

Shifting Leadership Across AI

Market Review Commentary for the Second Quarter 2026

Market Review

The second quarter of 2026 was quite volatile with sharp shifts in leadership with a market trying to parse the true leaders of the dawn of the artificial intelligence (AI) era. However, as the AI narrative continued to power index returns, the beneficiaries changed. In the second quarter, we saw a turn towards so called “bottlenecks” (i.e., the companies involved in the data center buildout with components where demand significantly outstripped supply). In many cases, the demand yielded large increases in revenue and earnings, but in other cases, investors speculated on potential growth.

In the second quarter, a few high-level themes stood out:

- **Small caps once again outperformed large caps**, with the Russell 2000 Index up nearly 21.49% versus 15.20% for the S&P 500 Index. Mid-cap stocks delivered healthy, albeit less impressive returns, with the Russell Midcap Index up 13.83%.
- **Technology dominated, but leadership has changed.** Within small caps, technology was up 56%, with semiconductors up over 100% and hardware up almost 50%—eye-popping numbers for a single quarter. Industrials also performed well, up around 24%. What’s notable is technology in the growth indexes was not up nearly as much as in the value indexes. That’s because semiconductors are typically classified as value, given the lower multiples investors award these cyclical and often commodity-based companies.
- **Energy reversed course, becoming the laggard** after being one of the strongest sectors in the first quarter as tensions with Iran eased.

- **Higher beta and lower-quality factors led the way across the indices.** This provided a challenging backdrop for quality managers such as KAR as our strategies favor companies with lower earnings variability and lower betas.

Returns as measured by return on equity (ROE) and price-to-earnings experienced a barbell effect. Both negative and very low ROE names outperformed, but so did companies with very high ROEs—with everything in the middle being left behind. Even more striking, companies with negative price-to-earnings ratios—that is, companies with no earnings—were among the biggest outperformers across the small, mid, and large-cap segments. Investors digested a host of difficult news stories and turned to the most immediate earnings beneficiaries of the massive AI CAPEX buildout, with little regard for quality or valuation.

In this commentary, we address five questions clients have been asking most, including questions on the AI cycle and what it all means for portfolios built on quality.

1. Why do KAR portfolios have little exposure to some of the best-performing areas of the market, and how does that reflect our discipline?

This is the question we've been getting most often, and it deserves a direct answer. The market leadership of the second quarter—semiconductors, high-beta names, non-earners—are not the types of businesses with the qualities we consistently look for: durable earnings, strong competitive positioning, and an ability to generate strong returns through an entire business cycle. They are near-term beneficiaries of a large spending cycle. However, they are also highly dependent on the fact that the cycle continues and that it continues to grow further.

In small caps, we've seen more of the musical chairs that we saw in the first quarter. Leaders change as investors try to predict where the next bottleneck in the AI build-out will appear. That is not the same as identifying a company that can compound earnings reliably over the long term.

What we think is most important, and worth repeating, is just how extreme this period has become. Low-quality has now outperformed high-quality by roughly three standard deviations from the median.

Figure 1: Outperformance of Low Quality Within Small Caps is Now a 3-Standard-Deviation Event

Rolling 12-Month Relative Performance of High vs. Low Quality (Russell 2000® Index Top/Bottom Quintile by Return on Invested Capital)



Data as of June 30, 2026. Source: FactSet Research Systems, BofA US Equity & US Quant Strategy. Indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

The only other times we've seen dislocations of this magnitude were around 1999 and 2009. We can't predict when we will see some normalization, but we do believe investors will eventually begin to care about profitability and returns on capital. What gives us confidence is investors have already turned their backs on the Magnificent 7, with these massive CAPEX investments already pressuring returns. It's worth noting that with prices increasing for all the components in data centers, the bar is even harder to climb to achieve the strong returns the Magnificent 7 used to enjoy in their core businesses.

