

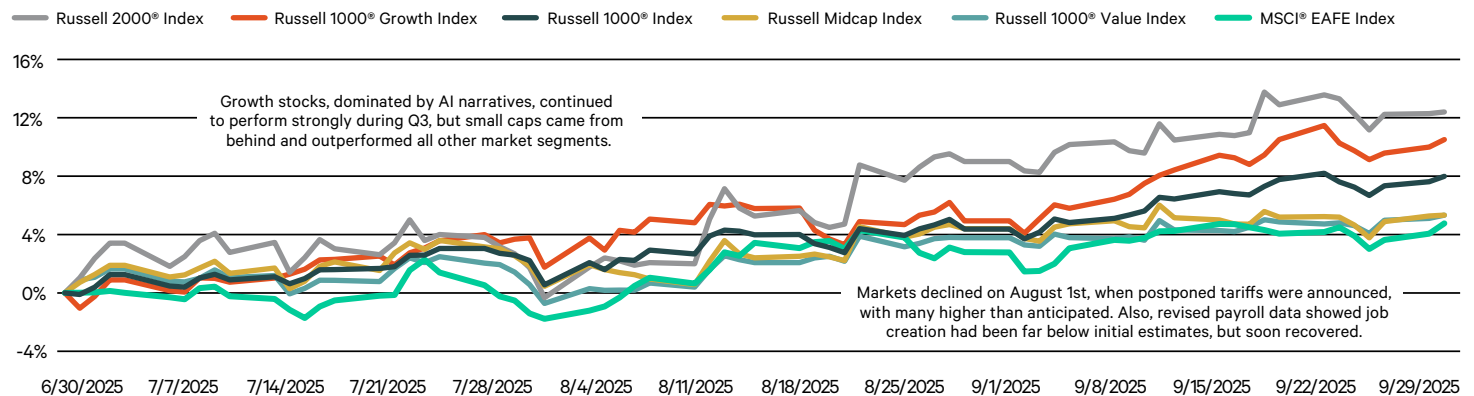
Market Review Commentary

3Q
2025

Market Review

Technology stocks in general and AI-related stocks in particular continued to dominate the news for much of the third quarter, boosting the large cap growth segment of the market. Halfway through August, small cap stocks surged, helped by a number of factors, including growing expectations that the Federal Reserve would likely cut short-term interest rates (which it did, as we discuss below), a sense that tariffs may not hurt smaller companies as much as originally feared, and attractive valuations compared to large-capitalization stocks.

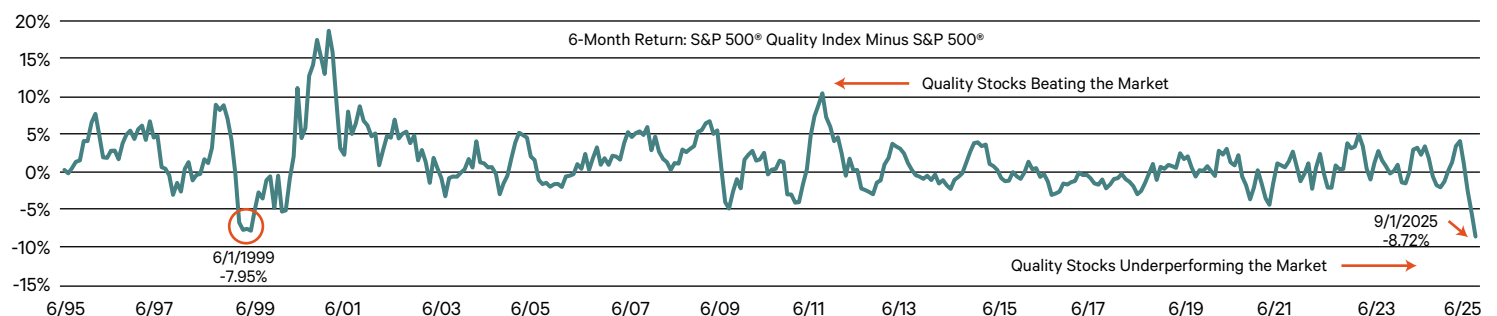
FIGURE 1: 3Q INDEX RETURNS



Data presented is for the three months ending September 30, 2025. Data is obtained from FactSet and is assumed to be reliable. Please see the end of this commentary for additional information regarding the indices. **Past performance is no guarantee of future results.**

The market is being led by many extremes—extremes in capital expenditures, index concentration, valuations, and AI euphoria—all of which led to extremes in the outperformance of low-quality companies not seen since 1999.

