

Small Cap Market Review

Q3 2025

Growth Enthusiasm Meets Macro Crosscurrents

Markets continued their upward climb in the third quarter, and this quarter, smaller-cap stocks outpaced their larger counterparts, demonstrating 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 and 2500 Value Indices returned 12.6% and 8.2%, respectively, 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 as expectations for additional Fed rate cuts supported multiples, but enthusiasm was most visible in unprofitable and speculative segments of the market.

Macro: Growth Steady, Policy in Motion

The U.S. economy continues to expand at a steady pace, with consumer spending resilient and corporate earnings broadly positive. Higher-frequency data (such as restaurant bookings, TSA air travel data, and credit and debit card data) also appear broadly strong. That said, forward-looking indicators are sending cautionary signals. Inflation, although lower than in prior quarters, continues to run above the Fed’s comfort zone, and labor markets are showing early signs of softening. This combination leaves the Federal Reserve in a tricky spot. 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. The move was cautious, signaling that policymakers remain data-dependent, especially given the lingering risk of inflation. Among Fed voices, some urge further easing if the softening in the labor market accelerates; others, including Boston Fed President Susan Collins, have cautioned against overly aggressive cuts, reminding markets that inflation dynamics are not yet fully under control. Markets currently expect two additional cuts by year-end. Historically, this type of environment—characterized by falling rates with growth intact—has been favorable for equities. Yet, policy uncertainty remains around tariffs, fiscal priorities, and the trajectory of government debt, creating a volatile backdrop.

AI Excitement—and Possible Pockets of Froth

Artificial Intelligence remains a dominant theme, with adoption accelerating and capital flowing into infrastructure, semiconductors, and cloud-related businesses. These strategic investments 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. For small- and mid-cap value investors, this environment presents both risks (as speculative flows distort near-term price signals) and opportunities (as less-followed, fundamentally strong companies remain overlooked).

Valuations and Opportunity in Small Caps

While large-cap multiples remain elevated relative to history, we believe small- and mid-cap value stocks continue to trade at significant discounts. Relative valuations for small-caps vs large-caps remain near multi-decade lows on an EV/EBITDA basis. In our view, this is precisely the environment where disciplined stock selection matters most. Periods of dislocation widen the opportunity set for investors focused on value and profitability. We believe this relative discount provides fertile ground for long-term value creation.

Our Process: Consistency in an Uncertain Market

As always, our emphasis is on process, not prediction. 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 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.