

Market Review Commentary

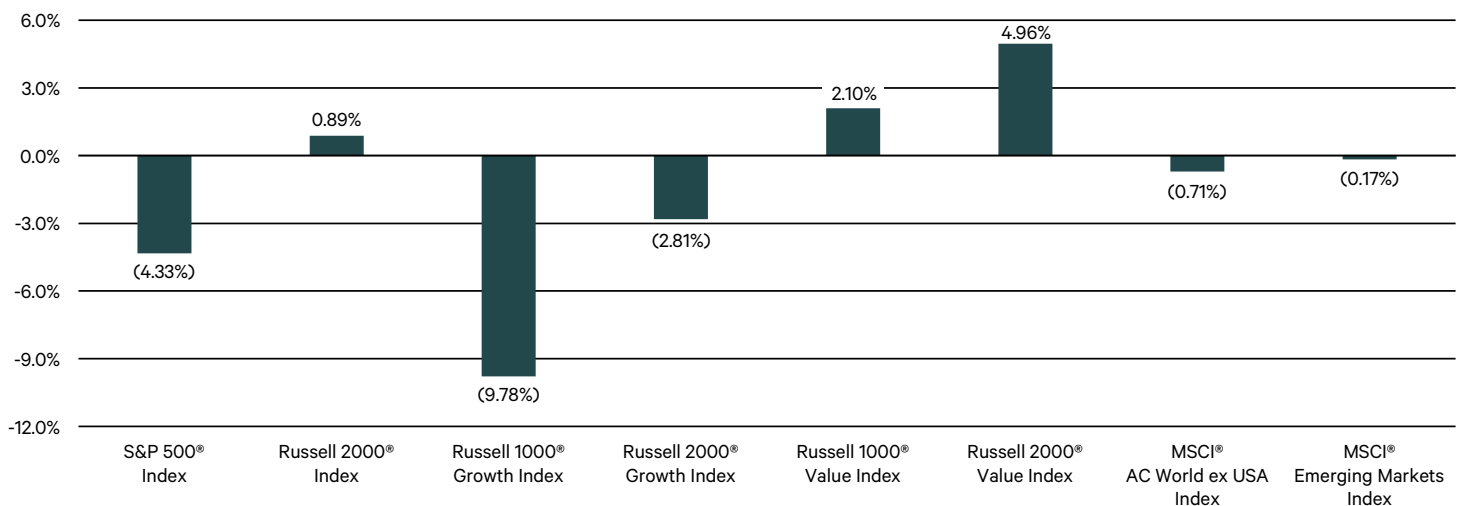
1Q
2026

Market Review

The first quarter of 2026 was marked by sharp shifts in leadership and rapidly changing market narratives. Figure 1 highlights a few high-level themes about equity market performance in the first quarter of 2026.

- Small caps (Russell 2000) outperformed large caps (S&P 500).
- Growth—in particular large cap growth—pulled back, as value benchmarks surged higher.
- Non-U.S. stocks outperformed the S&P 500, despite a dramatic pullback in March, as the blockade of the Strait of Hormuz proved far more disruptive for economies abroad than for the U.S., which benefits from domestic oil and gas reserves.

FIGURE 1: Q1 2026 INDEX RETURNS



Data presented is for the three months ending March 31, 2026. Source: FactSet. Please see the end of this commentary for additional information regarding the indices.
Past performance is no guarantee of future results.

Beneath those headline outcomes, however, markets were anything but stable, as investors repeatedly repositioned in response to a steady stream of developments.

AI-related news set the tone early in the quarter, driving a move away from large, “asset-lite” companies toward so-called HALO (Hard Assets, Low Obsolescence) stocks and smaller-capitalization names. Investor enthusiasm for the largest technology companies also cooled, with all members of the so called Magnificent 7 posting negative returns for

the quarter. The weakest performers were among those committing the most capital to AI-related investments, including Amazon, Alphabet, Microsoft, and Meta, as investors grew more cautious about the timing and scale of potential returns.