FIGURE 2: HIGH QUALITY STOCKS' UNDERPERFORMANCE IS AT 1999 EXTREMES



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Profitable small and mid-cap companies have been particularly challenged, especially since Liberation Day. After large market corrections like we saw in April, it is typical for there to be a junk or lower quality rally. Approximately 42% of the Russell 2000 Index is not profitable which has made the rally more extreme within small caps.

FIGURE 3: RUSSELL 2000® INDEX EARNERS AND NON-EARNERS PERFORMANCE THROUGH SEPTEMBER 2025

GICS Sector	September		Third Quarter		Start of Year - April 8, 2025		Since April 8, 2025	
	Earners	Non-Earners	Earners	Non-Earners	Earners	Non-Earners	Earners	Non-Earners
Communication Services	0.5%	10.6%	2.9%	30.6%	(24.5%)	(23.6%)	26.7%	68.2%
Consumer Discretionary	(0.9%)	0.3%	10.6%	12.5%	(22.3%)	(37.4%)	36.2%	48.3%
Consumer Staples	(7.4%)	3.7%	(0.7%)	10.9%	(6.7%)	(8.7%)	7.9%	7.5%
Energy	4.8%	3.5%	14.6%	18.7%	(32.9%)	(33.9%)	43.3%	63.7%
Financials	(2.8%)	(2.6%)	4.6%	2.7%	(14.7%)	(19.3%)	25.4%	29.1%
Health Care	1.7%	8.1%	1.4%	22.0%	(7.5%)	(27.5%)	14.4%	48.9%
Industrials	4.5%	9.3%	16.3%	19.5%	(18.0%)	(37.4%)	47.9%	86.9%
Information Technology	6.9%	12.2%	13.1%	20.7%	(26.1%)	(33.1%)	52.3%	76.8%
Materials	5.4%	4.2%	22.9%	24.8%	(19.3%)	(21.8%)	47.7%	73.7%
Real Estate	(2.0%)	0.0%	5.4%	11.5%	(16.7%)	(15.2%)	18.6%	30.8%
Utilities	2.5%	24.7%	6.5%	44.9%	1.0%	(18.7%)	9.8%	81.5%

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It is useful to look back over the quarter to remind ourselves that where we are today is only one point in time, and that we arrived here only after experiencing ups and downs as investors digest all types of inputs. The same applies to any point in time in the future.

In this commentary, we hope to answer some questions that we believe are top of mind for our clients.

1. How will Federal Reserve interest rate cuts impact the economy and stocks, in particular small caps?

At its September meeting, the Federal Reserve decided to lower the federal funds rate target by 25 basis points to 4.25%-4.50%. This was the first rate cut since December 2024, after which members of the Fed said they wanted to wait to see how the new Trump administration's policies would affect the economy.

