

Positive Surprise: Recognizing change before consensus

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Why small-cap growth is about expectations, not just earnings

Small-cap growth companies often operate in dynamic, high-potential markets where innovation and execution can produce rapid scaling. Unlike large-cap or value-oriented names, their valuations are dominated by expectations of future cash-flow growth rather than current profitability. This forward-looking pricing dynamic makes them particularly sensitive to shifts in the growth outlook.

A positive surprise occurs when a company delivers results or provides signals that meaningfully exceed consensus expectations, thereby raising the market's view of its sustainable growth rate. In small-cap growth, where valuations are largely driven by long-term growth assumptions embedded in discounted cash flow valuation models, such surprises can have an outsized impact on both earnings expectations and valuations.

Including positive surprise in an investment framework provides a foundation for identifying these opportunities before they are fully reflected in market prices. By anchoring analysis in observable change and expectation gaps, investors can seek to capture both earnings revisions and valuation re-ratings over time.

Defining positive surprise

At the core of the framework is the identification of change that produces a sustainable improvement in fundamentals. This requires isolating developments that alter the long-term earnings trajectory, rather than transitory or one-off events.

We group these developments into three categories of essential story elements:

- **Company-specific changes**, such as new product launches, management transitions, acquisitions, and/or divestitures.
- **Secular changes**, including broad technology shifts, demographic trends, or supply-chain realignment.
- **Industry-level changes**, such as competitive dislocation, regulatory tailwinds, or market-share consolidation opportunities.

To be investable, these elements must plausibly translate into sustained improvements in revenue growth, margins, or free-cash-flow generation.

The positive surprise framework

Due diligence is oriented around systematically evaluating the gap between expectations and reality. In practice, this involves:

1. Establishing near-term and long-term expectations for each essential story element embedded in consensus forecasts.
2. Assessing current fundamental performance relative to those expectations. When execution, adoption, or financial results exceed forecasts, it signals that the conditions may be in place for a positive surprise.
3. Evaluating the Total Addressable Market (TAM) and the long-term market opportunity. A large and expanding TAM, combined with evidence of scalability (e.g., proven unit economics, repeatable go-to-market motion, or defensible intellectual property), supports the potential durability of the upside opportunity.

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Using these essential story elements as the starting point, and validating them against real-time fundamental momentum, investors can identify companies where positive surprises are not random but the logical outcome of identifiable, investable change. Importantly, when fundamental momentum is paired with a large addressable market opportunity, positive surprises become repeatable rather than episodic.

Why positive surprise can generate alpha in small-cap growth stocks

In small-cap growth stocks, valuation is primarily driven by terminal growth assumptions in discounted cash flow models. Because near-term earnings are often minimal or negative, the market often prices small-cap growth names on the expected duration and magnitude of high-growth compounding.

Therefore, positive surprise, particularly when supported by underlying fundamental momentum, can have two mutually reinforcing effects that are especially powerful in this segment of the equity market:

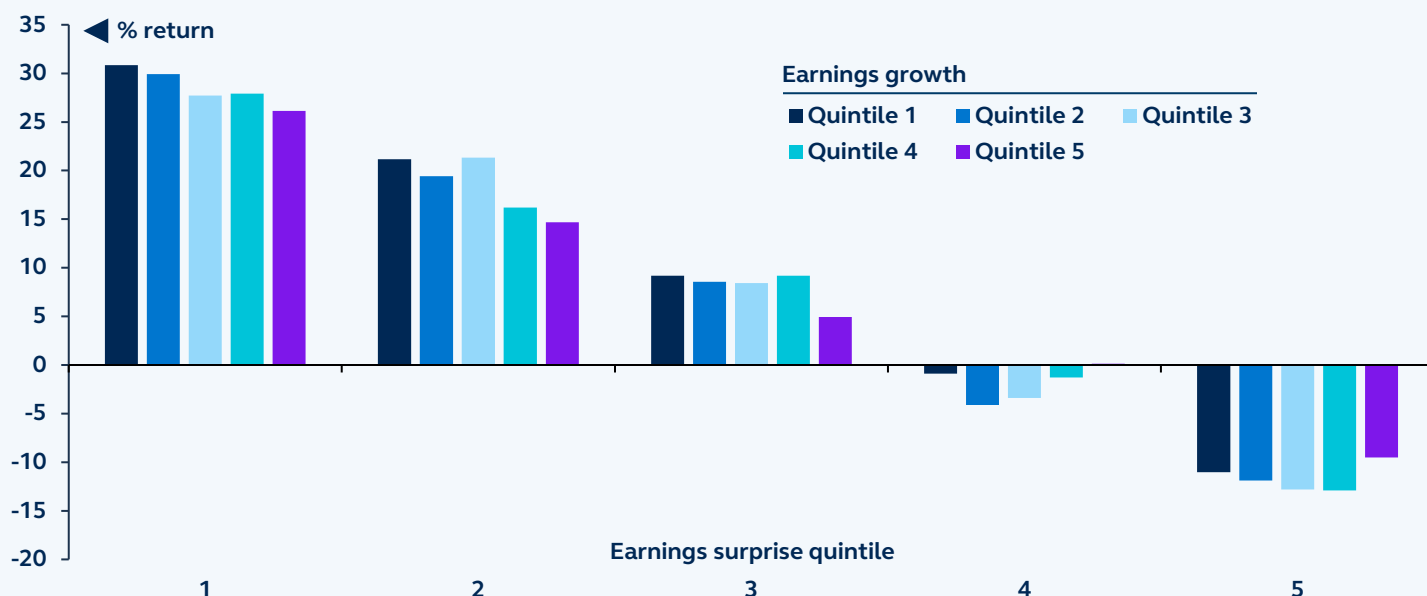
- 1. Higher perceived sustainable growth.** When surprises are rooted in company-specific or secular essential story elements and are reinforced by ongoing fundamental momentum (e.g., new products gaining traction, scalability finally materializing, or market-share gains accelerating), they validate the underlying investment thesis and increase confidence that growth can persist. This validation often prompts analysts and investors to materially raise long-term earnings forecasts. Notably, the upward revision in the perpetual growth rate can have an outsized impact on valuation because most of the present value resides in the terminal period.
- 2. Multiple expansion.** As the perceived sustainable growth rate rises, investors are willing to assign a higher price-to-earnings (P/E) or enterprise-value-to-sales (EV/Sales) multiple. The company is now seen as capable of compounding at a higher rate, for longer. This “leverage effect”—the combination of higher earnings power and a higher multiple—is far more pronounced in growth stocks than in value stocks, where valuations are more anchored to current assets or near-term cash flows.