Alongside these developments, the U.S. entered into the conflict with Iran on February 27, and the resulting global oil supply shock became the dominant force shaping returns and pushed most sectors into negative territory. Not surprisingly, energy was the top-performing sector across market capitalizations, boosting value benchmarks with heavier energy exposure. Select materials companies tied to higher oil prices (e.g., fertilizer companies) also performed well. The quarter ended with a sharp rally fueled by optimism that hostilities might ease and the Strait of Hormuz could reopen.

FIGURE 2: ENERGY OUTPERFORMS ALL SECTORS

S&P 500® Sector Performance Since Start of Iran War

Sector	February 27, 2026	March 31, 2026	% Change
Energy	855.10	943.30	10.31%
Utilities	482.91	466.42	(3.41%)
Financials	853.79	822.22	(3.70%)
Information Technology	5,365.45	5,158.06	(3.87%)
Consumer Discretionary	1,854.79	1,748.22	(5.75%)
Real Estate	278.35	259.98	(6.60%)
Materials	675.69	627.82	(7.08%)
Communication Services	453.56	420.28	(7.34%)
Consumer Staples	1,003.08	925.56	(7.73%)
Health Care	1,864.30	1,710.39	(8.26%)
Industrials	1,497.59	1,369.67	(8.54%)

Source: FactSet, S&P. Custom Performance in U.S. Dollar Grouped by GICS Sector & GICS Industry. Please see the end of this commentary for additional information regarding the index. **Past performance is no guarantee of future results.**

This quarter also saw differences between value and growth returns within individual sectors. For example, technology posted a positive return in the Russell 1000 Value Index, but it was one of the lowest performing sectors in the Russell 1000 Growth Index. This divergence reflects underlying index composition: semiconductor stocks, particularly memory chip companies, carry higher weights in value indices, while software companies, which are addressed in greater detail later in Question 4, represent a much larger share of growth benchmarks.

We believe investor demand for HALO stocks reflects profound uncertainty that AI could displace many information driven companies, like software or insurance, rather than a fundamentally driven preference. These “heavy asset” companies typically trade at lower valuation multiples for a reason. They are typically capital intensive and generate lower return on equity (ROE). Many are cyclical, with high fixed costs. That’s great when revenue is growing, as margins expand. But when revenue declines, profits are squeezed and cash flow can be a problem.

1. How is the AI Narrative Evolving?

Handwriting about the economics of the massive capital expenditures in the AI space for hyper-scalers led investors to turn to the beneficiaries of that spending. That includes equipment makers, networking specialists, and power management companies. The AI buildout has been boosting demand for memory chips, and the usually cyclical companies that make them saw returns north of 50% this quarter.

AI headlines also created notable areas of weakness this quarter. Concerns that easy-to-use AI coding tools would doom the business model for Software-as-a-Service (SaaS) companies caused what is being called the SaaS apocalypse:

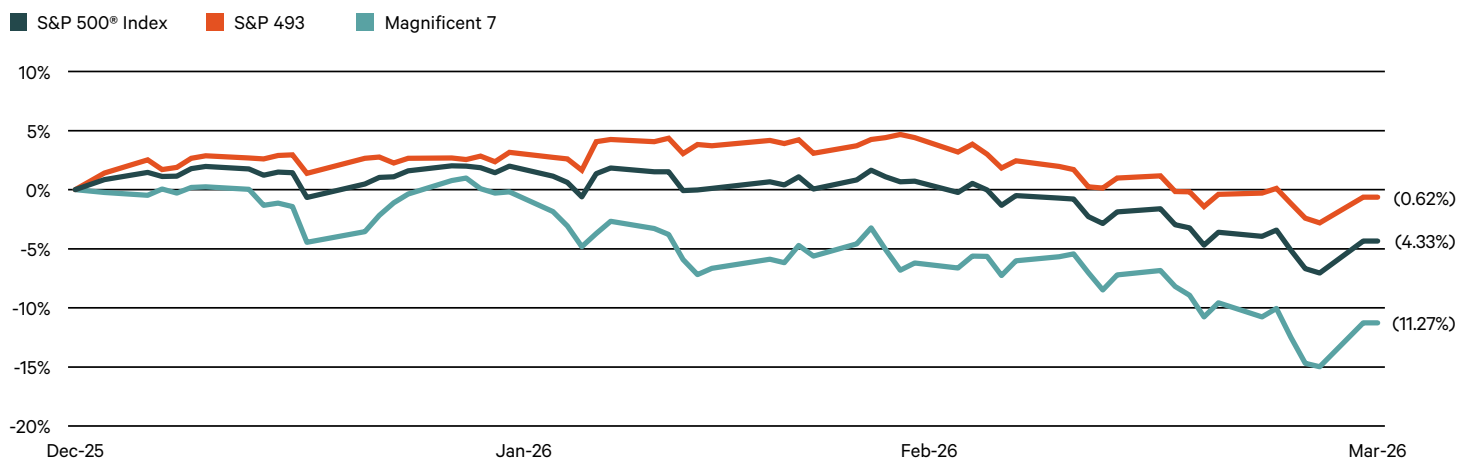
- New versions of AI’s easy-to-use coding capabilities suggested that companies that charge high monthly fees for their software products could be easily replaced with home-grown capabilities.
- Many high-quality stalwarts came under tremendous pressure, albeit with some recovery at quarter-end.
- What began as a sell-off in software companies then spread to insurers, credit bureaus, online marketplaces, and other businesses you might not think of as being vulnerable to generative AI disruption.

