Confluence Investment Management

A Narrow Market

"The four most dangerous words in investing are: this time it's different."

– Sir John Templeton

SETTING THE STAGE

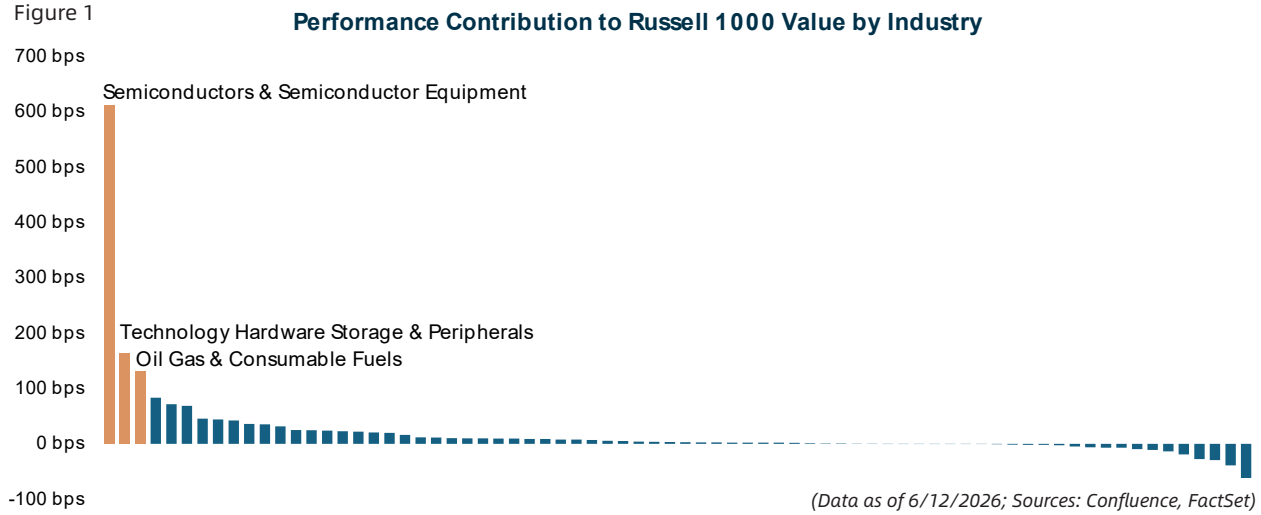
In two earlier publications, we examined the construction and evolution of the Russell 1000 Value Index. In "Shining a Light on Indexes," we explored the inherent limitations of passive, market cap-weighted benchmarks and why their composition and risk profile can diverge meaningfully from the strategies that use them as reference points. In "Understanding the Benchmark," we took a closer look at how the Growth and Value indexes are structurally linked, demonstrating how the extraordinary concentration of market capitalization in a small group of mega-cap growth companies has pushed the Value index to absorb businesses that, by traditional measures, would not have been considered value stocks at all. Together, these pieces made the case that the indexes are more complex and dynamic instruments than they might appear.

We now examine the current return profile of the Russell 1000 Value Index, which offers a real-time illustration in narrow market leadership and why understanding it matters for evaluating active managers during periods like this one.

A NARROW MARKET

Through June 12, 2026, the Russell 1000 Value Index is up approximately 14% – a stellar start to the year by any measure. Performance like this can create the impression of broad-based economic strength, and it would be reasonable for the average investor to assume those gains reflect health across a wide range of businesses. When one looks beneath the surface, however, a very different story emerges.

Figure 1



(Data as of 6/12/2026; Sources: Confluence, FactSet)

Over 60% of the Value index's year-to-date return through mid-June was driven by just three industry sub-sectors: Semiconductors & Equipment, Technology Hardware Storage, and Oil & Gas (Figure 1, previous page). Both Semiconductors and Tech Storage are direct beneficiaries of AI infrastructure spending, while the Oil & Gas sub-sector has been lifted by geopolitical tensions. Performance in 2026 has been extremely narrow, with a small subset of stocks generating a disproportionate share of index returns.

If we sort every constituent of the Russell 1000 Value by its individual contribution to index performance and place them into deciles (Figure 2), this dispersion becomes even more striking. The index's 14% year-to-date return, as of 6/12/2026, is almost entirely concentrated in the top decile of contributors. The top-performing 10% of stocks generated over 15% of return for the index, while the bottom 90% collectively detracted 1%. The top 20 contributors alone account for nearly 75% of the benchmark's total return.