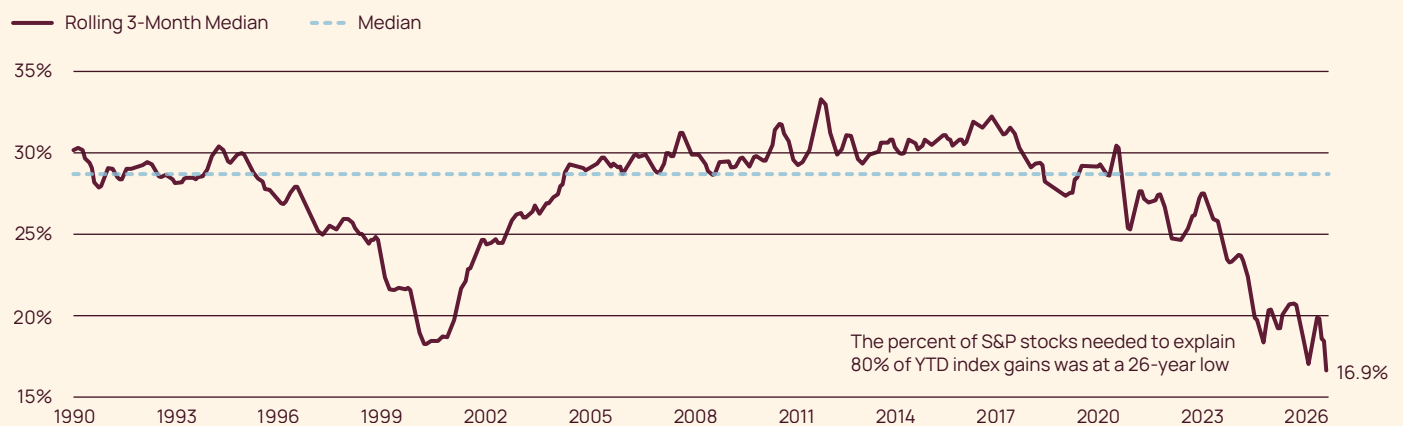
2. Does this environment represent a temporary dislocation or a more durable shift in market behavior?

Periods of highly concentrated returns are not new (the late 1990s are an obvious parallel) and they tend to make markets less stable. What makes *this* cycle distinctive is that the earliest leaders in the AI boom were large, highly profitable, and cash-generative companies with near-monopoly positions. Market leadership experienced some shift to other early beneficiaries. Now the conversation is increasingly about bottlenecks—where supply is constrained, who gets pricing power as the data center build-out continues, and which memory, networking, compute, or power names will benefit next.

Investors have done a reasonable job guessing where the next inflection in earnings growth will appear. This is one large difference from the dot.com boom. Investors are recognizing a coming bottleneck, then trading into those stocks, their multiples expand, and the cycle continues to find the next idea. This type of investing activity creates a tough dynamic for longer-term investors however, where the challenge becomes evaluating the durability of earnings growth. But it's worth noting that the rotation away from yesterday's beneficiaries is itself a sign that the durability of those earnings is perhaps not as strong as the prior valuations implied.

We would also point out that what looks like persistent index leadership is, on closer inspection, a rotating cast. This indicates that the market has stayed relatively narrow in its performance even though the companies driving the gains have changed. This is not exactly the broadening we had hoped for.

Figure 2: 16.9% of S&P 500® Stocks Explaining 80% of Absolute Total Return



Source: FactSet Research Systems, 22V Research. Indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

One other note of interest is what's happening with the frontier-model companies themselves. Many of the companies leading the AI build-out were near-monopolies that historically stayed in their respective lanes (e.g., Google in search, Meta in social, Microsoft in software, etc.). Today these companies are competing head-to-head, at scale, in a way they never have before.