We believe this indiscriminate selling is fear-driven, but it’s too soon to know which companies will be hurt and which will be helped by AI over the longer term.

2. Has the Magnificent 7 Lost Its Shine?

All Magnificent 7 stocks declined this quarter (Figure 3) and their performance had an outsized impact on overall index returns given their substantial weights. While these companies proved more resilient than many traditional application software firms (and not all the Magnificent 7 are software-focused), even modest pullbacks among such heavily weighted names can meaningfully drag on index performance—underscoring our long-standing concerns around concentration in market-cap-weighted strategies.

FIGURE 3: HEAVYWEIGHTS UNDER PRESSURE
Q1 Price Path of the S&P 500®, S&P 493, and the Magnificent 7



Data presented is as of March 31, 2026. Source: FactSet, S&P. The Magnificent 7 stocks are comprised of Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. The S&P 493 represents the remaining constituents of the S&P 500 after excluding the Magnificent 7. Please see the end of this commentary for additional information regarding the indices. **Past performance is no guarantee of future results.**

With that said, we view this setback as a pause, not a capitulation. Long before the generative AI boom, these were powerhouse names with fortified balance sheets, ample free cash flow, and enjoyed near impervious competitive positions and scale. The question now is, what will the economics of generative AI turn out to be, and who will benefit most? Initially, most assumed the large language model owners would be the victors and would enjoy all the spoils. Now some are questioning whether this ultimately resembles the airline industry, where competition benefits consumers but heavy capital investment puts sustained pressure on returns.

3. Did All Small Caps Outperform This Quarter?

We saw a continuation of solid performance in small caps that began last year on the hopes of lower interest rates. Some of that early lead in small caps diminished as the U.S. entered into war, but the Russell 2000 Index still finished ahead of the S&P 500 Index for the quarter—the Russell 2000 Index returned 0.89% versus the S&P 500, which fell 4.33%. Energy was the top performing sector within small caps. Industrials also did very well, as did real estate, utilities, and consumer staples, as investors pivoted to hard assets. The worst performers were health care, consumer discretionary, communications services, and financials.

It is often helpful to look at specific factors that investors favored to make sense of quarterly performance and to understand if this was a period where investors favored higher or lower quality companies. If we look at ROE, we saw a continuation of the fourth quarter where lower ROE (and thus lower quality) companies were clearly in favor. We believe this is a function of very strong performance of energy companies, which often have much lower ROEs than peers. As a side note, a lack of energy in our portfolios provided a 100-200 basis point headwind in relative performance. However, lower quality did not outperform by every measure. Companies with high levels of debt were routinely punished in the first quarter. We believe this is a key fundamental to watch and we think it reflects some concern that interest rate relief from the Fed may not be on the immediate horizon.