A closer examination of the top decile (Figure 3) reveals that these businesses delivered below-average growth over the past three years, yet forward estimates call for sharp acceleration, and valuation multiples have expanded dramatically.

Figure 2

Decile	Companies	Average YTD Total Return	Contribution to R1000V Performance (bps)
1st	87	66%	1,560
2nd	87	38%	197
3rd	87	29%	91
4th	87	21%	46
5th	86	13%	22
6th	86	11%	5
7th	86	-10%	(5)
8th	86	-14%	(23)
9th	86	-20%	(65)
10th	86	-22%	(375)
Top 20	20	132%	1,092

(Sources: Confluence, FactSet)

Figure 3

		Last 3 Years Median growth (FY-2, FY-1, FY0)			Current and Next Year Median growth (FY1, FY2)			FY1 Valuation		
Decile	Companies	Sales	EBITDA	EPS	Sales	EBITDA	EPS	EV/ Sales	EV/ EBITDA	PE
1st	87	3.4%	4.4%	4.7%	9.4%	15.6%	16.0%	5.9x	19x	26x
2nd	87	4.3%	5.8%	5.5%	6.3%	9.6%	11.8%	3.6x	14x	21x
3rd	87	3.4%	6.1%	4.7%	5.2%	8.0%	8.9%	3.7x	14x	21x
4th	87	3.7%	3.9%	6.2%	4.5%	7.3%	9.9%	2.8x	13x	19x
5th	86	4.0%	5.4%	5.3%	4.8%	7.0%	9.7%	3.5x	12x	19x
6th	86	2.7%	1.7%	2.8%	4.8%	6.8%	9.8%	3.1x	12x	17x
7th	86	5.0%	6.1%	5.3%	5.6%	8.0%	11.1%	2.8x	12x	17x
8th	86	5.0%	7.8%	7.8%	4.6%	7.0%	8.9%	2.3x	10x	13x
9th	86	6.5%	8.5%	9.7%	5.5%	6.9%	9.2%	2.1x	11x	15x
10th	86	6.0%	7.2%	9.0%	6.8%	7.8%	10.2%	3.4x	12x	15x
Top 20	20	4.4%	3.9%	3.3%	18.2%	27.4%	30.4%	10.2x	27x	30x

(Sources: Confluence, FactSet)

BIG AI WINNERS

The top 20 contributors to the Russell 1000 Value's year-to-date performance (Figure 4) are dominated by businesses riding the demand wave created by the massive artificial intelligence (AI) capital expenditure cycle.

Figure 4

	Ticker	Company	Sector	YTD Total Return	YTD Performance Contribution (bps)
1	MU	MICRON TECHNOLOGY INC	Information Technology	244%	259
2	INTC	INTEL CORPORATION	Information Technology	238%	128
3	SNDK	SANDISK CORP	Information Technology	734%	81
4	AMD	ADVANCED MICRO DEVICES INC	Information Technology	139%	67
5	AMAT	APPLIED MATERIAL INC	Information Technology	121%	59
6	CSCO	CISCO SYSTEMS INC	Information Technology	58%	58
7	GOOGL	ALPHABET INC CLASS A & C	Communication	15%	57
8	MRVL	MARVELL TECHNOLOGY INC	Information Technology	229%	53
9	CAT	CATERPILLAR INC	Industrials	59%	46
10	WDC	WESTERN DIGITAL CORP	Information Technology	227%	45
11	XOM	EXXON MOBIL CORP	Energy	24%	38
12	JNJ	JOHNSON & JOHNSON	Health Care	18%	27
13	DELL	DELL TECHNOLOGIES INC CLASS C	Information Technology	215%	26
14	ADI	ANALOG DEVICES INC	Information Technology	55%	24
15	GLW	CORNING INC	Information Technology	105%	24
16	UNH	UNITEDHEALTH GROUP INC	Health Care	24%	24
17	TXN	TEXAS INSTRUMENT INC	Information Technology	75%	23
18	CVX	CHEVRON CORP	Energy	25%	22
19	GS	GOLDMAN SACHS GROUP INC	Financials	22%	17
20	LIN	LINDE PLC	Materials	24%	15

