

Investment Commentary: Small Cap Q3 2026

And Suddenly...Quality Matters Again

After a first half characterized by speculative enthusiasm and narrow market leadership, Q3 brought a sharp reversal in AI infrastructure stocks and a broader pullback in small-cap equities. Meanwhile, the gap between the Russell 2000's index return and its median constituent's return widened to 13.5%, exceeding the comparable gap in the S&P 500. Against this backdrop, our quality-focused small-cap strategy outperformed the Russell 2000 by 8.7% in Q3. We believe the results reinforce the value of our disciplined fundamental process. End of the 40-Year Bond Bull Market

AI Infrastructure Update

Our last quarterly commentary took a deep dive into the AI buildout, focusing on AI infrastructure companies in particular—the beneficiaries of the enormous capital spending by the major technology platforms. We highlighted that the market appeared to be “paying for the story, not the fundamentals,” as investor enthusiasm for the AI investment cycle pushed valuations higher across much of the infrastructure supply chain.

After an extraordinary first-half rally, AI infrastructure stocks experienced a sharp reversal during the third quarter. The Philadelphia Semiconductor Index declined approximately 12%, while the S&P 500 advanced 2.3%. Infrastructure-focused ETFs experienced similar weakness, with the VanEck AI Infrastructure ETF declining 11.7%. Meanwhile, the broader AI sector remained positive as leadership rotated away from hardware and infrastructure toward software and the major technology (large cap) platforms. The divergence illustrates how quickly market leadership can change, even within one of the strongest secular investment themes.

But the reversal in AI infrastructure was only part of a broader change in market leadership. Beneath the headline indices, the third quarter also marked a potential turning point for small-cap stocks, where speculative and lower-quality companies had enjoyed an extraordinary run.

Market Concentration: A Small-Cap Problem, Too

It is well known that the S&P 500 is unusually concentrated, with the performance of its largest constituents supporting the overall index. What is less widely appreciated is that the Russell 2000 has become at least as concentrated from a performance perspective—and, by one measure, considerably more so.

Through September 2026, the S&P 500 had returned 12.8%, compared with just 4.0% for its median constituent, a gap of 8.8%. The Russell 2000 had returned 13.9%, while its median constituent gained only 0.4%, a much wider gap of 13.5%.

2026 through 9/30

S&P 500 index	12.8%
S&P 500 median stock	4.0%
Difference	8.8%

Russell 2000 index	13.9%
Russell 2000 median stock	0.4%
Difference	13.5%

In fact, 55% of the companies in the Russell 2000 (1,086 stocks) are technically in a bear market, meaning they are at least 20% below their recent highs. Let that sink in because the implication is important: strong index-level returns have not translated into broad-based gains for the typical small-cap stock. The Russell 2000 is +13.9% on the year, while the majority of small cap names are actually in a bear market.

The second-quarter rally illustrates this dynamic. The Russell 2000 surged more than 20% in Q2, its strongest quarter since late 2020. Yet the rally was characterized by a pronounced preference for risk and speculation. According to research from Aristotle Capital, high-beta stocks had their strongest relative quarter in a decade, while companies with high short interest and those that did not pay dividends also performed well. The index's ten largest contributors accounted for approximately 1800 basis points (that's 90%!) of its total quarterly return, making the rally unusually concentrated even by the standards of strong small-cap quarters.

The Q3 Quality Comeback

Perhaps the clearest evidence of the speculative nature of the Q2 rally came from company profitability. During Q2, unprofitable Russell 2000 companies outperformed profitable companies by more than 12% (!!). The lowest-ROIC quintile also dramatically outperformed the highest-ROIC quintile, reaching an extreme that Aristotle Capital characterized as approximately a three-standard-deviation event in rolling 12-month relative performance.

In other words, the market was not simply rewarding exposure to AI infrastructure or accelerating earnings. It was also rewarding riskier businesses, including companies with weak profitability and poor capital efficiency.

