Investing in Tomorrow's Quality Today: Finding Quality in Small Cap Before It Becomes Consensus

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Executive Summary

Investors have spent decades chasing quality companies. In the small cap space, the biggest winners are often found before they ever look like quality. Investors generally gravitate toward companies exhibiting high returns on invested capital, expanding margins, stable earnings, abundant free cash flow, and fortress balance sheets. Those businesses deserved premium valuations, and they received them.

The success of that approach has also created its greatest challenge. Markets are remarkably efficient at recognizing established quality. Rather than purchasing companies that already look exceptional, small cap investors have been rewarded for identifying businesses **becoming** exceptional. Quality is not a static financial screen. It is the result of a business evolving over time through better management execution, improving competitive positioning, expanding returns on capital, and disciplined capital allocation.

The greatest investment opportunities often emerge long before traditional quality metrics recognize them.

Great Companies Are Rarely Born Great

The businesses that ultimately create exceptional shareholder value are rarely static. Their economics improve over time as they expand into larger addressable markets, introduce new products, diversify their revenue streams, gain operating leverage, strengthen competitive advantages, or benefit from transformational leadership. Many of history's greatest compounders appeared statistically ordinary at the beginning of their journeys. They have not yet exhibited the high returns on capital, expanding margins, or consistent earnings growth that traditional quality screens demand. The investment opportunity lies in recognizing those improving businesses before conventional financial metrics reveal their full potential. Eventually, these businesses are recognized as "quality companies." The greatest investment returns, however, are often earned by identifying them before that transformation is complete.

Great 10-Year Compounders

Traditional quality investing often begins only after a company's transformation is well underway. Our experience suggests, however, that the greatest value creation often occurs during the transformation itself. As the chart below illustrates, many of the strongest 10-year compounders began with below-average returns on invested capital (ROIC). Over time, as their businesses matured and competitive advantages strengthened, ROIC improved dramatically.

10-Year Compounders:

Great 10-Year Compounders

10-Year Period Ending	Count	Average 10-Yr CAGR (%)	Average Sales Growth	Median Sales Growth	Average EPS Growth	Median EPS Growth	Average ROIC	Median ROIC	Median ROE	Average NTM P/E	Median LTM EV/ EBITDA	Average Mkt Cap $mm	Average Max 12Mo. Drawdown	Average Beginning ROIC	Average Ending ROIC	Median Net Debt/ EBITDA
2005	56	24%	24%	21%	29%	28%	11%	10%	16%	22.0	16.1	2,189	-53.6%	9%	16%	1.6
2006	49	24%	22%	19%	22%	24%	23%	10%	17%	24.1	13.8	2,245	-51.7%	8%	16%	2.1
2007	29	27%	21%	17%	37%	35%	12%	12%	20%	24.7	10.5	2,621	-55.7%	7%	19%	1.6
2008	9	25%	26%	19%	44%	43%	17%	17%	24%	6.9	15.6	2,457	-56.9%	7%	26%	0.8
2009	16	25%	22%	17%	20%	30%	14%	11%	17%	16.1	9.5	1,646	-62.9%	-2%	17%	0.9
2010	21	26%	19%	11%	27%	39%	13%	12%	19%	22.3	9.3	2,515	-65.0%	-1%	21%	1.2
2011	18	25%	19%	14%	27%	30%	13%	12%	19%	23.7	11.8	2,277	-71.6%	3%	20%	1.3
2012	35	25%	19%	16%	29%	28%	15%	12%	17%	19.8	11.1	2,037	-62.8%	9%	17%	1.0
2013	43	24%	17%	15%	23%	23%	17%	14%	19%	8.9	9.6	2,319	-64.0%	12%	18%	0.9
2014	26	25%	17%	16%	10%	21%	18%	14%	18%	25.2	11.0	2,384	-61.7%	13%	19%	1.3
2015	18	25%	19%	16%	9%	21%	18%	16%	22%	31.0	12.1	2,387	-62.5%	14%	16%	1.2
2016	23	26%	22%	18%	23%	23%	16%	17%	22%	26.9	12.5	2,116	-61.6%	9%	16%	0.8
2017	29	25%	18%	13%	27%	25%	14%	13%	21%	26.3	12.2	2,273	-56.1%	6%	16%	0.7
2018	91	25%	10%	9%	18%	23%	17%	11%	18%	18.4	11.9	2,638	-43.7%	7%	18%	1.5
2019	82	25%	13%	11%	25%	25%	17%	12%	18%	24.0	13.0	2,624	-39.4%	8%	20%	1.4
2020	78	26%	15%	11%	22%	22%	19%	12%	17%	25.5	14.9	2,730	-46.0%	9%	19%	1.4
2021	141	26%	13%	11%	24%	25%	16%	11%	16%	23.5	14.2	2,592	-47.6%	9%	18%	1.5
2022	60	25%	17%	13%	21%	24%	15%	13%	20%	33.5	15.8	2,789	-52.3%	10%	18%	1.4
2023	39	26%	15%	11%	23%	25%	18%	16%	22%	38.1	17.1	2,912	-50.5%	12%	26%	1.2
2024	52	25%	15%	12%	26%	31%	16%	15%	19%	47.8	19.1	2,817	-56.4%	9%	20%	1.1
2025	76	26%	15%	13%	21%	29%	12%	10%	17%	34.0	13.7	2,453	-57.7%	6%	14%	1.3
Average	47	25%	18%	14%	24%	27%	16%	13%	19%	24.9	13.1	2,429	-56.2%	8%	18%	1.2
Median	39	25%	18%	14%	23%	25%	16%	12%	19%	24.1	12.5	2,453	-56.4%	9%	18%	1.3