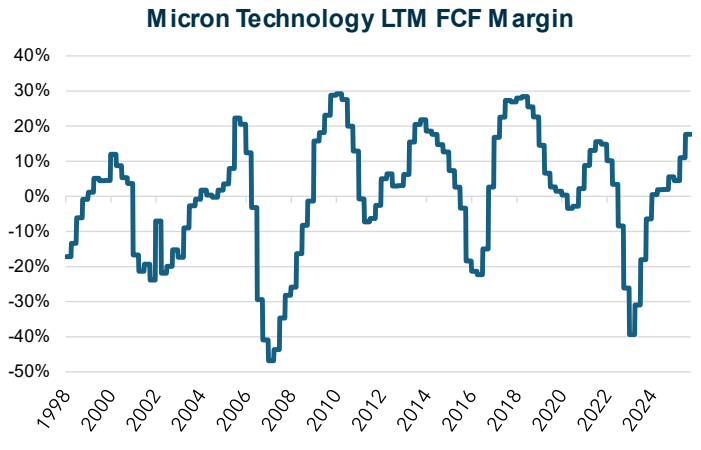
AI / Related Components	
Datacenter Buildout	
Top 20 Total:	1092

(Sources: Confluence, FactSet)

Many of these businesses reside in the Value index because they are low-growth, highly cyclical, and capital-intensive, which are characteristics that have historically resulted in relatively low valuation multiples. The components that many of these companies produce share commodity-like characteristics, with pricing power that fluctuates dramatically based on industry demand and capacity. This stands in contrast to businesses that possess durable pricing power derived from genuine competitive advantages.

Consider Micron Technology (MU), which has contributed over 250 basis points to index performance this year. Micron manufactures memory chips – effectively a technology commodity. This is evident in its historical free cash flow margins (Figure 5), which exhibit extreme cyclicality. When demand outstrips manufacturing capacity, prices rise and cash flow is generated. Customers double- and triple-order to secure supply, and the industry builds new capacity. That capacity then overshoots demand, prices fall precipitously, and the cycle repeats. From the peak of the tech bubble in 2000 to the financial crisis in 2008, Micron's stock fell 98%. Through the end of May, the stock was up over 15x since last summer. Having enjoyed its run inside the Value index, Micron is set to migrate to the Russell 1000 Growth Index at the June reconstitution.

Figure 5



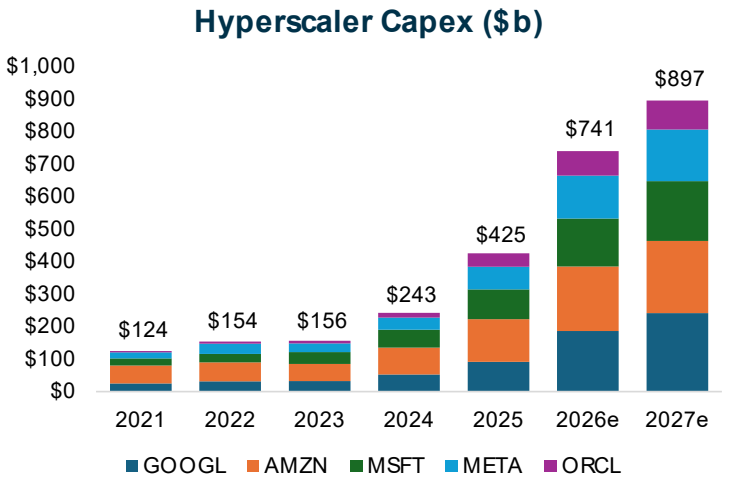
(Sources: Confluence, FactSet)

CAPEX FRENZY

When ChatGPT launched in late 2022, the public encountered a genuinely remarkable technology: large language models (LLMs) capable of answering questions, performing analysis, and reasoning creatively in conversational format. The capabilities of these systems have advanced rapidly, with research labs releasing progressively more powerful models. Hallucinations have become less frequent, and the ability of models to write code has enabled people with no software background to build applications in hours that would previously have required teams of developers working for weeks. Complex, multi-stage tasks can now be delegated to coordinated AI agents that troubleshoot and iterate in the background before delivering a finished product.

As greater computing power has been deployed toward training and running these models, their capabilities have continued to scale. The result has been an extraordinary capital expenditure cycle (Figure 6) in which enormous financial resources are being deployed to procure computing hardware, build data centers, and train the next generation of models. The five largest hyperscalers are expected to spend over $700 billion on capital expenditures in 2026 alone.

Figure 6



(Annual data as of 12/31/2025; Sources: Confluence, FactSet)

Much of this capital comes from mega-cap businesses that have historically generated substantial free cash flow and managed pristine balance sheets. The degree of investment has reached a level that not only consumes available cash flow but, in several cases, is now being supplemented with debt. In addition, sizeable off-balance-sheet liabilities tied to future data center lease commitments have emerged. In total, a tremendous financial bet on AI has been placed. However, given the evolving economics of the AI industry, the prospective returns on this investment remain highly uncertain.