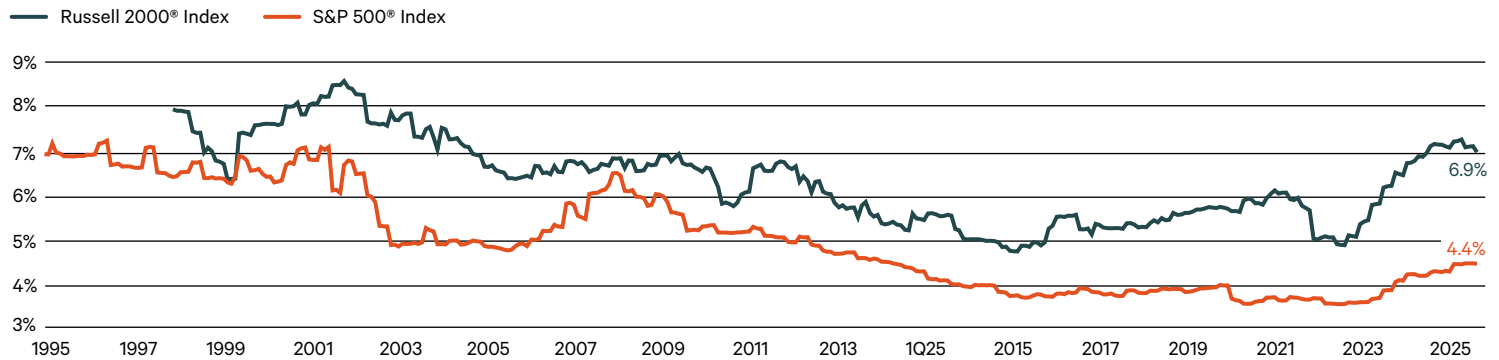
The Fed has a dual mandate: pursue full employment and maintain stable prices (i.e., control inflation).

During the press conference that followed the September meeting, Fed Chair Jerome Powell highlighted that the risks to employment had become more significant than the risk of persistent inflation. This came on the heels of large negative revisions to employment data from the Bureau of Labor Statistics, a non-partisan agency that gathers data and compiles various reports for the government.

Against that backdrop, we saw significant optimism that more rate cuts would be forthcoming, providing relief to sectors stressed by higher borrowing costs. We agree that looser financial conditions could benefit the economy by making it economically feasible for businesses to pursue various projects. It could also help companies facing high loan rates to find lower-cost financing, which would improve their earnings. Consumers would also benefit from lower borrowing rates, which could support discretionary spending.

Investors saw the rate cut as an opportunity to buy stocks of businesses that are most sensitive to interest rate changes. In many cases, this meant a renewed focus on small-cap companies. In general, smaller companies use variable rate debt, which means they could not lock in low rates earlier this decade and thus felt the impact of rising interest rates most acutely.

FIGURE 4: INTEREST EXPENSE AS A PERCENT OF TOTAL DEBT



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Thus, we can understand why an improved outlook for lower rates quickly increased investor interest in small cap stocks. Indeed, the Russell 2000 Index and the S&P 600 Small Cap Index (which includes only profitable companies) easily outperformed the S&P 500 in the third quarter—the Russell 2000 even outperformed the tech-heavy Nasdaq this quarter.

Looking at the small cap space a bit more carefully, we see that many of the outperformers are lower-quality businesses. This includes companies with high levels of debt or cyclical earnings, or speculative businesses that are not expected to show positive earnings until far in the future, such as small biotech companies. We can easily see this by noting that even though 42% of the companies in the Russell 2000 are “non-earners,” that index outperformed the higher quality S&P 600 by 328 basis points in the third quarter.

While we think much of the price action in the markets makes sense, we have some reservations regarding the sustainability of this rally, which has favored higher-beta, lower-quality stocks. Admittedly, as high-quality investors we would be expected to have this view, but with that said we do see some risks to the market’s current positioning.

If the Fed is cutting rates because inflation looks tame and the cuts are designed to move toward a more neutral rate, somewhere between 3%-4%, that is neither restrictive nor stimulating, that would certainly be positive for all stocks—small, mid, and large. However, if the rate cuts are a reaction to a deteriorating labor market and concerns for the economy, that would not favor more speculative or low-quality stocks.

2. What are the risks and opportunities associated with some of the administration’s policies on tariffs, immigration, and deregulation?

We see both clear opportunities and notable risks arising from the administration’s recent policy changes. On the positive side, some pruning of regulations could be beneficial to improving financial conditions, reducing barriers to stronger economic activity, and generally making it easier for companies to do business.

