THROUGH THE LENS OF DE LISLE PARTNERS
THE STAGE IS SET FOR A US SMALL CAP RESURGENCE

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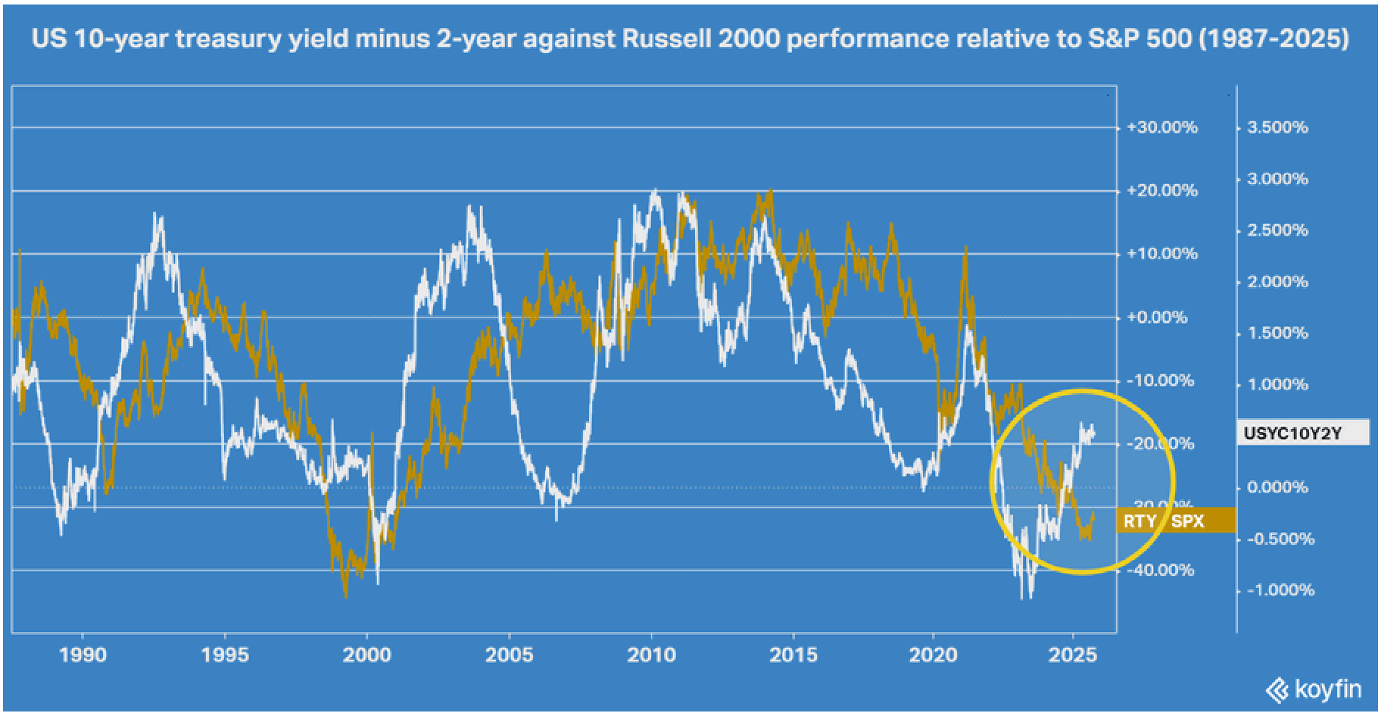

Over the last couple of years, we have highlighted the historic discrepancy in valuations between small stocks and large stocks, but now the economic environment is catalysing this cheapness into growth.

The economic staging is captured by this chart. The white line plots the US Treasury yield curve, showing the difference (ie. the spread) between the US 10-year maturity treasury yield and the 2-year yield. The spread is how much extra yield an investor is receiving as compensation for holding a longer duration treasury bond. When the white line rises, the yield curve is steepening and when it falls the curve is flattening or – when below zero – inverting. A steepening curve is associated with economic growth and inflation while the reverse indicates economic contraction and deflation or an inversion when it drops below zero.

