Investment Commentary: Small Cap Q3 2025

Epic Small Cap Junk Rally! Quality Underperforms

Executive Summary

Last quarter we sang the virtues of ***quality*** – a factor that has powered large caps to outperform small caps over much of the past decade. Naturally, the market responded with a sense of irony in Q3, delivering an ***epic junk rally***.
Consider a few striking statistics from the quarter:

- **High Beta Surge**. According to LPL, the highest beta small caps returned 75% in Q3, versus 13% for the lowest beta names.
- **Value Destroyers Lead**. The small caps with the lowest Cash Flow ROIs (“value destroyers” with a median ROI of -15%) dominated the last 6 months (+33% relative performance over the Russell).
- **Leverage Pays (Temporarily)**. The highest levered companies (“zombies”) also outperformed the Russell. The shareholder return for the highest levered quintile of the Russell was +26% for the last 6 months. The 10-year return for this same group is -36%!
- **Profitability Penalty**. The S&P 600 small cap index, which requires companies be profitable for inclusion in the index, has underperformed the Russell 2000 by nearly 1000 basis points YTD.

Our investment process remains firmly grounded in quality—a focus on strong cash flow, high returns on capital, and conservative balance sheets. This profile naturally results in lower beta and less leverage, which worked against us in a quarter dominated by speculative risk-taking. Even so, our **nine-year alpha remains above +3%**, and we believe our positioning is exceptionally strong heading into the next cycle.

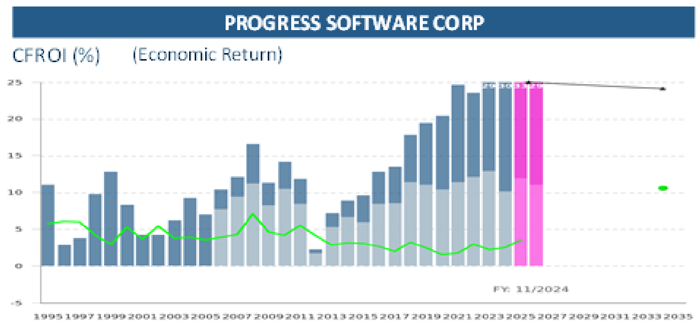
Recent Trades & Positioning

During Q3, we trimmed two strong performers—Sterling Infrastructure (STRL) and Hawkins (HWKN)—which exceeded our expectations. We redeployed capital into four names that have underperformed so far in 2025—Baldwin Insurance (BWIN), Progress Software (PRGS), Inter Parfums (IPAR), and SPS Commerce (SPSC)—where we see compelling long-term value.

The charts below (UBS HOLT™) illustrate the Cash Flow ROIs for two of these additions. Both SPSC and PRGS deliver outstanding profitability, each generating 25%+ Cash Flow ROIs, yet remain under the radar.

These are businesses focused on helping companies operate more efficiently—SPSC through supply chain optimization software, and PRGS through open-source applications for development and data management.

For contrast, the top-performing Russell 2000 names year-to-date—The Oncology Institute (TOI) and Oklo Inc. (OKLO)—report negative ROIs of -55% and -25%, respectively.



Note: Above charts from UBS HOLT™

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
STRL	Sterling Infrastucture	44.6%	Engineering & Construction	*Trimmed in Q3*
SXI	Standex International	35.6%	Industrial supplies	-
BWXT	BWX Technologies	28.2%	Nuclear components for Navy	-
HWKN	Hawkins	27.6%	Water treatment	*Trimmed in Q3*
MLI	Mueller Industries	27.6%	Water management systems	-