We agree that some of the capital requirements placed on banks may be too onerous and worth revisiting. However, eliminating some of the guardrails put in place after the 2008 global financial crisis would give us some pause. We believe

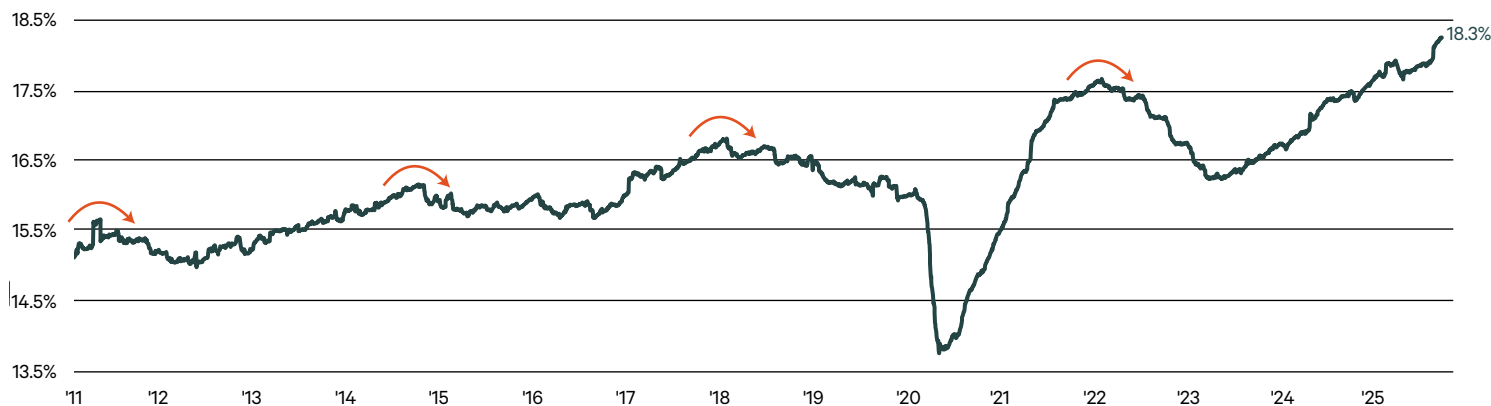
some of these regulations protected the economy during the mini-crisis unleashed when Silicon Valley Bank failed. We also believe some of the policies enacted after the financial crisis protect consumers from unscrupulous or misleading financial practices.

It is also possible that reducing regulation would increase M&A activity, which could support markets and generate more economic activity. Yet again, we have some concerns. If we look at the concentration of power in the technology sector, where most of the economic benefits of AI appear to be accruing to a small number of companies, it is possible that an absence of regulation will lead to even greater concentration that would be counter-productive to economic growth and could lead to unfavorable pricing to boot. We will continue to monitor how anti-trust policy evolves from here.

Tariffs continue to be a focus for investors and companies alike. We are still only seeing modest pricing pressure in the data, although that data is backward-looking and has been impacted by tremendous front-loading of imports that occurred at the beginning of the year to avoid some of the tariff pain. At present what is clear is that foreign companies and governments are absorbing only a modest amount of the tariff impact. The majority is being borne by companies and to a much lesser extent, at least for now, the consumer. That could change over time, as many companies are talking about passing along more price increases if margin pressures reach a certain point. The good news is that profitability remains quite healthy for U.S. companies, which could cushion some of the tariff impact.

FIGURE 5: ESTIMATED S&P 500® INDEX OPERATING MARGIN

Next 12 Months



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Finally, we note one area that perhaps has received less media attention than it should, namely how immigration policies will impact the U.S. economy. While we agree that the Biden administration's approach led to a massive increase in illegal immigration and a fair bit of chaos, the influx of new workers did have some positive impacts. Firstly, the increase in the labor pool came at a time when wages were spiking, particularly for hourly workers. The sudden increase in the supply of workers—estimated to be four times larger than what is typical—clearly put downward pressure on the increase in wages and helped slow the surge in wage inflation.

Study after study shows increased immigration, both legal and illegal, benefits the economy. Excluding immigrants, population growth in the U.S. (and most developed countries around the world) is stagnating or declining, and the existing population is aging, which increases health care costs and puts a strain on Social Security. Immigration supports consumer spending and tax revenue and adds to overall economic growth.

