CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q3 2023

A Market On Edge

This year has been a turbulent one for smaller-capitalization stocks, and the third quarter was no different. The primary debate continues to be focused on the macroeconomic picture, with hopes for a soft landing balanced against fears of a hard landing. As some concerns have eased, new ones have taken their place. The Federal Reserve is in a tricky spot as they try to navigate reducing inflation without crushing economic growth. **The latest moves in the bond market have been nothing short of massive, with the long end of the curve rising dramatically. This has started to create turmoil as the quarter comes to a close. While this can be frustrating, volatility and uncertainty can create some great opportunities to buy great companies at inexpensive prices and trade around positions.**

Causes For Concern Are Multifaceted

Given the litany of concerns today, it makes sense to highlight a few of the most prominent ones. First, the health of the consumer is up for debate. Many companies have pointed to a strong consumer, but there is evidence that those days may be fading, and others, perhaps those which are less promotional, have said the exact opposite. During COVID, there was a massive fiscal transfer to consumers, which resulted in a big increase in the savings rate and high levels of excess savings, which J.P. Morgan had estimated at over $2.1 Trillion at the peak. However, as those transfers slowed or stopped, consumers continued to spend at an elevated rate and have been rapidly depleting those savings, with estimates of remaining buffer only around $0.2 Trillion by the end of the third quarter. This will make the fourth quarter one to watch more closely as those excess savings dwindle, and that coincides with a period where many will need to start making student loan repayments. We will be watching early indicators of credit deterioration such as auto and credit card loans. **Another concern remains inflation. While inflation has come down significantly from the peak, it is still running above trend. With wage growth remaining strong (the latest reading from the Atlanta Fed Wage Growth Tracker in August was 5.3%) and labor remaining tight, it continues to put an upward bias to prices.** Additionally, oil prices have moved significantly higher of late, which will lift inflation measures. The U.S. already drew down on the Strategic Petroleum Reserve earlier in the year, making any relief on that front less likely. Lastly, while Congress narrowly avoided a government shutdown, the can has merely been kicked down the road for 45 days, so related uncertainty remains and can scare some investors. However, we would point out that this last concern is not likely to have a meaningful impact on the market, as prior government shutdowns have shown a negligible impact on equities.

But Confusion & Turmoil Make Stock Prices More Volatile Than The Fundamentals Which Determine Value

We continue to hunt for opportunities where we believe fear is excessively in the price. Maybe that is a retail business crushed by fears of a deteriorating consumer and trading at a throwaway valuation. Maybe that is a high-quality insurance company that has traded lower as their book value has dropped due to higher interest rates, but now faces the potential for significantly higher earnings on their investment portfolio. Maybe that is an equipment supplier to oil and gas companies that traded lower as rig counts decline but has taken share and has a product that saves its clients significant time and money.

Continue Sweating the Small Stuff

We continue to manage our portfolio and positions in the same steady way. We look for mispriced opportunities, good companies, and reasonable balance sheets. Much of our outperformance this year and quarter can be attributed to broadly avoiding or being underweight areas of trouble such as banks, office REITs, biotech, companies with high leverage, and AI-disrupted businesses. **We remain laser-focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship. This means low leverage, a proven ability to reduce costs, strong free cash flows, etc.** As we noted last quarter but wish to reiterate, we are continually examining our portfolio and our convictions to ensure that we hold stocks trading at material discounts to our conservative assessments of their worth, and we remain excited about our stocks over a multi-year time horizon.

Sincerely,

The Cornerstone Investment Team

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.