BOTTOM 5 PERFORMERS

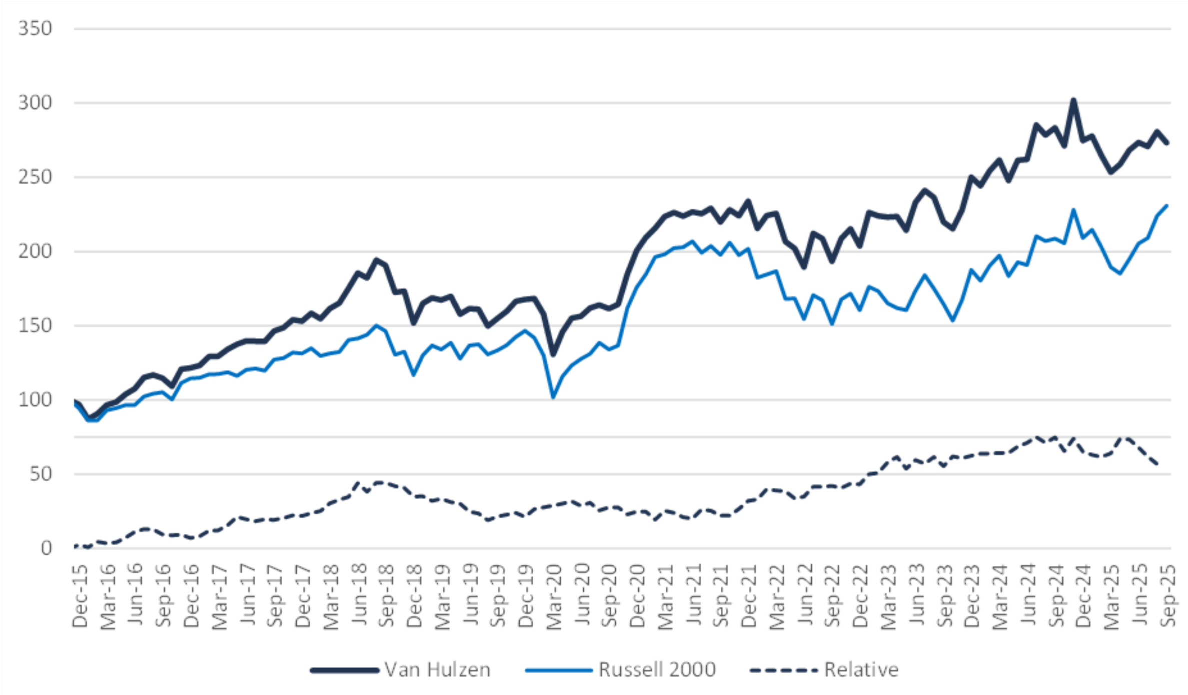
		Return	Description	Actions/Notes
BWIN	Baldwin Insurance	-33.4%	Insurance brokerage	*Added in Q3*
PRGS	Progress Software	-31.9%	Open source business apps	*Added in Q3*
BMI	Badger Meter	-26.9%	Industrial meters	-
IPAR	Inter Parfums	-24.7%	Perfumes	*Added in Q3*
SPSC	SPS Commerce	-22.9%	Supply chain software	*Added in Q3*

Long Term Performance & Outlook

Since inception, our strategy has delivered an annualized return of 10.8%, versus 8.9% for the Russell 2000, producing 3.2% annualized alpha.

While the market backdrop remains uncertain, we continue to advocate patience with small caps. The era of large-cap dominance is showing signs of fatigue, and although low-quality, highly levered companies may lead in the early stages of a rebound, quality tends to win in the end. Today's disciplined small caps are the likely large caps of tomorrow.