We have some concerns that sharply curtailing immigration could create an economic headwind, and recently announced policies could prove challenging to broader, long-term economic growth. For example, increasing the fee for H1-B visas to \$100K favors companies that can easily afford the cost. This means that smaller technology companies will now have a much harder time finding the talent they need to grow, while only large tech companies will be able to pay for talent outside the U.S.

3. How is AI impacting the economy today and what are the investment opportunities?

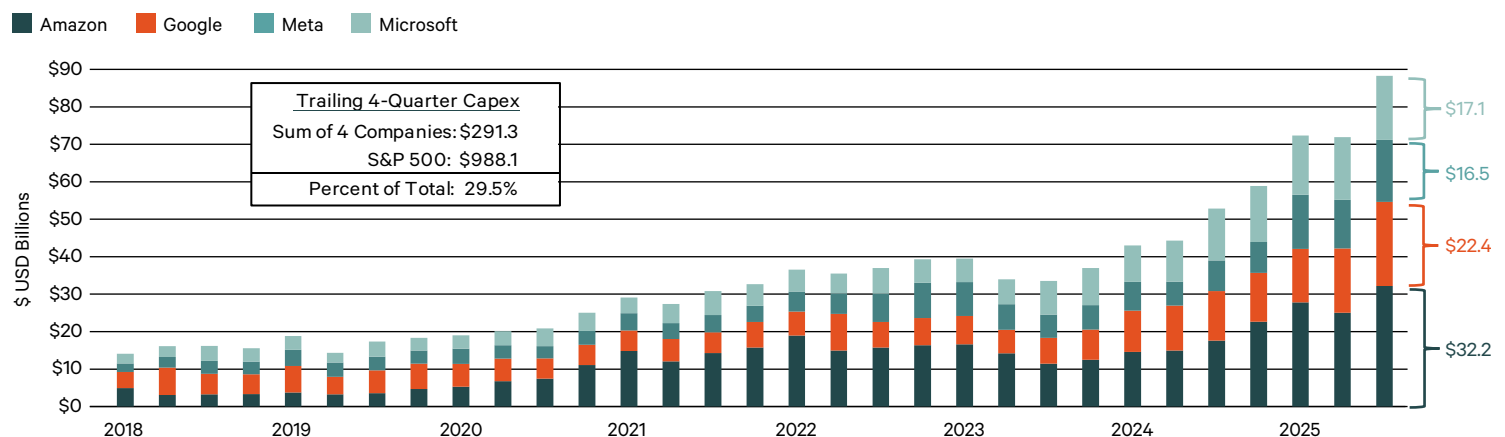
We are bombarded daily by debates about the future of AI. We know with certainty that AI has been a boon to research entities seeking to understand its impacts, podcasters predicting AI will either be the end of human civilization or unleash boundless economic productivity, and endless reporting from empty vistas where data centers will be built. It makes it very hard to determine reality from hype, and how it will impact us all.

In terms of the impact on the economy today, most notable is the eye-popping level of capital expenditures hyperscalers are undertaking. It is unusual to see a stock go up when a company increases its capital expenditures' budget dramatically, as this reduces free cash flow and typically leads to a lower return on capital over the medium to long-term. That isn't generally good news for investors. But given AI's voracious need for "compute" capacity, investors are flocking to the capacity-builders that are pursuing market share most aggressively, believing those entities will establish massive physical moats that will be hard to overcome by any would-be future competitor.

We believe these companies without their AI businesses are all high quality companies with high levels of profitability and are usually quite asset light. This helps mitigate some of the risk for these companies in the inevitable fits and starts of any technology transition. But what about the rest of the economy? We are seeing a startling concentration of capex in just a handful of companies. And that could present a risk if a few boards of directors decide to pull back on spend.

