CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q3 2026

A Quarter Where the Indexes Told Different Stories

The third quarter displayed a reversal from the broad-based strength seen during the first half of the year. The S&P 500 Index gained just over 2%, supported by a relatively small group of large technology and AI-related companies, while the equal-weighted S&P 500 Index declined and the Russell 2000 Index fell by over 7.0%. The Russell 2000 Value Index declined by roughly 5%. Much of this divergence between large cap stocks and small cap stocks can likely be traced to a dramatic move in interest rates. The 10-year Treasury yield rose from 4.4% on June 30 to roughly 5.3% at quarter-end, its largest quarterly increase in more than 30 years. Higher long-term rates raise financing costs across the market, but smaller companies tend to be particularly sensitive because they generally rely more heavily on bank financing and floating-rate debt. Headline index returns for large cap stocks therefore obscured some weakness beneath the surface, particularly among smaller and more rate-sensitive companies.

The Reconstitution's Timing Mattered

Last quarter, we wrote that the benchmark changed more than the market. The third quarter showed why that mattered. At the June Russell reconstitution, many AI-related companies that had appreciated sharply over the prior year were removed from the Russell 2000 Value Index, and the benchmark's technology weighting fell meaningfully. The timing proved consequential. The reconstitution occurred near a local peak for many AI infrastructure stocks, and semiconductor and other AI-related equities then experienced a sharp correction in July. In effect, the benchmark captured much of the earlier appreciation from these companies while carrying materially less exposure to them during the subsequent decline. At the same time, the benchmark's small-cap profile left it exposed to the significant rise in interest rates during the quarter. Although these forces worked in opposite directions, the episode is an important reminder that an index is not static and that changes in its composition can materially influence short-term relative results.

AI: Fear in the Stocks, Demand in the Data

AI-related equities experienced significant volatility during the quarter as investors questioned the durability of the enormous capital spending that has supported the buildout. Concerns around returns on investment, financing requirements, AI safety, and growing community and regulatory pushback against new data center construction all weighed on sentiment at different points during the quarter. Local concerns around electricity costs, grid reliability, water use, and land development have become increasingly visible as the physical footprint of AI expands. Yet the underlying demand data remain strong. Industry estimates indicate that data center capital spending will continue to grow rapidly, while major cloud providers have generally maintained or increased their infrastructure investment plans. The companies we cover across the cap spectrum say demand continues to outpace supply. They have also made strong commitments to their investments in AI, and suppliers are highlighting significant visibility into orders. Demand for networking, optical connectivity, power, and other critical bottlenecks also remains robust. We believe there is an important distinction between a valuation reset in AI-related equities and an actual reset in end

demand. Our focus remains on businesses where we can underwrite durable earnings growth from these infrastructure needs without relying on ever-higher valuation multiples.

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.

Cornerstone at 25

Lastly, this quarter marks 25 years since Cornerstone Investment Partners opened its doors. Over that time, we have invested through the aftermath of the dot-com bust, the financial crisis, a global pandemic, and many other periods of uncertainty, and we reach this milestone with our culture, philosophy, and client focus intact. We owe that continuity to you, our clients, whose trust has made it possible, and to our team, whose ownership of the firm creates a personal commitment to our work and the relationships we build. While we are proud of our 25-year history, we know we must earn your trust every day, and we remain committed to the approach that has guided us from the start. Our mission is unchanged: to be an independent group of experienced investors committed to investment excellence and exceptional client service.

Thank you for being part of our first 25 years. We look forward to the next 25.

Sincerely,
The Cornerstone Investment Team

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Investments in companies associated with artificial intelligence and related infrastructure may involve significant risks, including changing technology, competition, regulatory developments, valuation uncertainty, and the possibility that anticipated demand or investment returns may not materialize.

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