Relative Performance Since Inception



Alpha

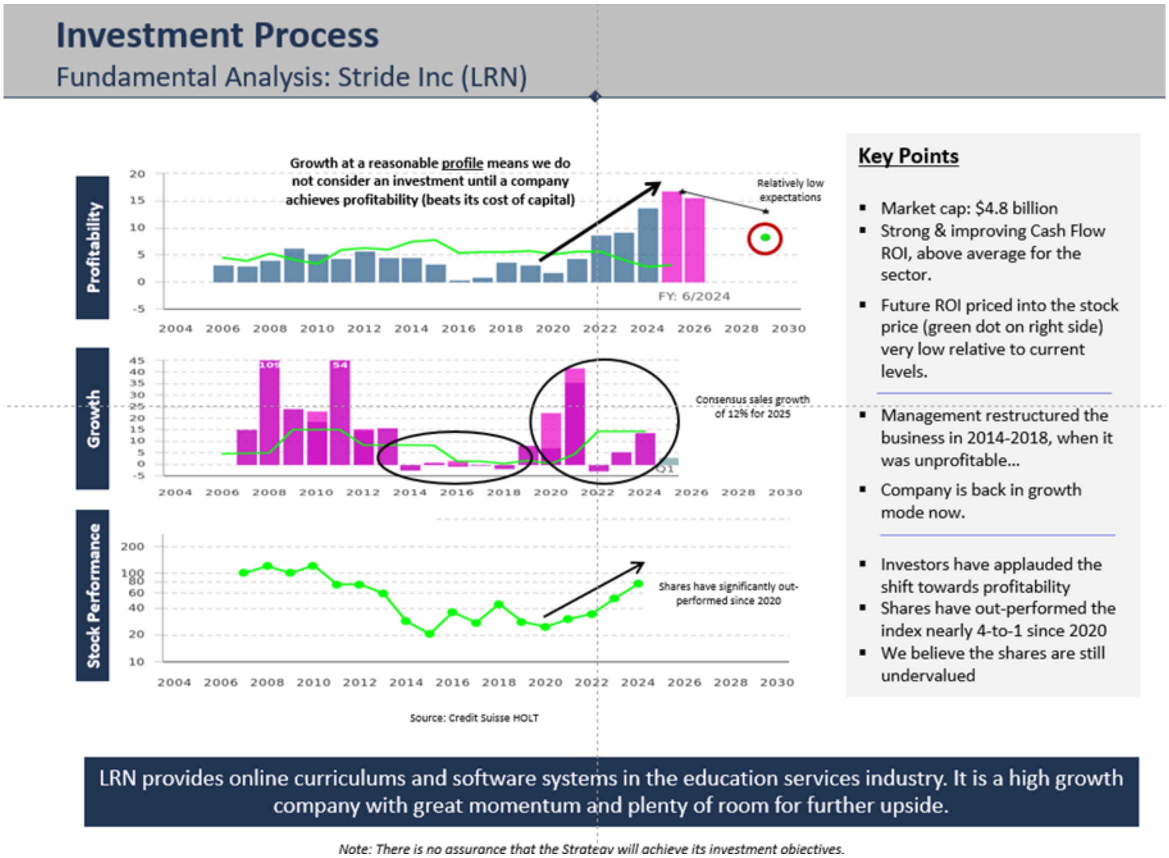
a = Rp – [Rf + (Rm – Rf) ß]

	Russell 2000	S&P 600
Rp = Realized return of portfolio	10.8%	10.8%
Rm = Market return	8.9%	9.3%
Rf = risk-free rate	2.0%	2.0%
ß = Beta	0.81	0.81
Alpha (relative to RUT)	**3.2%**	**2.8%**

Key Takeaways

- After significantly outperforming over the first four months, the portfolio has lagged the Russell 2000 during the post-Liberation Day rally of Q2-Q3
- This “junk” rally has favored the highest beta names, many of which are unprofitable and often over-levered
- The portfolio remains focused on **high-quality, low-debt, cash-generating companies**—a strategy that has delivered consistent outperformance for more than nine years.

Investment Process



Note: Above charts from UBS HOLT™

Top 10 Holdings

Company	Business description	Weight	Mkt Cap ($mm)
Qualys (QLYS)	Cyber security	4.4%	4,600
Addus HomeCare (ADUS)	Personal home care & Hospice	4.3%	2,050
Progress Software (PRGS)	Open source business apps	4.1%	2,010
Viper Energy (VNOM)	Oil & natural gas	4.1%	12,400
Stride (LRN)	Learning technology	4.0%	6,060
SPS Commerce (SPSC)	Supply chain software	4.0%	3,980
Hamilton Lane (HLNE)	Investment banking	3.8%	6,910
Merit Medical (MMSI)	Cardiovascular/Endoscopy supplies	3.7%	4,890
Gibralter Industries (ROCK)	Building products	3.6%	1,890
Applied Industrial (AIT)	Motion/fluid/power control	3.4%	9,540

Qualys. Progress ADDUS HOMECARE A Family Of Companies Hamilton Lane Stride

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