Just four companies make up approximately 30% of capex for S&P 500 companies, on a *trailing* basis:

FIGURE 6: QUALITY CAPITAL EXPENDITURES

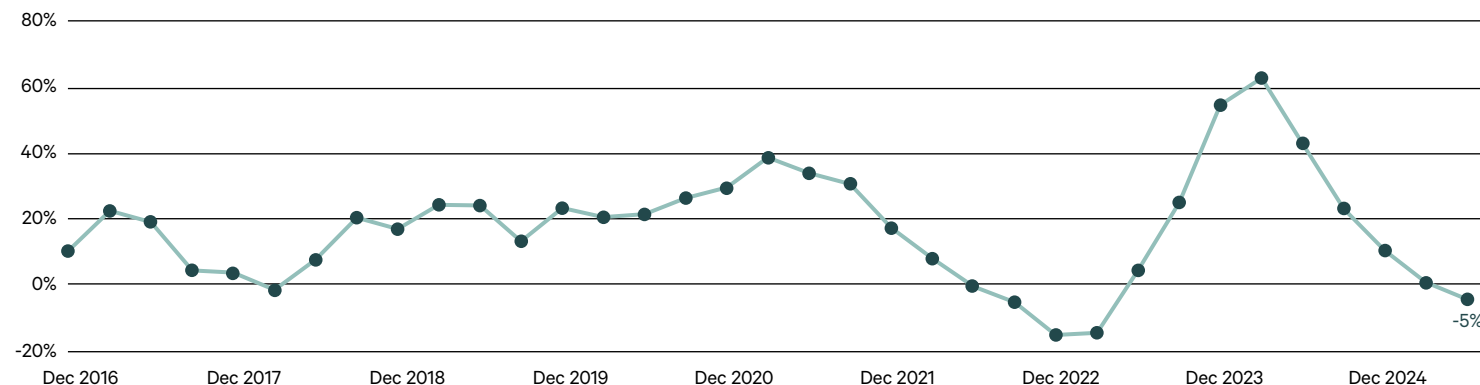


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For the first time in two years, despite substantial earnings growth, free cash flow growth for the Magnificent 7 is turning negative.

FIGURE 7: MAGNIFICENT 7 FREE CASH FLOW GROWTH

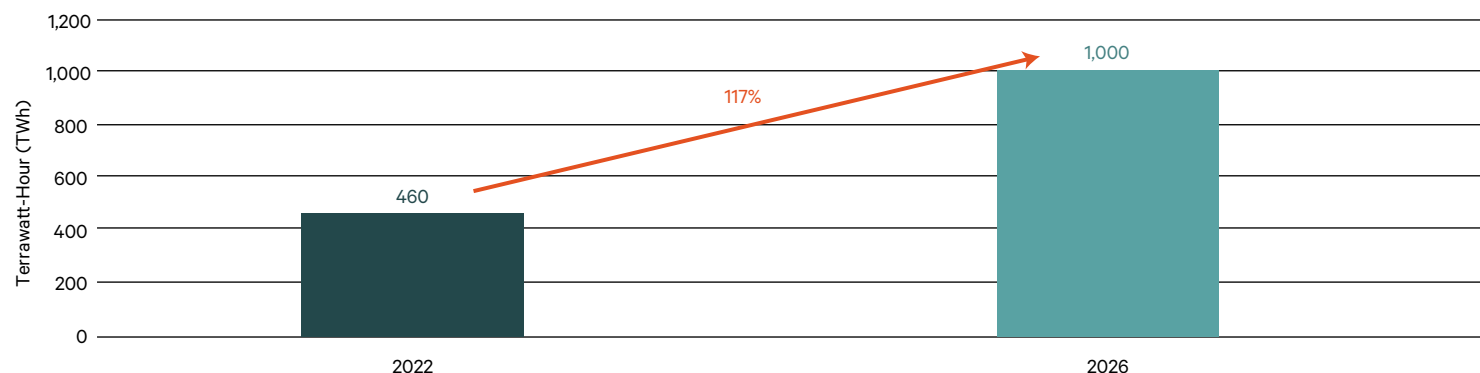
Year-Over-Year



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And what about the rest of the economy? This has implications beyond data centers. As we've all heard, generative AI's power demands are growing exponentially, but our ability to generate that power is struggling to keep up. Despite higher rates being charged to data centers, consumers saw substantial increases in utility rates in 2024, and that is expected to continue into 2025 and 2026. That impacts inflation.

