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Value Vantage Point
by Franklin Mutual Series

Smaller company stocks get back on track

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Steve Raineri

Lead Portfolio Manager
Franklin Mutual Series

While the market focus over the past few months has been on big US tech companies and the boom in artificial intelligence (AI) investment, small- and mid-cap (SMID) stocks have been quietly chugging higher. Expectations that the US Federal Reserve (Fed) could continue to trim interest rates, along with better earnings, have helped fuel the latest leg of the SMID-cap advance. We think those factors can help the group's value companies continue to deliver strong risk-adjusted returns over time.

We see solid longer-term prospects for the quality names in the group, given attractive valuations, strong earnings and a potentially more favorable regulatory backdrop.

Successful smaller company investing, in our view, comes down to active management that is focused on profitable, higher-quality SMID-cap stocks. We define quality as stocks with positive or growing earnings and low-leverage, stable business models and good corporate governance, which are also trading at depressed prices relative to their future earnings power.

Carrying a more even load

US stock market performance appears to be broadening from the singular focus on the mega-cap technology stocks that has characterized the past couple of years. While interest in AI remains intense, more economically and interest-rate-sensitive SMID-cap stocks rallied when the Fed cut interest rates in September. Should rates continue to decline, smaller companies may react positively, in our view.

Certainly, an economic slowdown could impair the short-term growth prospects of SMID-cap companies. However, those smaller, US-focused companies with strong margins, lower debt levels and robust earnings growth can fare well, in our estimation, even if the uncertainties around tariffs and the health of the US economy linger.

With small-cap valuations still relatively attractive compared to their long-term history, we believe those with solid earnings growth should be able to better deliver robust returns over time.

Earnings growth may pick up speed

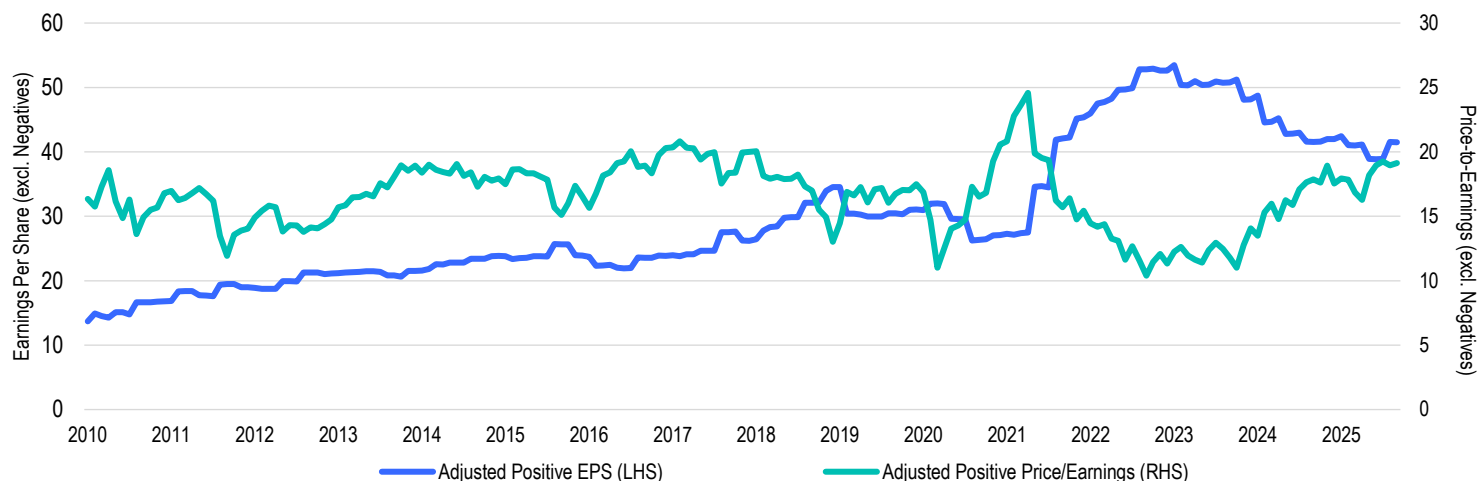
Our quality focus favors companies with positive earnings growth potential over their more challenged counterparts. SMID-cap companies have grown over time, with earnings for value companies within the SMID-cap space increasing at a 4.8% compound annual growth rate over the past 20 years, according to data from Bloomberg.

Although earnings per share have declined from their peak in early 2023, we have begun to see a rebound in recent months, along with an ongoing increase in SMID-cap valuations. (See Exhibit 1 on the next page). With the profit recovery likely just beginning, we see a long track for earnings to potentially rise and share prices to follow back to those loftier 2023 levels.

