environment. Smaller companies are generally more sensitive to interest rates, and if borrowing costs continue to ease (as is expected in 2026), it could provide meaningful support. Historically, small-cap stocks have performed well following Federal Reserve rate cuts as cheaper financing lowers the cost of capital for younger, more highly levered, or faster-growing businesses.

Meanwhile, if the run-up in the largest technology stocks slows or stabilizes, investors may begin looking for new opportunities — potentially turning toward smaller companies that have been overlooked for years.

## Evolving Dynamic in the Space

As highlighted in a previous Key Questions article [Key Questions: Investing Before Lift Off – What Should Investors Know About Private Markets and the Next IPO Cycle? | Key Wealth](#), the decline in IPO volume and the rising age of companies at IPO reflect a trend of firms choosing to remain private longer. Expanded access to private equity financing has reduced the need for early-stage companies to go public, narrowing the universe in which active small-cap managers can allocate capital. As a result, the index's weighted-average market cap has risen, leaving fewer publicly traded small-cap companies for active managers to choose from. This dynamic will be something to watch into 2026 and beyond.

## Active Management Struggles in 2025

Many small-cap fund managers faced a challenging 2025, struggling not only against their benchmarks but also in comparison to large-cap performance. The performance gap between the two segments was among the widest ever recorded, and the small-cap rebound that did occur was largely powered by lower-quality, higher-volatility names. In fact, many of the top performers were businesses with no earnings at all — and more than 40% of the small-cap index is made up of these non-earners.<sup>1</sup>

Most active managers, however, tend to favor higher-quality companies — a term that varies by investor but generally refers to a preference for companies with strong balance sheets, consistent earnings growth, and capable management teams with proven track records of generating strong returns for shareholders. That quality focus is normally a strength, but last year it worked against them.

Because the market rewarded riskier, unprofitable companies, there was a clear mismatch between what performed best and what most managers intentionally chose to own. As a result, even managers making sensible, long-term decisions struggled to keep up with the index.

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## What This All Means:

The strong early performance of small-caps in 2026 is a reminder of why diversification across company sizes is so important. When one segment of the market outperforms for several years (as large-caps have), it can cause a portfolio to become unintentionally unbalanced.

If large-cap returns have pushed your allocation out of alignment with your long-term plan, this may be a good time to consider rebalancing. That means trimming the areas of your portfolio that have grown above their target allocations and adding to areas where you might be underweight due to underperformance, such as small-cap stocks.

Maintaining adequate diversification and keeping your portfolio aligned with your goals helps to ensure your portfolio is well-positioned irrespective of the market environment — whether small-caps take the lead from here or market leadership shifts again in the future.

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For more information, please contact your advisor.

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<sup>1</sup> According to Factset data for iShares Russell 2000 ETF (IWN) as of 12/31/25

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