

Small caps surge ahead: Why 2026 could be a breakout year

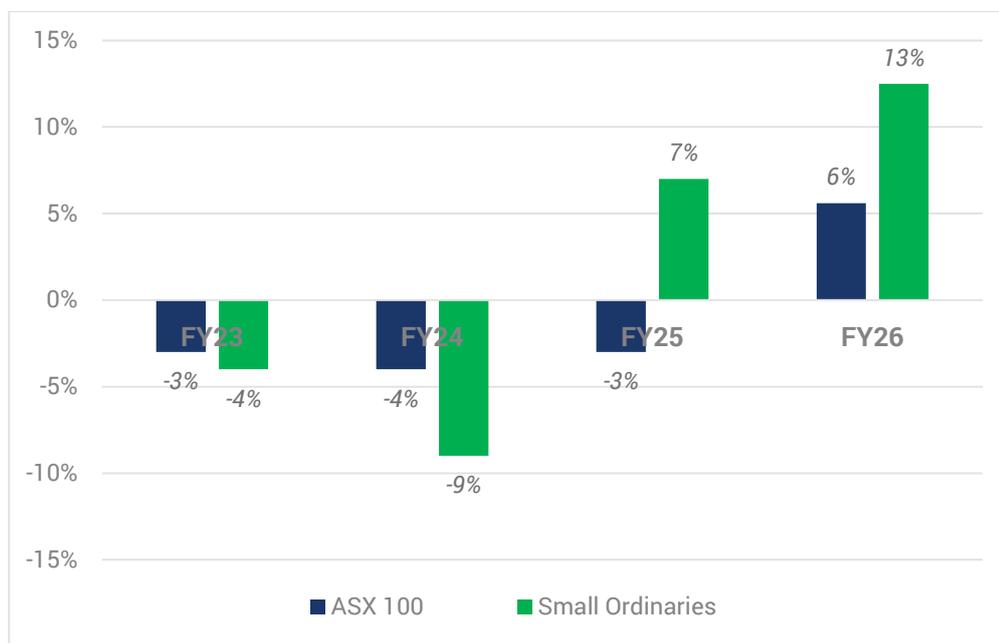
By Michael Steele, Co-Portfolio Manager, Small Caps

At the time of writing, the ASX Small Ords has rallied +21% for CY25, far outstripping the ASX100's +8% return. This stunning performance reflects the earnings momentum of Australia's small companies cohort hitting an inflection point, with earnings growth increasing +7% after two consecutive years of decline. This positive momentum is expected to continue through FY26, with earnings growth of 10-15% likely to be delivered.

It is noteworthy that small company earnings growth rates are expected to be materially higher than for larger companies in FY26, continuing the trend from FY25 (refer Chart).



Chart 1. ASX100 vs Small Ordinaries EPS Growth



Source: Goldman Sachs/YCM, Dec 2025.