Empirical evidence supports the power of this approach. Combining earnings growth with positive earnings surprises targets companies with strong fundamentals and upward momentum, which may lead to market-beating returns. This strategy helps identify firms whose earnings exceed analyst expectations (positive surprises) and demonstrate sustainable growth (fundamental momentum), ultimately acting as a catalyst for price appreciation.

HISTORICALLY, STOCKS WITH HIGHER EPS SURPRISES DRIVEN BY SUSTAINABLE FUNDAMENTAL MOMENTUM OUTPERFORM ACROSS LONG TIME PERIODS

The power of earnings surprise

Earnings growth by quintile of the Russell 2000, ranked by earnings surprise quintile, March 2016 – March 2026



For illustrative purposes only.

Source: Factset, Principal Asset Management. Data as of March 31, 2026.

Amplifying behavioral and structural factors

The alpha potential of positive surprises is often amplified by market inefficiencies, which are common to small-cap growth names:

- **Sparse analyst coverage** limits the speed at which new information is incorporated into forecasts.
- **High forecast dispersion** reflects uncertainty around business models and execution, increasing the likelihood and magnitude of surprises.
- **Complex and evolving business models**, including heavy R&D spend, unproven scalability, or multi-year customer-adoption cycles, make early signals difficult to interpret.

In these environments, investors often anchor more strongly to prior expectations and systematically underreact to positive news. Price discovery, therefore, occurs with a lag, creating an opportunity for disciplined fundamental investors to establish positions before the full re-rating occurs.

Practical implications for investors and analysts

Implementing this framework requires a research-intensive, bottom-up approach that prioritizes forward-looking change over backward-looking financials. Key practices include:

- Maintaining a focused watchlist of companies where essential story elements are evolving.
- Monitoring early fundamental beats can serve as leading indicators of broader recognition.
- Conducting regular “expectation audits” to compare realized progress against embedded assumptions.
- Stress-testing TAM assumptions and unit economics to assess if the surprise is durable.

At the same time, risk management remains critical. Not all surprises persist, and position sizing should reflect both the magnitude of potential upside and the inherent volatility of small-cap growth equities.

Turning earnings beats into repeatable alpha

Positive surprise is not merely a statistical event or an isolated earnings beat – it is the observable manifestation of fundamental change that the market has yet to fully incorporate. In small-cap growth, where valuations are anchored in long-term growth expectations rather than near-term profitability, even modest shifts in perceived sustainability can drive meaningful changes in earnings forecasts and valuation.

By systematically identifying company-specific, secular, and industry-level shifts that drive sustainable improvements, investors can isolate small-cap growth names poised for outsized earnings revisions and multiple expansion. The structural pricing of these stocks based on long-term growth assumptions, combined with behavioral underreaction in under-covered and complex situations, can create a repeatable source of alpha.

Importantly, this framework reframes positive surprise not as luck or short-term timing, but as the logical outcome of identifiable, investable change. Focusing on essential story elements and validating them against sustained fundamental momentum and TAM potential allows investors to distinguish sustainable inflections from transitory noise and to act ahead of consensus.

Applied with discipline, an investment framework built on fundamental momentum and positive surprise can offer a durable source of alpha in one of the most dynamic segments of the equity markets. It transforms what might otherwise appear to be isolated earnings beats into a structured, high-conviction investment process grounded in strengthening fundamentals and reinforced by persistent market inefficiencies.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance does not guarantee future return. All financial investments involve an element of risk. All companies face significant investment risks due to limited resources, intense competition, and rapid product obsolescence, making them particularly vulnerable to market volatility. International investing involves greater risks such as currency fluctuations, political/social instability, and differing accounting standards.

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