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Exhibit 1: SMID-Cap Earnings Grow as Valuations Rebound

Russell 2500 Value Index: Adjusted Positive Earnings vs. Adjusted Positive Price/Earnings
January 29, 2010–September 30, 2025



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Earnings are expected to grow 21% from 2025 to 2026, according to data from Bloomberg and index provider Frank Russell.¹ Given this expected earnings expansion, we believe the SMID- cap stocks' rebounding valuations may not fully account for climbing profits. And if the US economy slows, those quality companies that continue to boost earnings may still outperform, in our view. In all, investors can find growing, quality small- and medium-sized companies at still- appealing multiples.

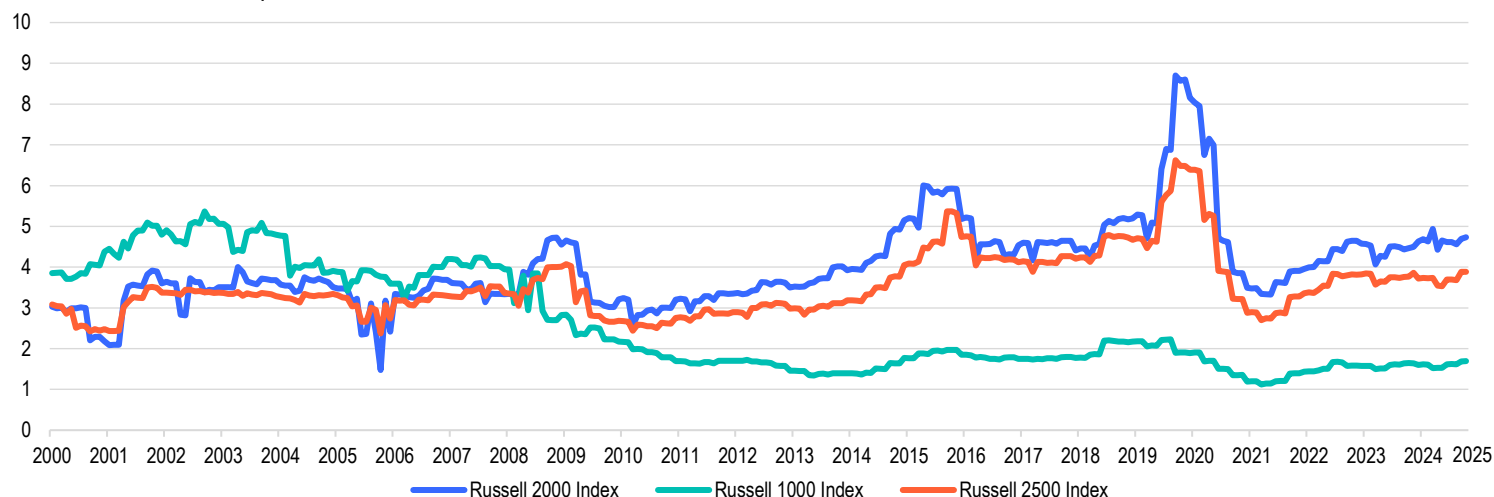
Regulatory changes provide ballast

Beyond valuations and earnings growth, recent regulatory changes and the potential for an uptick in mergers and acquisitions under the current US administration could further fuel interest in smaller companies.

Recently passed legislation allows companies to deduct more interest expense from their taxes, for one. The maximum business interest expense deduction now includes depreciation and amortization, thereby further improving profits, in our view. With smaller companies tending to hold more debt than their larger counterparts (See Exhibit 2), this change may be beneficial.