Source: Furey Research Partners and FactSet. "Compounders" refers to companies which traded on U.S. exchanges that have compounded at a 20% annualized rate over a 10-year period between 12/31/1995 and 12/31/2025. Companies had to possess a market capitalization between \$1 Billion and \$6 Billion at the end of each calendar year from which each ten-year return period is calculated. The cohort Year designation refers to the last year at which each ten-year period ends; cohort constituents are based upon December 31st at the start of each ten year period, i.e. the "2025" cohort is measured as of 12/31/2015. Sales growth and EPS growth were capped at 250% for any individual observation. Companies constituting the '25 cohort can be found in Figure 6.

Rethinking the "Junk Rally" Narrative

The least profitable quintile of the Russell 2000 Growth significantly outperformed the most profitable quintile during the second quarter of 2026. Some observers have concluded that active managers who outperformed must have benefited simply from owning lower-quality businesses. That reasoning overlooks an important distinction between factor performance and security selection.

Lower-quality companies, measured by traditional backward looking financial metrics clearly led the rally, but not all active outperformance resulted from indiscriminate exposure to speculative stocks. Some reflected security selection among companies whose reported financial characteristics remained ordinary even as their underlying economics improved through new products, expanding markets, operating leverage and stronger execution. Traditional quality screens describe what a company has been. Fundamental research seeks to understand what it is becoming. The quarter rewarded both speculative risk and genuine fundamental improvement, but we believe long-term performance will be driven primarily by the latter.

The natural question: How does one identify tomorrow's quality companies before they become obvious?

There are many approaches to be sure. One example is having specialized expertise. Biotechnology provides a useful example. The sector is often dismissed as uniformly speculative because many businesses lack current earnings and face substantial clinical risk. Yet detailed scientific, commercial, and management research can distinguish credible innovation from poorly compensated risk. Portfolios must then be deliberately constructed and sized so that returns reflect security selection rather than undifferentiated sector exposure. The same principle applies across other industries. Identify improving competitive positions before they are broadly recognized and manage uncertainty through disciplined portfolio construction.

