

Large Cap Market Review

Q3 2025

"Life can only be understood backwards, but it must be lived forwards."

Soren Kierkegaard

As investors, we are reminded that markets rarely move in straight lines. Periods of exuberance are often followed by caution, and today's environment is no different. While headlines continue to focus on AI and a handful of mega-cap winners, we see both opportunity and excess. Our job is not to predict every twist and turn, but to prepare portfolios for a range of outcomes—balancing participation in secular growth drivers with discipline in valuation.

The third quarter saw equity markets climb steadily, with smaller-cap stocks outpacing their larger counterparts. This demonstrated a rotation in risk appetite and an improved outlook for small caps following the first rate cut since 2024. The S&P 500 gained 8.1%, led once again by a handful of large-cap growth and AI-related companies, with the Russell 1000 Value up 5.3%. The Russell 2000 Index returned 12.4%, reflecting hope for lower rates to drive increased profitability for the more leveraged and domestically oriented smaller-cap companies. Investor appetite for "risk" broadened somewhat, but enthusiasm was most visible in unprofitable and speculative segments of the market.

Broadly, the U.S. economy continues to expand at a steady pace, with consumer spending resilient and corporate earnings growing nicely. Higher-frequency data (such as restaurant bookings, TSA air travel data, and credit and debit card data) also appear strong. Still, forward-looking indicators flash caution: inflation, though lower than before, remains above the Fed's comfort zone, and labor markets show early signs of softening. Against this backdrop, the Fed delivered a 25-basis-point rate cut in September, nudging the target range to 4.00–4.25%, its first cut since late 2024. Markets currently expect two additional cuts by year-end. Historically, periods when rates fall and growth is intact have been favorable for equities—but policy uncertainty around tariffs, fiscal priorities, and government debt adds volatility.

Within this backdrop, one theme dominates investor attention: Artificial Intelligence. Adoption continues to accelerate, and capital is flowing into infrastructure, semiconductors, and cloud-related businesses. Like other technological advancements before it, AI is likely to have a massive impact on individuals, companies, industries, and geopolitics alike. Just as the Earth appears flat when standing on the ground, exponential change often feels imperceptible. But once you step back, like looking from a plane, the curve is pronounced. AI adoption is unfolding faster than most expect.

Massive amounts of strategic investments (some of which are seemingly more intertwined than one would hope) have lifted sentiment and valuations across growth stocks. At the same time, pockets of froth have appeared: baskets of unprofitable tech companies have surged well beyond their profitable peers. Froth occurs when the market focuses too much on the long term without considering the near term. While speculation is high in some areas of the market, much of the actual spending today from public company hyperscalers is funded by free cash flow - not external debt or equity. That discipline suggests companies are making reasonable ROI-based decisions versus other projects or returning capital, even if some projects are admittedly driven by the need to "keep up with the Joneses." However, it will be important to monitor seemingly aspirational vendor equity partnerships, chiefly involving NVIDIA and OpenAI, as leading indicators of demand. We remain appropriately skeptical of future estimates for companies engaged in such transactions, and recognize the risk of these type of corporate entanglements to the broader industry and market.

There is considerable discussion about the eventual extent and duration of AI infrastructure spending. Actual and promised capital expenditures (capex) amount to approximately 1.2% of U.S. GDP, similar to the internet buildout of the late 1990s/2000s (~1%) and second only to 19th-century railroad expansion (~6%). While we cannot predict company-level outcomes, we know all businesses will be impacted in some fashion, and we are actively assessing how this affects our holdings and portfolio positioning.

We are not new to companies in the AI space, nor is this a change in perspective. We firmly believe that a company's past track record is the best indicator of its future fundamental performance. Some firms will adapt; others will underreact or overreact.

As the Kierkegaard quote above observes, "life can only be understood backwards, but lived forwards." We won't know the future until it is behind us. Today, we live forward and are preparing our portfolio for a range of outcomes - participating in secular growth where appropriate and justified by their valuations, but resisting clear examples of overpricing. Importantly, capital is finite. Excess flows into AI-related stocks create opportunities elsewhere, where high-quality value builders may be overlooked.

We believe that elevated volatility expands the opportunity set for disciplined, bottom-up investors like us. Our performance in recent years, amid sharp shifts in style between core and value, reflects the benefits of this philosophy. In the short term, the market reacts; in the long term, it responds to fundamentals. We continue to manage the portfolio with consistency and diligence—holding high-conviction positions trading at discounts to our conservative estimates of intrinsic value. We remain confident in the multi-year prospects of our holdings.

We recently published a thought paper digging further into the recent performance of active equity managers. Although it may not seem so, over the last five years, median large cap growth and value managers have performed almost identically on a total return basis. However, the performance of individual managers across the style spectrum varied widely, creating an opportunity to distinguish between those managers who demonstrated skill and those who did not. We are proud to show very strong absolute and risk-adjusted returns over that time period versus both benchmarks. We recommend reviewing the paper, which may help you consider manager performance from a different perspective.

Sincerely,

The Cornerstone Investment Team

The opinions expressed represent the views of the 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.