The gold line plots the relative performance of the Russell 2000 (small caps) against the S&P 500 (large caps). When the line is rising, small caps are outperforming large caps and, when the line is falling, vice versa. The line is a ratio expressed as a percentage, showing that since June 1987 small caps have underperformed large caps by over 30% (ie. the Russell 2000 has recorded around 70% of the cumulative performance of the S&P 500).

What is perhaps more surprising is that, despite long periods of underperformance of small caps relative to large caps, the longer-term data going back nearly a hundred years to 1926* still shows small caps coming out on top, producing over 120% of the cumulative performance of large caps over this period.

The next observation to make on this chart is the broad positive correlation between the white and gold lines. When the yield curve steepens, small caps outperform and when it flattens or inverts, large caps outperform. There have been two exceptions: the dot com bubble bust in 2000, where the spike in small cap outperformance was only by virtue of not going down as the large caps crashed, and the 2008 Global Financial Crisis (GFC) when everything fell together.

Source: Chart - Koyfin as at 30/09/2025. *Fama & French, O'Shaughnessy.

This correlation makes sense, as small caps generally like economic expansion. They also prefer a bit of inflation where they can grow their sales and pass on costs in their supply chains. Apart from the brief post-Covid period, such an environment has been alien to the US for a decade or more.

We can see the small-versus-large performance ratio reaching a new high around April 2011 and peaking in March 2014, before tumbling downwards for the next 10 years. This trend illustrates clearly the extended fallout from the GFC. Large cap companies (initially the FAANGs, now the Magnificent 7) developed their current supremacy through monopolistic tech platforms while wider economic growth was scarce. This induced the Fed to supress the yield curve through near zero interest rates and Quantitative Easing bond buying programmes.

Small caps do not like an inverted yield curve. The most recent inversion lasted for a record 783 days, from July 2022 to September 2024, as the rate hiking cycle tempered economic growth to tame an inflation spike.

Yet the most striking takeaway from this chart is the way in which the white line leads the gold line, suggesting that a steepening yield curve is predictive of small cap relative outperformance. Most excitingly for our area of the market is that this is happening right now.

As the yield curve has taken off, the small versus large relative performance is beginning to gain momentum. Since August 1, the S&P 500 is up 5.9% while the Russell 2000 is up 11.1%.* This tick up seen on the far right of the chart could be the start of small caps outperforming large and - as we can also see - these cycles are long ones.

While it is largely their cheapness that makes small caps attractive, there are three fundamental economic reasons for this outperformance to continue: interest rate cuts, continued government fiscal spending and the big tech companies using their enormous cash flows to build out AI infrastructure. All these actions force growth into smaller companies in the wider economy.

Despite a hard 15 years for small caps, the VT De Lisle America Fund has still produced an annual return of 14.9%.* This compares to the Russell 2000's 10.1%,** showing the value that can be created by picking the right stocks.

Holdings in our portfolio include Sterling Infrastructure (data centre construction), Everus Construction (electrical engineering) and Modine Manufacturing (data centre cooling) which have surged this year on all this physical infrastructure capex. But there are other unrelated beneficiaries from an expansion of the real economy, spurred on by rate cuts. Since August, homebuilder Toll Brothers, RV supplier Thor Industries and cabinetmaker MasterBrand have ticked up, not due to better earnings right now but from the market rediscovering cyclical growth stocks, anticipating better earnings to come. This combination of low valuations and tangible economic catalysts is once more putting the wind back in the sails of small cap companies. The future is looking bright.

Source: *Morningstar, TR in USD as at 30/09/2025. **Morningstar, TR in GBP as at 30/09/2025.

Upcoming Event

VT De Lisle America Fund Webinar:

15 years at 15% annualised. What's next?

Date: Tuesday 28 October 2025

Time: 2:00pm - 2:30pm

Register here

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September 2025

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May 2025

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If you would like to arrange a meeting with the manager, or for further information on the Fund, please email investor-relations@delislepartners.uk or call 020 7074 3572.