Q3 brought a meaningful reversal in small-cap performance. The Russell 2000 declined 7.2%, while the Russell 2000 Growth Index fell 9.4%, compared with a smaller 4.9% decline for the Russell 2000 Value Index. Meanwhile, the Philadelphia Semiconductor Index and AI infrastructure-focused investments also retreated sharply. These moves suggest that the market began reassessing some of the stocks that had led the first-half advance.

We believe this backdrop reinforces a fundamental principle of investing: **price momentum and business quality are not the same thing**. During speculative rallies, companies with the most exciting stories can outperform regardless of their underlying economics. Over time, however, sustainable earnings, disciplined capital allocation, strong balance sheets and attractive returns on invested capital remain important drivers of long-term value creation. These are the types of metrics we focus on at Van Hulzen.

A Favorable Environment for Fundamental Stock Selection

Our small-cap strategy is built around the belief that business quality matters. We seek companies with durable competitive advantages, sound financial positions, attractive cash flow ROIs and the ability to compound value over time. We do not need to predict which speculative theme will lead the market in any given quarter; instead, we focus on identifying businesses whose fundamentals can support attractive long-term returns. This process has generated a **2.7% Alpha over 10+ years**.

That discipline can be frustrating when investors aggressively reward lower-quality companies. The second-quarter rally was a case in point: the more than 12% advantage enjoyed by unprofitable companies demonstrates how far market leadership can diverge from traditional measures of quality. But when speculative leadership reverses, a portfolio built around fundamental strength may be better positioned to weather the change.

Q3 provided a striking example. Our strategy outperformed the Russell 2000 by **8.7% during Q3** and by **13.2% since May 31**. Both figures are net of fees. We believe the results are consistent with the potential benefits of a quality-focused approach during a period when market leadership shifted and speculative excesses began to unwind.

Our Portfolio

Market volatility remained elevated as investors reassessed this year's themes in Q3. Despite our portfolio's relatively low beta, we saw holdings go up/down as much as 40% during the quarter.

The strongest contributors to performance in Q3 were SPSC (a supply chain software provider), FORM (a high-quality AI supplier) and QLYS (a cybersecurity company that we have owned for many years).

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
SPCS	SPS Commerce	44.3%	Supply chain software	Trimmed in Q3
FORM	Formfactor	38.2%	AI infrastructure	New name in Q3
QLYS	Qualys	35.0%	Cybersecurity	Trimmed in Q3
HLNE	Hamilton Lane	34.9%	Investment banking	Sold in Q3
VICR	Vicor Corp	33.6%	AI power converters	New name in Q3

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
STRL	Sterling Infrastructure	-41.1%	Engineering & Construction	-
GOLF	Acushnet	-30.2%	Golf equipment	Trimmed in Q3
SMPL	Simply Good Foods	-28.5%	Snack foods	-
BWXT	BWX Technologies	-27.8%	Nuclear components for Navy	Added in Q3
YOU	Clear Secure	-24.3%	Security systems	Trimmed in Q3

