CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q4 2023

A Positive Albeit Turbulent Year

After a roller coaster ride of oscillations between fears of a hard landing and hopes for a soft landing, Fed Chairman Powell gave the market what they wanted on December 13th with an apparent pivot, causing interest rates to fall and equities to move sharply higher. What was also particularly notable was the reversal in market leadership that occurred subsequently. Through the end of November, the largest stocks (mainly tech stocks) had significantly outperformed small stocks, as the Russell 2000 was up 2% for the quarter and the Russell 1000 was up 7%. However, **after Powell's December comments, leadership flipped, with the Russell 2000 up 12% for the month, versus 5% for the Russell 1000, and small caps outperformed slightly for the quarter. This was the second-strongest month for small caps versus large in the last 20 years**. Overall, the Russell 1000 returned 26.5% on a total return basis, while the Russell 2000 and Russell 2500 rose 16.9% and 15.5%, respectively . Demonstrating the power of the mega caps on the indices, the capitalization effect did not hold in the Value style, however, with the Russell 1000 Value up only 11.5%, the Russell 2000 Value up 14.7%, and the Russell 2500 Value up 13.5%.

Has The Market Gotten Ahead Of Itself?

While it is natural to feel optimistic when the market moves higher, there remain some legitimate causes for concern today, and we believe active stock picking remains critically important to identifying opportunities amid mixed macro signals. First, the market is pricing in two things that seem fairly oppositional to us. One being significant interest rate cuts, and the other being significant earnings growth. **While the Fed dot plot signals three interest rate cuts by the end of 2024, the market is pricing in seven cuts. This doesn't mean that the market is wrong, just that it expects the Fed to continue to shift in the direction of more cuts as they have recently.** However, what we find a bit puzzling is that EPS growth expectations for the broad market are still quite robust with estimates for 2024 EPS growth in the low double digits. The world in which earnings grow double digits does not feel like one that is likely to warrant seven interest rate cuts. Second, the consumer is still spending in excess of savings. While there remains a buffer built up during COVID, eventually resources get exhausted, and spending is curtailed. We are already seeing signs of strain in some pockets of the market, such as in lower-quality auto loans, where delinquency rates are steadily moving higher and 60+ day delinquencies are now the highest on record.

But Perhaps Soft Landing Achieved?

Offsetting the concerns noted above are some improvements in the near-term outlook. Inflation has moderated, with the latest readings closer to 3%, and the trend is supportive of continued moderation. The economy is expected to avoid a recession with GDP estimates remaining positive throughout 2024 and economists' surveys on the probability of a recession showing a clear reversal. Second, interest rate cuts during 2024, assuming the economy remains robust, would be supportive of equities on a relative basis as short-term fixed income no longer looks as appealing. Lastly, **while valuations overall look full, that is driven by significant concentration among the largest (and often most expensive) companies, which have gotten so large that the**

weight of just the top 2 companies in the Russell 3000 Index now represents over 3.5 times the weight of the bottom 2,000.

Continue Sweating the Small Stuff

We continue to manage our portfolio and positions in the same steady way, and recognize that smaller capitalization stocks still remain at historically inexpensive levels versus large cap. **The Russell 2000 trades at a 19 percentage point discount to the Russell 1000 on a forward EV/EBITDA basis, around the lowest levels in the last 20 years.** We look for mispriced opportunities, good companies, and reasonable balance sheets. 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.