

Small Cap Market Review

Q1 2026

A Shift in Leadership Emerges

The first quarter of 2026 marked a notable shift in market leadership. After an extended period of large-cap growth dominance, market leadership broadened in the quarter. Value stocks and small- and mid-cap equities outperformed, as what was likely some crowded positioning unwound, driving investors to smaller-cap stocks. While the S&P 500 fell modestly during the quarter, performance broadened across the market, with small cap core and value indices all positive and benefiting from renewed investor interest.

Macro Backdrop: Resilient Growth Amid New Uncertainty

The U.S. economy continued to demonstrate resilience during the quarter, with steady consumer spending, stable corporate earnings, and a labor market that, while gradually cooling, remains healthy. Inflation trends remained mixed but generally stable, allowing the Federal Reserve to maintain a more accommodative stance following the rate cuts implemented in late 2025. However, geopolitical developments introduced a new layer of uncertainty. Escalating tensions in the Middle East, including the outbreak of conflict involving Iran, led to a sharp increase in oil prices during the quarter. Higher energy prices have the potential to reintroduce inflationary pressures and weigh on consumer spending if sustained. While markets have thus far absorbed these developments relatively well, the situation remains fluid and demands being closely monitored.

AI Disruption: Opportunities and Emerging Concerns

Artificial Intelligence continues to be a dominant force shaping market dynamics, but the narrative is evolving. While infrastructure and hardware beneficiaries remain well supported, parts of the software ecosystem have come under pressure as investors reassess the potential for AI to disrupt existing business models. Concerns around pricing power, competitive moats, and long-term margin sustainability have led to increased volatility in certain segments of the technology sector. At the same time, we continue to see attractive opportunities in areas that enable AI adoption rather than compete directly with it. As demand for data processing and transmission continues to grow, the need for robust connectivity and infrastructure remains critical. Our focus remains on identifying companies with durable competitive advantages that can benefit from these structural trends without relying on speculative assumptions. We recently wrote a thought paper on how AI is likely to influence business models going forward which you can find on our website.

Valuation and Opportunity Set

Despite improved performance in small-cap stocks during the quarter, valuation disparities remain compelling. Small- and mid-cap value companies continue to trade at meaningful discounts relative to their large-cap counterparts on a variety of metrics. In our view, this reflects lingering investor caution rather than a deterioration in underlying fundamentals. Periods of shifting leadership often create opportunities for active managers. As capital begins to rotate more broadly across the market, we believe our investment



universe, which can contain underfollowed companies with strong fundamentals, remains particularly attractive.

Process Over Prediction

As always, our focus remains on process rather than prediction. We continue to emphasize fundamental research, valuation discipline, and a long-term investment horizon. The quarter provided opportunities to add to positions where volatility created dislocations, as well as to trim holdings where valuations became less compelling. We remain confident in the positioning of the portfolio and believe it is well aligned with both the current environment and long-term opportunities ahead.

Sincerely,
The Cornerstone Investment Team

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