

Small Cap Market Review

Q2 2025

Volatility Returned—But Not All Stocks Reacted the Same

The second quarter of 2025 began with one of the sharpest market pullbacks in recent memory. A surprise announcement of sweeping tariffs under the new administration’s “Liberation Day” trade initiative triggered a steep selloff, with the S&P 500 falling over 12% in the span of just three days. Yet, almost as quickly, the policy was reversed, fears abated, and markets rallied sharply. By quarter-end, the S&P 500 had gained 10.9% and the Russell 1000 Value rose a more modest 3.8%. For small- and mid-cap stocks, however, the recovery during the quarter was strong but off a lower base. The Russell 2500 and 2000 Value Indices rose 7.3% and 5.0%, respectively, in Q2, bringing their year-to-date returns to 1.0% and -3.2%. This YTD lag underscores the continued narrowness of market leadership. Despite positive economic indicators and corporate earnings, investor preference remained concentrated in a small group of large-cap, AI-driven growth stocks—many of which are simply not represented in the small- and mid-cap universe.

Trade Tensions and Style Volatility Drove Dispersion

As seen in the large-cap space, the quarter was characterized by wild swings in style performance. Value stocks lagged meaningfully, especially in the small-cap space, where companies tend to have greater domestic exposure and higher sensitivity to both trade and interest rate policies. While the tariff announcement was short-lived, the accompanying uncertainty highlighted small caps’ vulnerability to policy shocks and reinforced a “flight to size.” We may have entered a new global regime in which tariffs, trade renegotiations, and geopolitical flare-ups reappear more regularly. For small companies already facing margin pressure from wage inflation and input costs, such volatility creates added complexity. That said, it also creates opportunity. Rapid, emotional market reactions tend to produce dislocations—especially in small-cap stocks with lower liquidity and less analyst coverage. This is precisely where we look for mispriced value.

Market Signals Are Mixed—But We Stay Focused on Fundamentals

Macroeconomic data remains constructive overall. GDP growth has been solid, consumer spending resilient, and earnings generally healthy. Yet inflation expectations have ticked up, and the 10-Year Treasury yield remains above 4%. These signals have introduced ambiguity into the Fed’s path forward, with markets now uncertain whether additional rate cuts will materialize this year. That uncertainty continues to be a headwind for lower-quality small-cap companies that rely heavily on cheap financing. While the rally in large-cap tech has overshadowed the rest of the market, we believe small caps remain one of the most attractively valued segments of the equity universe. According to Furey Research, small-cap valuations relative to large caps remain near 20-year lows, even after accounting for differences in quality and profitability. We see this as an unusually attractive entry point for long-term investors.

Process, Not Prediction

We are frequently reminded that prediction is a dangerous game—particularly in environments driven more by headlines than fundamentals. Rather than reacting to every twist and turn, we remain committed to our process: bottom-up stock selection, conservative valuation frameworks, and an emphasis on quality balance



sheets and sustainable earnings power. As we've written in the past, our job is not to predict what the market will do next—but to own good businesses at reasonable prices that can endure uncertainty and thrive over time. We remain highly active in reviewing new opportunities and reassessing current holdings. Our conviction in the portfolio is strong, and we continue to find compelling new ideas trading at discounts to our estimates of intrinsic value. As ever, we are focused on building a portfolio that can weather near-term volatility and compound value over a multi-year horizon.

Sincerely,

The Cornerstone Investment Team

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