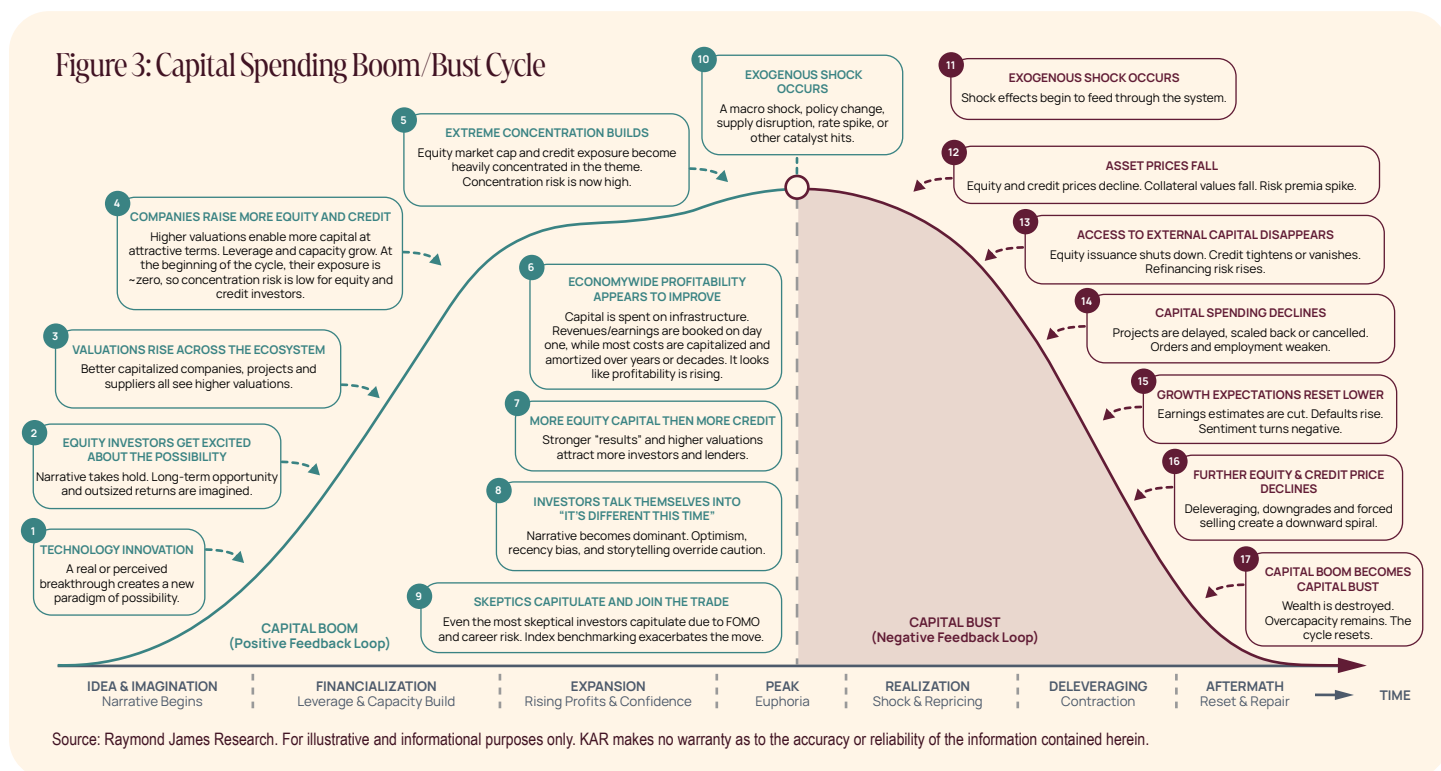
We have some concerns that these companies have not developed the kinds of differentiation that enabled the profitability they had enjoyed before. Think of how many workers are using Copilot for example. In many cases to switch the large language model a person is using, all someone has to do is switch within a drop-down menu. That is not the type of switching costs we would typically look for in a true winner-take-all

market. This raises some questions on the sustainability of the current pace of capital expenditures as well.