FIGURE 8: GLOBAL ELECTRICITY CONSUMPTION FROM DATA CENTERS



Data presented is as of June 30, 2025, is obtained from Strategas and International Energy Agency (IEA) 2024 Annual Electricity Analysis & Forecast and is assumed to be reliable.

Overall, we think the AI build-out could be a big positive for the economy and we are already benefiting from the large capacity investments hyperscalers are making. Our concern is the concentration of this spend and how it could raise costs for consumers.

Beyond the here and now, things are much more uncertain. MIT recently published a study that reveals 95% of companies' AI pilot projects thus far have failed to generate the revenue growth or cost savings needed to earn a return. Bain recently released a report showing the compute demands of generative AI could make it difficult to create enough

revenue to justify the massive investment. And yet, we keep hearing how impactful generative AI already seems to be in organizations that have figured out how to use it effectively. Anecdotally, some members of our investment teams have been testing AI in our research process and find it very effective at showing us where to find information, though its ability to synthesize or analyze information is less reliable.

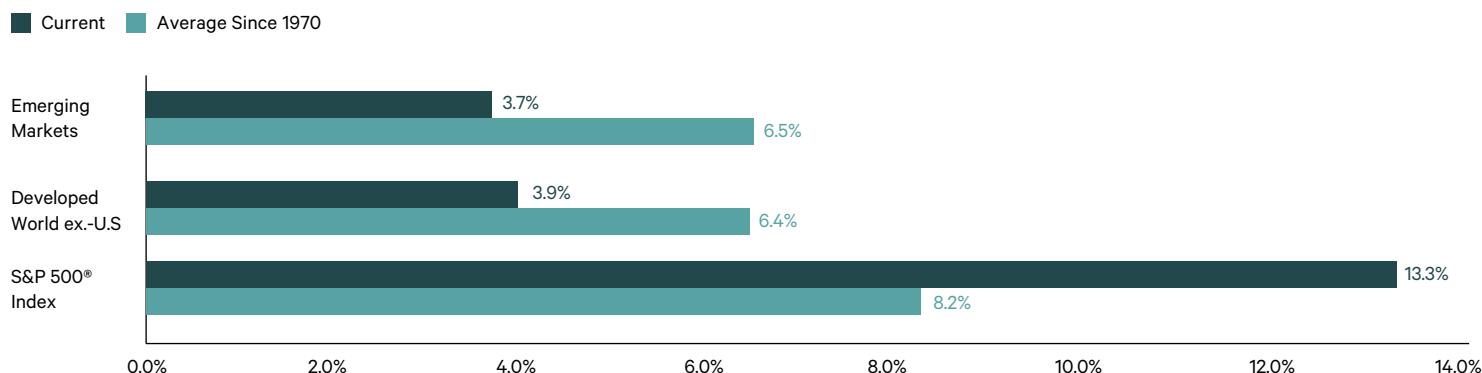
Investment opportunities remain centered in private markets, mega-cap technology stocks, and adjacent companies such as utilities. Given the excitement around AI, we think it is prudent to focus on the highest quality companies with an eye toward valuations. Small-cap tech stocks could benefit from AI in terms of speeding time to market and making development and engineering dollars stretch further, but direct beneficiaries are harder to pin down.

What is clear to us is this technology is incredibly promising and likely to change much of how we work with the information around us, and the opportunity to automate is substantial. Key unknowns are the timeline of adoption and what it will cost. We expect progress to be non-linear, much like other technology transitions, with periods of hype and skepticism that will impact the course of progress. For the time being, we continue to watch and learn.

4. What are the opportunities in international markets?

We continue to believe diversification for investors is always a good idea, as it is impossible to predict the future for economic growth, markets, interest rates, or other factors affecting investment returns. Over the last decade, U.S. equities have outperformed not just the rest of the world, but also historical average 10-year returns. International markets, on the other hand, have lagged longer-term historic averages.