Exhibit 2: Indebted SMID-Cap Companies May Benefit from New Legislation

Russell Indexes: Net Debt to EBITDA
December 31, 2000-September 30, 2025



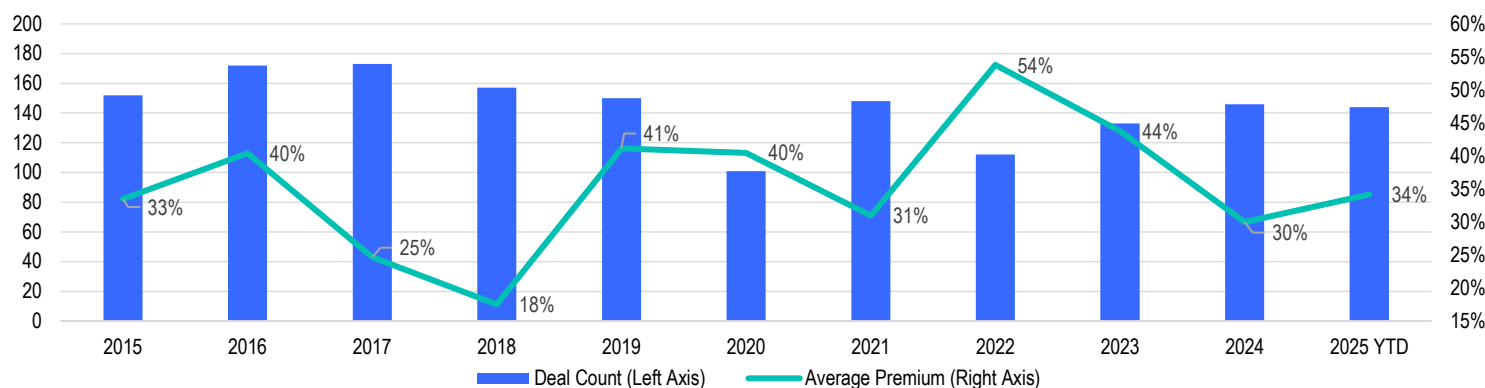
EBITDA: Earnings before interest, taxes, depreciation and amortization. Sources: Bloomberg, Frank Russell. The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe. The Russell 1000 Index measures the performance of the large-cap segment of the US equity universe. The Russell 2500 Index measures the performance of the small and mid-cap segment of the US equity universe. Frank Russell Company is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.**

The Fed's September interest-rate cut also had a positive impact on the highly indebted, lower-quality small- and mid-cap names that we tend to avoid, as they may find it easier to service their debts. However, as the benefits of interest rate cuts wane for highly indebted SMID-cap stocks, we would expect this rush into the lower-quality names to subside and quality names to take the lead.

We also see a more positive merger environment. The new administration should look more favorably on mergers and acquisitions, which could reduce barriers and be positive for smaller companies, given that they tend to be the targets of larger firms looking to expand or strengthen their businesses. We have already seen an uptick in deal activity in 2025 in small-cap stocks (See Exhibit 3) when compared with the same period in 2024, and more deal activity could be coming across the SMID-cap space.

Exhibit 3: M&A Deals Among Small Caps Have Increased

Merger & Acquisition Deals of Companies in the Russell 2000 Index
2015-October 14, 2025



Sources: Bloomberg, Frank Russell. As per Bloomberg classification, M&A, company takeover and majority purchases of companies in the Russell 2000 Index as target. Frank Russell Company is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company.

Deregulation for financial companies and other businesses could also improve the environment for small and mid-sized companies over the next few years.

SMID stocks have an open track

The Fed's rate cut, a more favorable regulatory environment and more appealing valuations, given expected earnings growth make SMID-cap stocks attractive, in our view, even after the recent advance.

SMID-cap value stocks, in particular, have delivered strong risk-adjusted returns over time. Historically, the Sharpe Ratio, which measures risk-adjusted returns, for SMID-cap value names in the Russell 2500 Value Index has been attractive over the mid to longer term. (See Exhibit 4).

Exhibit 4: SMID-Cap Value Stocks Offer Appealing Risk-Adjusted Returns

Annualized Sharpe Ratio
As of September 30, 2025



Source: FactSet. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the US equity universe. The Russell 2000 Value Index measures the performance of the small-cap value segment of the US equity universe. The Russell Midcap Value Index measures the performance of the midcap value segment of the US equity universe. Frank Russell Company is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.**

Moreover, with high concentration risk in the large-cap stock indexes, the lower correlations of mid-cap and small-cap companies compared to their larger counterparts make them good portfolio diversifiers, in our opinion.

Active stock selection in the SMID-cap universe remains crucial to finding quality names that can outperform, particularly given the limited analyst coverage. Additionally, with a broader set of opportunities, active management means portfolios can move up and down the market-cap spectrum to best take advantage of opportunities wherever they arise among small- and mid-cap stocks. SMID-cap stocks may be in the early days of an advance; we believe it is time to get on board.

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Endnote

1. There is no assurance that any estimate, forecast or projection will be realized.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

The **investment style** may become out of favor, which may have a negative impact on performance.

Equity securities are subject to price fluctuation and possible loss of principal. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks. There can be no assurance that **multi-factor stock selection** process will enhance performance. Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods.

Active management does not ensure gains or protect against market declines.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

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A **concentration of investments in certain securities, regions or industries** is subject to increased volatility.

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