That said, we are not predicting a slowdown. However, the combination of unprecedented head-to-head competition, low switching costs, and very high CAPEX commitments is something every investor should consider. For us, it is an indication that we are still very early in this technology cycle and that the cone of outcomes is wide. Predicting the long-term beneficiaries will be difficult.

3. Does the AI investment cycle resemble past innovation cycles, or is it structurally different?

History is pretty clear on one point—we have never had a major CAPEX investment cycle that avoided a bubble. Almost all large CAPEX cycles, like the railroad build-out or the telecom boom of the 1990s, eventually delivered enormous economic prosperity. But the early investors were rarely the long-term beneficiaries. Most bubbles begin funded with cash flows, but as more equity and debt are used, CAPEX spending becomes much more fragile. Typically, we see an exogenous event, sometimes completely unrelated to the CAPEX cycle itself, as the thing that bursts the bubble.



What previously gave investors great confidence in this cycle is the funding source was free cash flow

from the largest technology companies. But that has changed at the margin. We've seen an increase in companies coming to the debt markets for funding. Some, like Google, have even raised equity in the markets, after being consistent buyers of their own stock for years. We saw the largest IPO in history of a company that has created an impressive competitive moat in its space business, but its AI future is perhaps less certain. And we are waiting for two of the largest frontier model companies to go public as well. So while the volume of IPOs is still very low relative to the dot com bust the size of the equity raised is notable. This could make the cycle a bit more fragile.

The AI CAPEX cycle is a bit different from other CAPEX cycles in terms of the life of the underlying assets. The biggest line item in today's spend is the compute semiconductors, and these depreciate much faster than a mile of railroad track. That has some implications for this cycle specifically:

- If frontier models prove to be the dominant economic engine, that could mean that we need to constantly spend aggressively on cutting-edge compute, which could further pressure returns.
- If, on the other hand, smaller, cheaper models turn out to handle most enterprise use cases (which is something we're hearing from companies), the cycle could have a longer, more profitable tail because the existing investment can be amortized over a longer period.
- Data centers in space are another potential solution, certainly in use cases where latency is less of an issue. We would think of these more as racks in space than the large data centers that may come to mind. While these would have access to unlimited solar power, the harsh environment likely constrains how long these data centers can be used before being junked.

To be clear, we are not AI skeptics. It is a near certainty this technology will fundamentally reshape many aspects of all our lives. But the combination of (1) a CAPEX cycle concentrated in depreciating assets and (2) growing questions on the costs of these frontier models as well as the challenges of hallucinations leads us to believe we have a ways to go before we know how this technology will evolve.

We believe there is the potential that smaller, more efficient, and less ambitious models will increasingly find their place alongside the larger frontier systems. They tend to hallucinate less, cost far less to run, and may be a better fit for many automation use cases.

4. Is the swing in index EPS driven by a narrow group of AI beneficiaries? What does that mean for quality?

Whenever we underperform, we must look at our holdings critically and understand why we are lagging. Our honest, if unsatisfying, assessment after this quarter is that not much has changed. Broadly speaking, our companies are delivering solid earnings, maintaining their competitive positions, and thinking about how to protect those positions in an AI-centric world. But in many cases, they are simply not growing as fast as the AI beneficiaries of the day, and they are not drawing the same level of investor attention.

To be fair, earnings growth for the direct AI build-out beneficiaries, at least in the near-term, is genuinely impressive. Small-cap earnings growth is now running ahead of that of large cap, and even after a solid rally, small caps still trade at a meaningful discount to large caps on a relative basis. That discount could actually widen if the eventual Anthropic and OpenAI IPOs end up in large-cap indices—those companies are not yet profitable, which would push large-cap multiples higher still.