FIGURE 9: 10-YEAR ANNUALIZED PRICE RETURN
Current Reading vs. Monthly Average Since 1970



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This year, we saw a change. While U.S. equity market returns have been strong, some non-U.S. markets have been even stronger. We’ve seen countries all over the map, from South Korea to Spain, Japan, and Canada, outperforming the S&P 500 over the trailing 12 months. China is facing a challenging domestic market and has been constrained in its ability to sell into the U.S., yet its stock market has outperformed over the last 12 months.

FIGURE 10: PERFORMANCE OF INTERNATIONAL INDICES

International Indices (Price Change)	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	TTM
Sensex (India)	2.0%	7.3%	6.7%	(7.3%)	(0.9%)	8.0%	(4.0%)	(4.8%)
DAX (Germany)	10.0%	(3.9%)	6.0%	3.0%	11.0%	5.5%	(0.1%)	20.5%
Swiss Market Index	5.3%	2.2%	1.5%	(4.7%)	8.6%	(5.4%)	1.6%	(0.5%)
CAC 40 (France)	8.8%	(8.9%)	2.1%	(3.3%)	5.6%	(1.6%)	3.0%	3.4%
All Ordinaries (Australia)	4.1%	(1.7%)	6.5%	(1.4%)	(4.4%)	8.9%	4.1%	7.0%
MSCI EAFE Index	9.1%	0.0%	0.3%	(0.9%)	2.2%	3.7%	4.8%	10.1%
Bovespa (Brazil)	(4.5%)	(3.3%)	6.4%	(8.7%)	8.3%	6.6%	5.0%	10.6%
FTSE 100 (UK)	2.8%	2.7%	0.9%	(0.8%)	5.0%	2.1%	6.7%	13.5%
OMX Stockholm 30 (Sweden)	5.1%	2.0%	2.2%	(5.5%)	0.4%	0.0%	6.8%	1.4%
MSCI AC World Index	9.0%	2.9%	4.5%	1.0%	(2.5%)	8.8%	7.6%	15.3%
Bolsa (Mexico)	0.0%	(8.6%)	0.1%	(5.6%)	6.0%	9.5%	9.0%	19.3%
IBEX 35 (Spain)	9.6%	(1.2%)	8.5%	(2.4%)	13.3%	6.5%	10.6%	30.3%
Nikkei 225 (Japan)	20.6%	(1.9%)	(4.2%)	5.2%	(10.7%)	13.7%	11.0%	18.5%
Kospi (South Korea)	3.4%	1.9%	(7.3%)	(7.5%)	3.4%	23.8%	11.5%	32.1%
Hang Seng (Hong Kong)	(3.0%)	7.1%	19.3%	(5.1%)	15.3%	4.1%	11.6%	27.1%
S&P/TSX (Canada)	5.8%	(1.3%)	9.7%	3.0%	0.8%	7.8%	11.6%	24.9%
Shenzhen SE A Shares (China)	(4.9%)	(7.4%)	19.1%	1.6%	2.4%	3.5%	21.4%	30.7%

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We believe part of the story has been that valuations in other countries look relatively more attractive after years of U.S. market outperformance. Another factor could be that changes in Europe are leading to more domestic spending, including defense spending as the U.S. focus turns inward. Many countries' leaders are using tariff standoffs with the U.S. to create stronger alliances elsewhere, boosting their trading activity. Also, the U.S. dollar has declined roughly 10% this year, making returns in other currencies worth more when converted into dollars.

Regardless of the reasons, we think broader market participation is a good thing long-term, and we continue to espouse the benefits of diversifying by investing in quality companies abroad.

As always, we remain focused on the fundamentals of the high-quality businesses in which we invest and we thank you for your continued trust and confidence.



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 market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. 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 Russell 1000® Growth Index which 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 1000® Value Index which 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. Small-capitalization stocks are represented by the Russell 2000® Index which 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 Midcap® Index is a

free float-adjusted market capitalization-weighted index of medium-capitalization stocks of U.S. companies. The index is calculated on a total return basis with dividends reinvested. 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® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. 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.**