

Small Cap Market Review

Q4 2025

A Year-End Broadening of Participation

Equity markets finished 2025 on a firm footing, with participation continuing to broaden beyond the narrow leadership that defined much of the prior two years. During the fourth quarter, small and mid-cap stocks held their own, supported by improving investor confidence, easing financial conditions, and growing conviction that the U.S. economy can sustain growth even as monetary policy gradually normalizes. The S&P 500 advanced during the quarter, while smaller-cap value stocks delivered competitive returns as investors increasingly looked beyond mega-cap growth for opportunity. In this environment, the Russell 2000, 2000 Value, and 2500 Value Indices were up 2.2%, 3.3%, and 3.2%, respectively.

Macro Backdrop: Slowing, Not Stalling

From a macroeconomic perspective, the narrative exiting 2025 is one of moderation rather than deterioration. Economic growth slowed modestly but remained positive, consumer spending held up reasonably well, and corporate earnings continued to come in better than feared. While the labor market showed additional signs of cooling—most notably through slower job growth and easing wage pressures—unemployment and jobless claims remain historically low. Inflation trends, while still uneven, continued to move in a favorable direction. Goods inflation remained benign, services inflation showed gradual improvement, and longer-term inflation expectations stayed well anchored. Against this backdrop, the Federal Reserve delivered additional rate cuts during the quarter, reinforcing its intent to balance labor market risks with its inflation mandate, and markets are pricing in at least two additional cuts next year. Importantly, financial conditions eased meaningfully as markets gained confidence that policy is no longer restrictive in a way that threatens economic stability. Overall, credit markets suggest that recession fears remain low, with the lowest High Yield spread since 2007.

AI Investment Expands Beyond the Obvious Winners

While much of the market's attention has remained focused on a narrow set of high-profile AI beneficiaries, we continue to see opportunities further down the value chain. As AI workloads scale, demand for the underlying infrastructure required to move, store, and process vast amounts of data has increased meaningfully. In particular, optical networking and high-speed connectivity have emerged as critical enablers of this buildout, benefiting from rising bandwidth requirements across data centers, cloud service providers, and enterprise networks.

Valuation Still Matters

Despite the market's strong finish to the year, valuation dispersion remains wide. Large-cap equities—particularly those tied to dominant growth narratives—continue to trade at elevated multiples, while many small- and mid-cap value stocks remain priced at meaningful discounts on normalized earnings and cash-flow metrics. Relative valuation measures for small caps versus large caps, including EV/EBITDA and price-to-free-cash-flow, remain below long-term averages. In our view, this persistent valuation gap reflects a combination of lingering risk aversion, structural capital flows, and under-ownership rather than deteriorating fundamentals. As confidence in the economic outlook improves, we believe this discount provides an attractive foundation for future relative returns.

Process Over Prediction

As we conclude the year, we are reminded once again that successful investing is not about forecasting short-term outcomes, but about maintaining discipline through changing market regimes. Our approach remains unchanged: identify high-quality businesses with sustainable earnings power, strong balance sheets, and management teams aligned with shareholders—



then invest when those businesses trade at discounts to our conservative estimates of intrinsic value. The fourth quarter was an active one for the portfolio. We continued to add selectively to positions where volatility created opportunity, while trimming or exiting holdings where valuations more fully reflected our thesis. We remain encouraged by the fundamental progress across many portfolio companies and believe the strategy is well-positioned heading into 2026.

Thank You For 25 Years

2026 marks the 25th anniversary of Cornerstone's founding. We are honored by the trust that you and all of our clients have placed in us over the last quarter-century. Few investment firms reach this milestone, and it is only due to our partnership with you that this was possible. We believe we have fulfilled our mission to be an independent group of experienced investors that provides investment excellence & exceptional client service. But we cannot, and will not, rest on our laurels. Tomorrow is another day, another step, and we look forward to our shared success over the next 25 years.

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.