One of the questions we have been getting most is when will high-quality come back in favor. This current period is not dissimilar from 2022 in our minds, after Russia invaded Ukraine. Energy was up 41% in the Russell 2000 Index in the first quarter of 2022. Utilities were up 3% and everything else declined. Industrials, materials, and real estate held up best. The worst performers were consumer discretionary, health care, and technology. P/Es were inversely correlated with stock performance, and higher ROE companies underperformed. These parallels are worth noting as this is not dissimilar from what we just experienced in the first quarter.

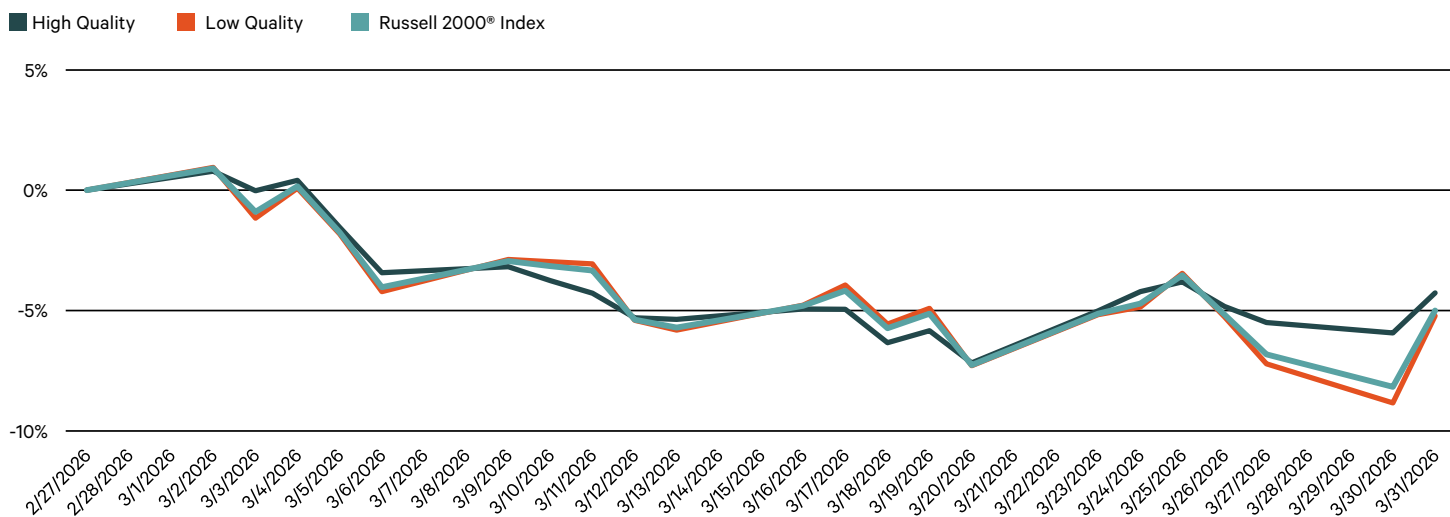
There are other time periods that are also relevant, such as in the early and mid-2000s. During both of these periods, quality materially underperformed. Reflecting back, these were both times when the early seeds of a recovery after a recession were beginning to take root in the economy. Early cyclical recoveries tend to favor the lowest quality names, as these were the stocks most aggressively sold down during a recession. The low-quality rally corrects the oversold conditions.

Eventually though, fundamentals become more important than valuations. Earnings growth and return on equity start to become much more correlated with stock performance as these factors drive a substantial share of appreciation. Why am I comparing these earlier cyclical recoveries as a parallel period to the current time when unemployment in the economy is hovering near decade lows? The reason is that Wall Street does not always perfectly correspond to the broader economy so while we have not had a traditional recession per se, small caps have been in a persistent earnings recession for a few years. This ended last year, and as a result, we saw a turn in enthusiasm for small cap companies

overall. We expect that as that demand moves on from the most beaten down, low-quality companies to those with better fundamental strengths, that quality factors will matter once more.

We cannot predict with any certainty when that will be. We would, however, note that quality has offered downside protection since the Iran war began, and we believe companies with durable business models, sound balance sheets, and consistent cash flow generation are best positioned to deliver attractive investment outcomes over the long term.