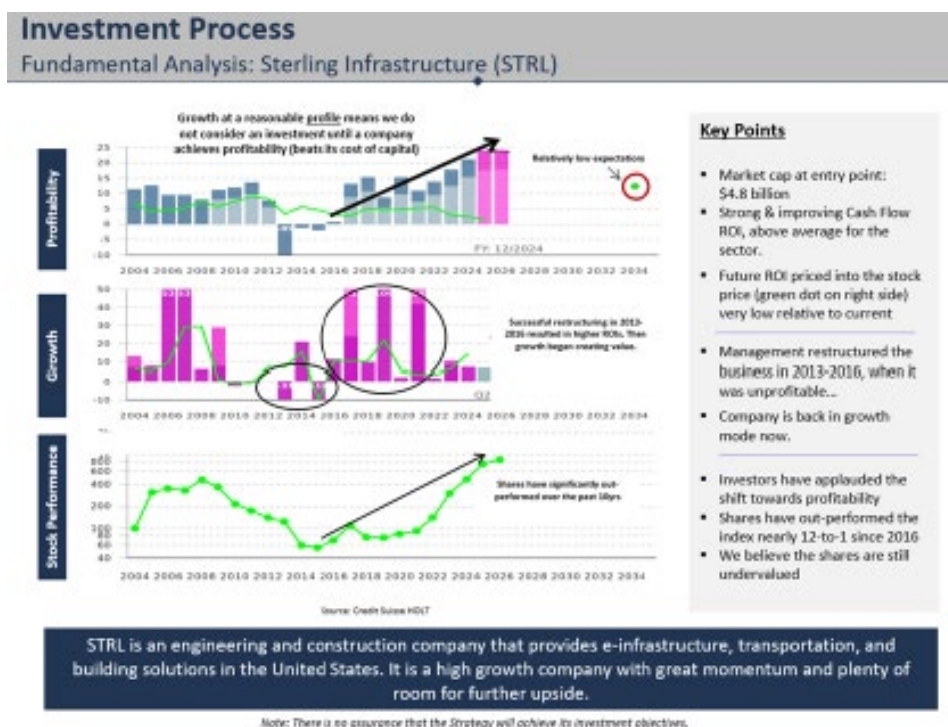
We believe all three names have additional long-term upside potential.

The weakest performers in Q3 were in the construction and consumer spending areas. STRL (our top returner in Q2) gave back about half of its gains, while inflation pressures hurt consumer holdings like GOLF and SMPL.

Key Takeaways & Outlook

- **Market leadership is shifting.** The third quarter's reversal in AI infrastructure and speculative small-cap stocks suggests investors are becoming more discriminating after the first-half rally. Although the timing and durability of this shift remain uncertain, the contrast between Q2's speculative leadership and Q3's pullback underscores the risks of chasing narrow market themes.
- **Index returns continue to mask significant dispersion.** Through September 30, the Russell 2000 had gained 13.9%, yet its median constituent was up just 0.4%. This 13.5% gap highlights how a relatively small group of winners can drive index performance while much of the broader market struggles. We believe this dispersion creates opportunities for active managers willing to look beyond headline returns and evaluate individual businesses on their fundamentals.
- **Our quality discipline remains unchanged.** Our strategy's outperformance in Q3 demonstrates the potential benefits of emphasizing business quality when speculative leadership reverses. We remain comfortable emphasizing businesses that already generate attractive returns on capital, possess sound balance sheets and deliver sustainable growth. That discipline can lag when investors aggressively pursue a narrow theme, but over a full market cycle, we believe actual cash flows and financial strength remain more dependable sources of long-term shareholder value.
- **We remain focused on long-term value creation.** We do not expect quality to lead in every market environment, nor do we assume the recent rotation will continue uninterrupted. Our focus remains on identifying attractively valued businesses with durable competitive advantages, disciplined capital allocation and the ability to compound intrinsic value over time. We believe this approach offers a sound foundation for navigating changing market leadership and pursuing attractive long-term returns for our investors.

Investment Process



Top 10 Holdings

Company	Business description	Weight	Mkt Cap (\$mm)
Qualys (QLYS)	Cyber security	5.1%	4,800
Hamilton Lane (HLNE)	Investment banking	5.0%	8,500
Sterling Infrastructure (STRL)	Engineering & construction	4.4%	10,700
Progress Software (PRGS)	Open source business apps	4.1%	1,700
Applied Industrial (AIT)	Motion/fluid/power control	4.0%	10,600
Merit Medical (MMSI)	Medical supplies	4.0%	4,900
Viper Energy (VNOM)	Oil & natural gas	3.8%	3,800
Addus HomeCare (ADUS)	Personal home care & Hospice	3.7%	1,900
American States Water (AWR)	Water Utility	3.5%	2,900
SPS Commerce (SPSC)	Supply chain software	3.5%	3,400



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