Mispriced Opportunities in U.S. Small Caps

April 2026

Brown Advisory Small-Cap Fundamental Value Strategy:

- The Strategy has been managed by David Schuster since its inception in 2008, seeking attractive risk-adjusted returns by identifying and capitalizing on market inefficiencies within the small-cap value asset class, focusing on companies with strong and persistent free cash flow, prudent capital management and attractive valuations.
- The U.S. remains a highly dynamic environment for innovative smaller companies, and we believe it offers a compelling opportunity set for disciplined, long-term, value-oriented investors. Talen Energy is an example of a company held in the portfolio, illustrating how overlooked businesses with improving fundamentals and attractive valuations can create compelling upside potential.[1]

History has proven that timing markets is a daunting task. The preference for growth stocks in recent times has led to the virtues of value investing being largely overlooked. Yet, instead of arguing why value is now ripe for a comeback, perhaps it is more helpful to remind investors why value remains a proven investment strategy, particularly within the less well-researched U.S. small-cap market. Recent market dynamics have further reinforced the relative opportunity with small-caps having outpaced their larger-cap peers, and value outperforming growth, reinforcing the case for a selective, long-term approach.

In simple terms, value stocks are often defined as companies that are trading at a discount to their intrinsic value. Frequently, these are well-established companies with steady profits that tend to redistribute those cashflows back to investors in the form of dividends or share buybacks. The goal of value investing is finding stocks that are not only undervalued but also well-positioned to regain their fair value over time. In small caps, this opportunity can be enhanced when corporate complexity, lower sell-side coverage or temporary dislocation leave a company misunderstood. In other words, these companies present a favorable risk/reward for selective and patient investors.

> "The market price of a stock often does not reflect a company's true value – particularly in the small-cap universe. We focus on businesses with persistent free cash flow and management teams that allocate capital effectively. The U.S. remains a highly dynamic environment for innovative smaller companies, and we believe it offers a compelling opportunity set for disciplined, value-oriented investors seeking differentiated sources of return in an increasingly complex market environment."
>
> *– David Schuster, Portfolio Manager*

While the identification of such outperformers is largely down to good stock selection, the small-cap value opportunity set can become particularly attractive when dispersion widens and investors reward durable cash generation and reasonable valuation. Historically, value stocks generally perform well during periods of high inflation and rising interest rates, as these conditions lead investors to seek out companies with strong fundamentals and stable earnings. The higher free cash flow yields offered by value stocks can provide a steady income stream that is especially appealing during times of economic uncertainty. Consequently, in an economic slowdown or during turbulent market conditions, value companies' reliable and durable business models can often present a stark contrast with their growth peers by offering greater stability and downside protection. Finally, there have occasionally been prolonged periods of time where value stocks have fallen out of favor with investors. Such environments can enhance the valuation discounts of unloved stocks, particularly in relation to highly-valued growth stocks and create an even more compelling reason to include value within a portfolio.

What Value Means To Us

The term "value" can undoubtedly mean many things to investors, including deep value and relative value approaches. Our small-cap value framework is distinct in that it focuses in on an assessment of free cash flow, valuation disparity and capital allocation discipline within an inefficient part of the market.

Our definition of value is centered on three distinct criteria that have guided the Strategy since launch in December 2008: free cash flow, valuation and capital allocation.

1. **Free cash flow**: We aim to invest in companies with attractive and durable free cash flow that we believe have the potential to generate returns through both good and bad times.
2. **Valuation**: We seek those companies that trade at a discount. We believe identifying stocks that meet this combination can deliver downside protection as well as provide optionality on the upside over time.

3. **Capital allocation**: We scrutinize capital allocation. If a company is generating a lot of free cash flow, we explore what it is doing with that capital and how it is being allocated. We favor management teams that allocate excess cash thoughtfully, whether through disciplined reinvestment, balance sheet improvement, recurring dividends or share repurchases.

A common misconception about value investing is that it equates to a sacrifice in quality. In our view, the value universe is full of attractive franchises that generate high levels of sustainable free cash flow with defensible market positions and good financial flexibility.

