

Small Cap Market Review

Q1 2025

Risk-Off Sentiment Drove the Quarter

The broad market, as measured by the S&P 500 Index, declined over 4% during the first quarter. Smaller-cap stocks fared worse, with the Russell 2000 and 2500 down 9.5% and 7.8%, respectively, as investors shifted into a risk-off posture. Market leadership rotated meaningfully, and heightened volatility – particularly around trade – led investors to reassess growth expectations. In this environment, Value stocks outperformed as capital rotated out of Growth and into more defensive or “safety” stocks offering perceived earnings stability. Reflecting this trend, the Russell 2000 Value and 2500 Value Indices declined a slightly more modest 7.7% and 6.3%.

Uncertainty Reigns

Despite steady economic growth—evidenced by Q4 real GDP coming in at 2.5%—uncertainty spiked during the quarter, primarily due to the new administration’s aggressive and unpredictable stance on trade negotiations with Mexico, Canada, and China. Since quarter-end, this tariff focus has broadened further across global trade partners. One way to quantify this uncertainty is the U.S. Economic Policy Uncertainty Index, which incorporates the frequency of policy-related news articles, the number of expiring federal tax provisions, and the dispersion of macroeconomic forecasts among economists. Current readings are near historical highs, excluding the COVID-19 period.

Uncertainty, If Prolonged, Can Lead to a Downward Spiral

At the end of the first quarter, this growing uncertainty had already begun to show an impact. The longer it persists, the greater the potential economic consequences. The earliest effects have appeared in soft data, such as consumer confidence and sentiment, both of which declined notably in March. Thus far, hard data—like industrial production and nonfarm payrolls—remain resilient, but the outlook is increasingly uncertain. Tariffs are also creating upward pressure on inflation. The two-year breakeven rate has risen sharply since the start of the year, as many companies explore supply chain diversification or pass costs on to consumers through price increases. Economic growth fears have become more pronounced, with the Atlanta Fed’s GDPNow estimate turning negative. While earnings estimates have not yet meaningfully declined, they tend to lag actual conditions. Many analysts are awaiting company earnings reports and forward guidance before adjusting estimates, reflecting the challenge of quantifying the current environment.

What Now?

We don’t know how this will unfold—and acknowledging that uncertainty allows us to focus on what we do know: how to identify and invest in mispriced stocks with strong fundamentals. We believe periods of elevated volatility expand the opportunity set for disciplined, bottom-up investors like us. Down markets are emotionally challenging. Investors make mistakes, selling everything in a period of fear. These mistakes produce compelling long-term opportunities for patient, disciplined investors like us. These periods drive heightened new idea research activity and portfolio review on our part. We continue to manage our portfolio with consistency, seeking high-quality businesses with solid balance sheets and attractive valuations—particularly among smaller-cap stocks, which remain historically inexpensive relative to large

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caps. As we emphasized last quarter and wish to reiterate, we continually re-examine our portfolio to ensure we hold high-conviction positions trading at discounts to our conservative estimates of intrinsic value. We remain excited about our holdings and confident in their prospects over a multi-year horizon.

Sincerely,

The Cornerstone Investment Team

The opinions expressed represent the views of Cornerstone Investment Partners investment. Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.