

JPMorgan Small Cap Equity

Investment Overview

The portfolio management team, led by Don San Jose and Dan Percella, brings more than 15 years of collaborative experience and is supported by four dedicated analysts. Their investment philosophy emphasizes quality businesses with strong free cash flow generation, managed by experienced leadership teams at attractive valuations. The team also aims for high differentiation with the benchmark index (Russell 2000) and currently has a 99% active share. The portfolio is constructed to include profitable companies that are industry leaders in niche markets with unique growth drivers. Notably, while 40% of small-cap companies are unprofitable today, 100% of the portfolio remains profitable. This quality-first approach is designed to deliver consistent performance through lower volatility compared to the broader market and reduced exposure to downside risk. Since inception, the team has achieved a 78% down capture alongside second-percentile returns.

Performance Commentary

Small Cap Equity protected on the downside in the first quarter during the market drawdown (+250bps) but was unable to keep pace in the second quarter as the high-beta rally emerged as the third strongest since 2012. In fact, 27 of the top 30 index performers in the second quarter were unprofitable businesses. While the recent underperformance in this environment aligns with a conservative mandate, the magnitude of the beta rally combined with a return-to-risk-on behavior in the market created a challenging backdrop for this style of investing. A similar dynamic occurred during late 2020 through early 2021, when unprofitable companies and speculative trading drove returns and the benchmark outpaced performance. Once fundamentals regained focus, however, the portfolio outperformed by more than 1,000 basis points over the following three years. In 2024, Industrials and thematic investing headwinds further drove underperformance, as speculative themes dominated index returns. Not owning speculative stocks such as space companies (+94% in the second quarter) and thematic exposures like Bitcoin (+66% in the second quarter) or speculative AI (+49% in the second quarter), while instead holding high-quality businesses in areas like residential and commercial construction, detracted from relative performance.

Over three- and five-year periods, similar trends persisted, compounded by a handful of stock-specific missteps in 2023. The strength of equity market returns over the last two and a half years meant that a lower-beta, more conservative approach lagged the benchmark in both 2023 and 2024, weighing on peer-relative results over longer horizons. Narrow leadership and concentrated performance in a small number of stocks—10 stocks accounting for nearly one-third of the Russell 2000's return in 2024—presented additional challenges. From a sector standpoint, technology and industrials, with their high growth expectations and elevated valuations, detracted from results. Stock-specific factors also weighed on performance, particularly within healthcare and consumer holdings given weaker IPO dynamics and poor selection. In response, the team re-underwrote portfolio companies, exited low-conviction positions, trimmed outperformers that graduated out of small cap, and redeployed proceeds into high-quality positions in consumer and industrials during periods of relative volatility. While the portfolio is not currently ranked at the highest levels among historical peers, the team remains committed to its focus on buying quality, profitable businesses that have consistently delivered top-decile performance since inception.

Recommendation

Our recommendation is to continue to monitor the strategy due to strong long-term risk-adjusted performance and the differentiation of the strategy complementing a passive index fund well. The fund continues to achieve its expected results given market conditions.

Disclosures

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