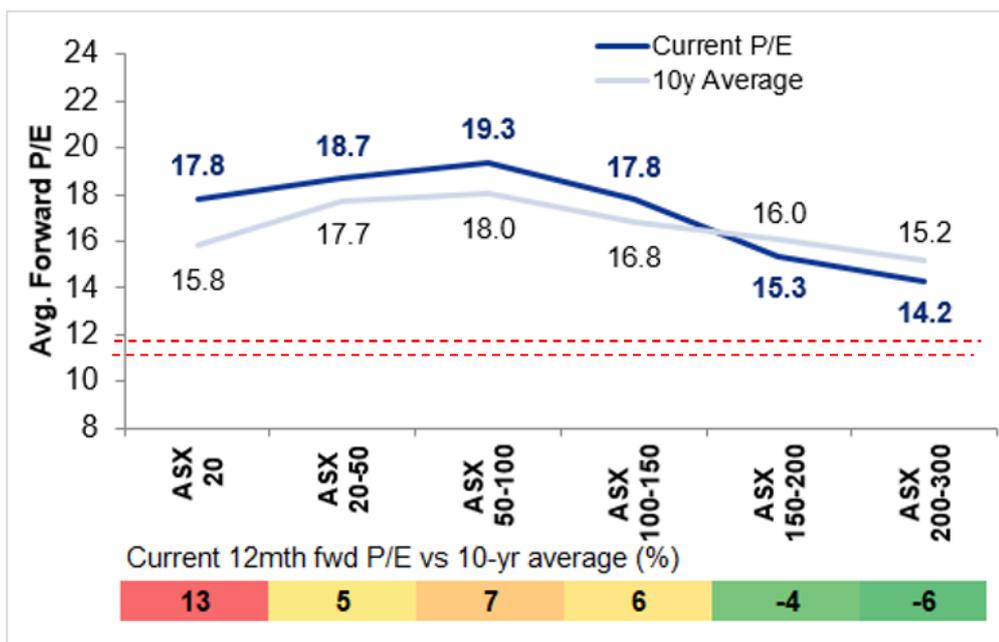
The improving earnings growth outlook is being supported by economic growth accelerating in Australia from a cyclical low point, market share gains, margin expansion from depressed levels as cost inflation moderates, interest cost reductions and capital deployment supporting earnings growth through higher capital expenditure and M&A.

The small companies market has a large cohort of companies earlier in their business cycle, with greater potential to grow independent of economic cycles. The portfolio owns a large number of companies with significant market share upside in their respective markets, including on a global basis.

We expect interest rates to fall further during 2026, contrary to consensus expectations. Historically – both in Australia and globally – small companies as a cohort have outperformed during periods of declining interest rates. Lower rates stimulate the more cyclical parts of the economy, which small companies are more exposed to, and with lower debt financing costs further supporting earnings growth.

In addition to the more attractive earnings growth outlook small companies also have more attractive valuations relative to their large company peers, with small company P/E multiples trading at a material 10% discount to large companies and a discount to historical average levels at 16-times forward P/E (refer Chart).

Chart 2. Valuation By Company Size – Current vs. 10-year averages



Source: Goldman Sachs, Dec 2025.

The small companies market also has the advantage of being a more diverse investment universe compared to larger cap equities, both in Australia where the concentration of major banks stifles diversification and globally where the technology sector dominates.

Australian cyclicals stand out as a part of the market with many compelling investment opportunities. Domestic cyclicals benefit from a depressed starting point for earnings, offering cyclical demand upside and a greater benefit from falling interest costs. They also have materially lower earnings risk from US tariffs. In addition to cyclical upside to earnings these companies have a market share opportunity, a stronger ability to expand margins and the ability to deploy capital to further grow earnings supporting a strong multi-year opportunity.

Two companies with these characteristics are **Centuria Capital (CNI)** and **Baby Bunting (BBN)**. CNI is benefitting from improving property sector valuations and asset class inflows, while BBN remains a category killer that is well placed for continued market share growth from its core product set and upside through further adjacencies.

The Resources sector also presents multiple opportunities in the year ahead, particularly across copper and rising exploration activity.

Our positive view of copper reflects the increasing demand for the commodity from both structural demand growth for electric vehicles, renewables, transmission and datacentres and economic activity more generally. Furthermore, the copper supply side is highly constrained, with long lead times for new mines and grades declining for existing mines. **Capstone Copper (CSC)** will benefit from increasing copper prices and offers additional upside from significant organic volume growth and an improving position on the cost curve.

Exploration markets are expected to recover from cyclically depressed levels with structural growth from increasing resources demand and new mines being deeper and lower grade. We expect **Imdex (IMD)** will benefit from market growth in addition to having a global market share opportunity via a compelling product set, including across its various technology solutions.