Figure 4: Small Caps Attractively Valued Relative to Large Caps

S&P 600® Index vs. S&P 500® Index Price-to-Earnings Ratio, Next 12 Months

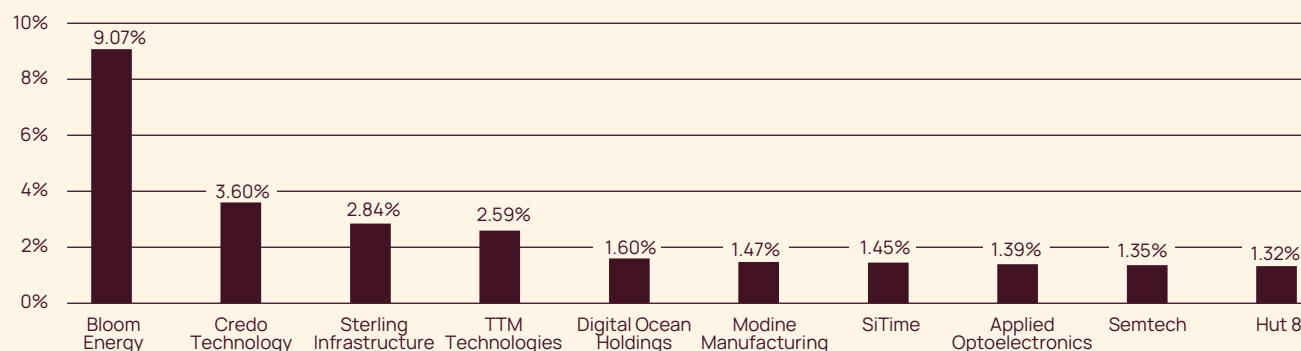


Data as of June 30, 2026. Source: Strategas, Factset Research Systems. Indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

The narrowness in market performance is real—AI-related sectors accounted for roughly 69% of small-cap returns year-to-date. At the end of June, the Russell 2000 rebalanced and the largest AI-driven winners were reclassified in the large cap Russell 1000 Index. That is, in some ways, the next real test for small-cap stocks. Can we see continued broadening in earnings growth to sustain index performance once the most concentrated leaders step out?

Figure 5: Top 10 Companies in the Russell 2000® Index

By Year-to-Date Return Contribution



Data as of June 18, 2026. Source: Strategas, Bloomberg. The chart above illustrates the year-to-date return contribution of the top 10 Russell 2000 companies as of the date noted. The companies shown are constituents of the index and do not represent any portfolio managed by the Adviser. The information is provided for market context and illustrative purposes only and should not be considered to be a recommendation to purchase or sell the securities mentioned. Indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

5. How are companies actually using AI to improve efficiency and productivity?

Almost every company is talking about AI and how it may be incorporated into its business operations. From what we're seeing across our holdings:

- Marketing appears to be an area where companies are beginning to see measurable benefits. Many of our companies are seeing improvements in efficiency in how they target, message, and convert. They are also using the technology for idea generation and brainstorming.
- Software development has emerged as one of the most significant generative use cases right now. Several of our small-cap software companies are using AI to accelerate their product roadmaps. One has talked about being able to slow its pace of acquisitions because internal development of new software is so much faster and easier.
- Operational and logistics optimization, such as routing, fleet management, and asset productivity, are producing perhaps less glamorous, but nonetheless meaningful operational efficiencies for our companies. These are the more gradual investments that compound over time.

- Consumer companies are using AI to parse customer feedback at a much larger scale than was previously possible. Many are using these large stores of data to help inform product development in a way that's more customer guided.

Certainly, some of our companies are also benefiting from data center-related spending. We welcome that, but with one caveat—because we still have questions about how long the current CAPEX cycle can continue to accelerate, we are not investing in companies that are wholly dependent on that single theme. We want durable earnings power that survives if data center spend decelerates or, in a worst case, contracts.

As always, we thank you for your continued trust and confidence and we welcome any additional questions you may have.



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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 S&P 500 Index** is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. **The Russell Midcap® Index** is a free float-adjusted market capitalization-weighted index of medium-capitalization stocks of 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 S&P Small Cap 600 Index** seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. **The Russell 1000® Index** is a free float-adjusted market capitalization-weighted index of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. 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.