Such companies exhibit capital discipline and trade at attractive valuations, which can lead to compelling risk-adjusted returns over the long term while providing a margin of safety for investors.

In Small-Cap Fundamental Value, we aim to be highly discerning in terms of the value companies that make it into our portfolio. Rather than relying on a rule-based screening approach alone, we generate ideas from multiple sources, including screening, analyst coverage and corporate actions, and then pursue a highly active research effort across the small-cap universe. The team actively researches roughly 250 companies per year, begins with an initial screening call to determine next steps, and often maintains dialogue with management teams over multiple years. Our due diligence is designed to understand industry dynamics, review public disclosures, interview management teams and build financial models that quantify both upside potential and downside risk, with particular emphasis on cash flow sustainability and current operating results rather than distant projections. We are benchmark-aware, but not benchmark driven, and seek to continually optimize upside/downside across a concentrated portfolio.

By consistently applying these rigorous principles, we believe we can develop a differentiated perspective on companies' prospects and build a portfolio designed to navigate a range of market environments over the long term.

Conclusion

The market price of a stock often does not reflect a company's true value – particularly in the small-cap universe, where inefficiencies and limited coverage can create persistent mispricing. By focusing on businesses with durable free cash flow and management teams that allocate capital effectively, we seek to capture that disconnect over time.

Today, as dispersion in fundamentals and valuations continues to widen, we believe the opportunity to identify mispriced companies is becoming more pronounced. We see an opportunity where patient, selective investors are increasingly well positioned to uncover overlooked opportunities and generate attractive long-term returns.

To find out more about our Small-Cap Fundamental Value Strategy, please visit our website.

CASE STUDY: TALEN ENERGY[1]

Within the U.S. small-cap universe, value opportunities can emerge when limited research coverage, corporate transitions or temporary complexity leave a business misunderstood. Sometimes a stock is simply overlooked, or there may be corporate actions on the horizon. Often, this is a result of the non-traditional way in which the company goes public.

Talen Energy is an independent power producer with a flagship nuclear plant in Pennsylvania. This business had previously gone bankrupt in 2022 after being over-leveraged and under-hedging its input costs under private equity ownership. The restructured entity, Talen Energy, emerged in 2023 with an appropriate capital structure and unburdened by many legacy environmental and pension liabilities. It had an attractive set of cash-generating assets and a motivated management team but lacked sell-side coverage. Its valuation was attractive and it also traded at a significant discount to other nuclear power-oriented utility companies.

Electricity pricing has been under significant upward pressure over the past several years due to several factors. Data center growth has been an increasingly significant user of base load electricity. Talen has a long-term power purchase agreement with Amazon Web Services (AWS) for a significant portion of the power from its nuclear facility. The re-shoring of industrial capacity, along with a continued trend towards electrification, has also increased demand. In addition, supply growth has been muted by a lack of new generation capacity, along with continued closures of coal-fired plants.

We believe Talen reflects several elements central to our Small-Cap Fundamental Value approach: a more durable free cash flow profile following restructuring, improved capital structure, a management team focused on shareholder value creation and an attractive valuation. It also has a business model with a significant portion of the revenues tied to a long-term contract. And finally, we believe there is the potential for a strategic sale (via a mergers & acquisitions (M&A) exit) that would further enhance the overall investment.

1. Source: Talen Energy is a current holding in the U.S. Small-Cap Fundamental Value portfolio as of 03/31/2026 and was selected on a discretionary basis for illustrative purposes only because the investment team believes it demonstrates the strategy's stated investment and value philosophy; It does not represent all of the securities purchased, sold or recommended for advisory clients and is not intended to represent or imply that the strategy's investment decisions were or will be profitable or that this example is indicative of the strategy's overall performance or effectiveness. Portfolio information is based on a representative Small-Cap Fundamental Value account.

Disclosures

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Terms and Definitions:

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value. Without cash, it's tough to develop new products, make acquisitions, pay dividends and reduce debt.

Free Cash Flow Yield (FCF Yield) is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share.