FIGURE 4: QUALITY PERFORMANCE SINCE THE ONSET OF THE IRAN CONFLICT



Data presented is as of March 31, 2026. Source: FactSet. S&P High Quality – Stocks in the Russell 2000® Index with an S&P quality ranking of B+ or higher. S&P Low Quality – Stocks in the Russell 2000® Index with an S&P quality ranking of B or less. Low quality also includes non-ranked stocks. Please see the end of this commentary for additional information regarding the index. **Past performance is no guarantee of future results.**

4. How Are We Thinking About Software Stocks?

In talking about quality, we cannot skip over how software holdings affected our performance this quarter. Historically, these businesses contribute to the high-quality characteristics of our portfolios, demonstrated by high returns on capital, earnings stability due to their recurring revenue, and low capital intensity. The companies we favor often make products that have high switching costs and other durable protections. But as noted above, there is a risk that generative AI will erode some of these competitive pillars. This requires us to evaluate each of our software holdings as dispassionately as possible to determine which companies might be vulnerable.

We believe several elements can help software companies withstand a competitive threat from AI. First, we think some of these companies are protected by genuine regulatory barriers. Required certifications can take a long time to obtain and may be central to a company’s ability to comply with regulators’ requirements. It would be a heavy lift to obtain and maintain these certifications with a home-grown system, and compliance failures could be quite costly.

We also evaluate where the software sits within an enterprise’s ecosystem. Those that are central to recording a business’s transactions would be difficult and risky to replace. The operational and reputation risk of changing such systems would likely not be the first place to try out a novel technology. Compare this to a workflow productivity tool, which we see as being much easier to replace with a home-grown, “vibe-coded” approach.

Finally, a software vendor’s proprietary data can make it less vulnerable to being replaced by in-house AI coding. A critical distinction is whether the data is truly proprietary. Much of what is termed “proprietary,” such as credit card data, can be purchased. The analytics that use the data may be unique, but in many cases not sufficiently so to justify the high prices SaaS companies charge, particularly as AI tools increasingly draw on broadly available data sources.

Even if a company has some or all these protective attributes, new entrants could materially change the unit economics of the business. Just the threat of AI can be enough for customers to demand price concessions, a big problem for companies that depend entirely on raising prices to grow. When companies must invest to leverage AI in new ways to reach customers, margins may come under pressure, and we must consider how these dynamics could affect the earnings power of any business—particularly in software.

Summary

Overall, the first quarter was a challenging quarter for investors. Volatility was high, market narratives swung from greed to fear in the blink of an eye, and headlines drove much of the price action. With that said, we remain resolute in our conviction that investors willing to roll up their sleeves and invest for the long term can find opportunities in this market, as we believe high-quality companies are well positioned to weather the storms of geopolitics, technology transitions, and turbulent credit markets.

Looking at our portfolios, our emphasis on quality persists. While we may modernize our process based on new technologies and new resources, we maintain a focus on understanding every company’s competitive strengths and using that to drive our investment decisions.



Julie Biel, CFA
Chief Market Strategist

Julie Biel, CFA is Chief Market Strategist, Portfolio Manager, and Senior Research Analyst with primary research responsibilities for the small and mid-capitalization information technology and health-care sectors. Ms. Biel began her equity research career in 2004.

The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The Russell 2000® Index is a free float-adjusted market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Growth Index is a free float-adjusted market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The Russell 2000® Growth Index is a free float-adjusted market capitalization-weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The Russell 1000® Value Index is a free float-adjusted market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The Russell 2000® Value Index is a free float-adjusted market capitalization-weighted index of value-oriented

*stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The MSCI AC World ex USA Index (net) is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets, excluding the United States. The MSCI Emerging Markets Index (net) is a free float-adjusted market capitalization-weighted index designed to measure equity market performance in the global emerging markets. The indices are calculated on a total return basis with dividends reinvested. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor’s opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Kayne Anderson Rudnick has chosen to include the securities in this commentary based upon objective criteria. It should not be deemed as a recommendation to purchase the securities mentioned, and it should not be assumed that securities recommended in the future will be profitable. **Past performance is no guarantee of future results.***