Why Active Management Matters More in Small Caps

If quality is evolving rather than static, active management becomes considerably more valuable, particularly in the small/SMID cap arena. More than 40% of the companies in the Russell 2000 Growth Index are currently unprofitable, according to data from Furey Research Partners and FactSet as of January 31, 2026. Passive investors own every one of them regardless of business quality, balance-sheet strength, or competitive position.

Small-cap investing remains one of the least efficient areas of global equity markets. Companies receive substantially less analyst coverage than their large-cap counterparts. Business models are often misunderstood. The dispersion between long-term winners and permanent disappointments is enormous. Those inefficiencies create opportunity. Active managers should possess the ability to distinguish between businesses experiencing temporary setbacks and businesses suffering permanent deterioration. More importantly, identifying companies whose future quality will differ dramatically from today's reported financial statements, is key.

The key objective should be to distinguish between companies becoming higher-quality businesses and those moving in the opposite direction.

Quality Is an Evolution

There are multiple paths to becoming recognized as a “quality company.” For example, some companies are innovators creating entirely new markets. Others are undergoing meaningful operational transformation. Still others have already established durable competitive advantages and consistently produce exceptional financial results. Each stage offers different opportunities and requires different analysis.

The first group of investments frequently represents companies that have not yet achieved consistent profitability but possess exceptional technologies, strong balance sheets, expanding addressable markets, and improving unit economics. Investing in Red Hat in 2002, with a market cap of $1 billion, was perceived by the street as an academic experiment. What they were doing was changing how enterprise software would be developed, deployed and supported. It was purchased in 2019 by IBM for $34 billion.

The second group are businesses experiencing internal dynamic change through new management teams, strategic repositioning, operational improvements, or cyclical inflection points. SodaStream illustrates how dramatically business quality can improve when investors underestimate the impact of strategic change. Early on the company struggled to gain traction marketing sugary beverage concentrates. The market cap was $350 million. New management repositioned the business around healthier lifestyles and flavored sparkling water that significantly expanded its addressable market. Ultimately PepsiCo's bought the company in 2018 for $3.2 billion.

The third example are companies whose superior economics have become increasingly evident but whose long-term growth opportunities remain underappreciated; however the market most likely has recognized their potential and valuations are may be higher. For many years, investors viewed Axon Enterprise as a manufacturer of Taser devices with a limited growth opportunity. What they failed to recognize was the company's transformation into a recurring-revenue public safety technology platform. There were many opportunities to buy the stock when it was valued between $2 billion - $4 billion, and today the company is valued at $46 billion.

The common characteristic is not current financial perfection. It is improving business quality. Ironically, this sometimes causes confusion. Because emerging company investments may not yet satisfy conventional quality screens, some observers mistakenly conclude they represent lower-quality businesses. Some of these in fact represent tomorrow's quality companies before the market fully recognizes their potential. The ability for a small cap manager to distinguish these can be an important source of long-term alpha.

The debate surrounding quality investing often asks the wrong question. The issue is not whether quality still matters, but whether it has been defined too narrowly. Traditional quality measures are useful descriptions of what a company has already achieved. They are less effective at identifying what a company may become. That does not mean abandoning quality discipline. It means applying that discipline prospectively.

Emerging quality must also be distinguished from indiscriminate exposure to unprofitable or speculative companies. The relevant evidence may include expanding addressable markets, improving unit economics, disciplined capital allocation, strengthening competitive advantages, capable management, and a balance sheet sufficient to fund the path to profitability.

Granahan's lifecycle framework is designed to evaluate businesses across that progression, from early innovators to companies undergoing operational transformation to established compounders. The objective is not simply to buy companies that already screen as high quality, but to identify those becoming higher-quality businesses and adjust conviction as the evidence develops.

Great companies are rarely born great. They become great. For active small-cap investors, the opportunity is to recognize that transformation before it becomes obvious.

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