High quality Infrastructure opportunities are also prevalent, with our preferred exposures **Auckland Airport (AIA) and Chorus (CNU)**. We believe the strategic value of these assets is being undervalued given short term headwinds from the New Zealand economy, cyclical weakness in airline volumes and legacy copper headwinds. Taking a longer-term view, both companies have strategic assets which will benefit from an accelerating earnings growth outlook with strong balance sheets to fund growth capital expenditure or higher distributions.

An ever-present risk to avoid when investing in small companies is the rise and fall of concept stocks. While performance of these stocks can be extremely positive over short periods of time (aided by passive investing), these businesses prove to not be durable over the longer term, failing to generate sustainable free cash flow with share prices collapsing back to reality. The rise and fall of several defence and pre-production commodities companies during 2025 were examples of the risks associated with concept stocks.

Investors should be excited at the potential returns from the Australian small caps in 2026. They enter the year with strong tailwinds, underpinned by accelerating earnings growth, attractive valuations, and supportive macro conditions. With expected earnings growth of 10–15%, a material valuation discount to large caps, and greater exposure to cyclical recovery and falling interest rates, the sector is offering a plethora of compelling alpha generation opportunities for bottom-up, active investors.



Contact us

If you require further information, please contact your relevant [Business Development Manager](#).



2026 could be a breakout year for Australian small companies

Yarra Funds Management Limited (ABN 63 005 885 567, AFSL 230 251) ('YFM') is the issuer and responsible entity of a range of registered managed investment schemes, which includes those named in this document ('Funds'). YFM is not licensed to provide personal financial product advice to retail clients. The information provided contains general financial product advice only. The advice has been prepared without taking into account your personal objectives, financial situation or particular needs. Therefore, before acting on any advice, you should consider the appropriateness of the advice in light of your own or your client's objectives, financial situation or needs. Prior to investing in any of the Funds, you should obtain and consider the product disclosure statement ('PDS') and target market determination ('TMD') for the relevant Fund by contacting our Investor Services team on 1800 034 494 or from our website at www.yarracm.com/pdsupdates/. The information set out has been prepared in good faith and while Yarra Funds Management Limited and its related bodies corporate (together, the "Yarra Capital Management Group") reasonably believe the information and opinions to be current, accurate, or reasonably held at the time of publication, to the maximum extent permitted by law, the Yarra Capital Management Group: (a) makes no warranty as to the content's accuracy or reliability; and (b) accepts no liability for any direct or indirect loss or damage arising from any errors, omissions, or information that is not up to date. No part of this material may, without the Yarra Capital Management Group's prior written consent be copied, photocopied, duplicated, adapted, linked to or used to create derivative works in any form by any means.

YFM manages the Fund and will receive fees as set out in the PDS. To the extent that any content set out in this document discusses market activity, macroeconomic views, industry or sector trends, such statements should be construed as general advice only. Any references to specific securities are not intended to be a recommendation to buy, sell, or hold such securities. Past performance is not an indication of, and does not guarantee, future performance. Information about the Fund, including the relevant PDS, should not be construed as an offer to any jurisdiction other than in Australia. With the exception of some Funds that may be offered in New Zealand from time to time (as disclosed in the relevant PDS), we will not accept applications from any person who is not resident in Australia or New Zealand. The Fund is not intended to be sold to any US Persons as defined in Regulation S of the US federal securities laws and has not been registered under the U.S. Securities Act of 1933, as amended.

References to indices, benchmarks or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that the portfolio will achieve similar results. Holdings may change by the time you receive this report. Future portfolio holdings may not be profitable. The information should not be deemed representative of future characteristics for the strategy. There can be no assurance that any targets stated in this document can be achieved. Please be advised that any targets shown are subject to change at any time and are current as of the date of this document only. Targets

are objectives and should not be construed as providing any assurance or guarantee as to the results that may be realized in the future from investments in any asset or asset class described herein. If any of the assumptions used do not prove to be true, results may vary substantially. These targets are being shown for informational purposes only.

© Yarra Capital Management, 2025.