On the cost side, the surge in demand for hardware has caused severe supply-demand dislocations, driving prices sharply higher not only for advanced proprietary components such as NVIDIA's GPUs, but also for relatively undifferentiated, commoditized parts. On the revenue side, the pricing of AI services remains unsettled as model companies wrestle to determine what individuals and enterprises will sustainably pay. Early evidence raises questions. Several companies have reported burning through their annual AI budgets in a matter of months, with executives openly questioning whether spending is generating economic returns commensurate with its cost. Further complicating the picture is the circularity embedded in many large AI deals (Company A invests in Company B so that Company B can purchase products from Company A).

Businesses deploy capital when they believe the return on that capital will be attractive. At this moment, unprecedented sums are being invested not on the basis of demonstrated returns, but on the conviction that AI will prove transformative and that underinvesting would be competitively catastrophic. That assumption may prove correct, but overinvestment is also a risk.

HISTORY RHYMES

> *"The two most important industries in the first half of this century were the auto industry and the airplane industry...you might have thought it was a great way to get rich. But very, very few people got rich by riding the back of that auto industry. And probably even fewer got rich by participating in the airline industry. Millions of people are flying around every day. But the number of people who've made money carrying them around is very limited."*
>
> *– Warren Buffett, 1999*

The history of major technological innovation cycles tells a consistent story. The advent of railroads, automobiles, airplanes, and the internet each triggered a frenzy of capital deployment, grounded in the reasonable belief that the underlying technology would prove transformative. Each time, that belief was correct. What these episodes have in common is that they functioned as what economists call "productive bubbles." The infrastructure built during the mania created enormous and lasting economic gains for consumers and society, while much of the capital deployed in building it was ultimately destroyed. Investors funded the future but didn't get to keep much of the return.

The AI capex cycle has hallmarks of a similar moment and there is a further distinction worth noting. The infrastructure laid during prior technology cycles – railroad track, copper wire, fiber optic cable – had useful lives measured in decades and retained value long after the companies that built it went bankrupt. The physical assets of the current AI cycle are different in character. GPUs and specialized AI chips depreciate rapidly, become obsolete within a few years as newer architectures emerge, and carry questionable residual value. As a result, the capital being deployed in this cycle may be destroyed more quickly than in those that preceded it.

Within the Value index, there are 22 stocks that are up over 100% in less than six months, all beneficiaries of AI-related infrastructure spending. Most of these businesses are mature, slow-growth, capital-intensive, and cyclical, yet they are currently exhibiting growth characteristics and garnering expanded valuation multiples due to the AI capex cycle. They do not possess the attributes that we believe are required for long-term compounding. Their current strong performance is less about possessing deep competitive moats; rather, they are benefiting from being in the path of one of the largest capital waves in history.

PHILOSOPHY AS THE FOUNDATION

At Confluence, we have consistently adhered to the same investment philosophy since inception. Through deep fundamental business analysis, we seek to identify companies that possess durable competitive advantages, generate excess free cash flow, maintain conservative balance sheets, and are led by experienced managers who think like owner-operators. We believe concentrated portfolios of such businesses will outperform over the long term, measured across full business cycles. We attempt to invest in them with a margin of safety by purchasing at a discount to our estimate of intrinsic value.

This philosophy has served our clients well. In the current environment, many businesses that do not meet our investment thresholds are enjoying dramatic outperformance, and it can feel painful to watch from the sidelines. But for the philosophy to work, it must be applied consistently. We experienced a similar environment during the technology bubble at the turn of the millennium. Joining the party would have required abandoning our process and ultimately would have proven costly. When the bubble burst and markets crashed, our discipline paid off as performance recovered and our strategies demonstrated strong downside protection in comparison.

We believe AI will be transformative, and we expect many of the high-quality businesses in our portfolios will leverage it to become more efficient and deepen their competitive advantages. Nevertheless, attempting to time the market, by riding the wave and exiting at precisely the right moment, is a difficult and unreliable strategy. We will continue to adhere to our philosophy, confident that discipline today will serve our clients well over time.

Mark Keller, CFA | Tore Stole | Tom Dugan, CFA | Dustin Hausladen | Brett Mawhiney, CFA | John Koenig, CFA
Dan Winter, CFA | John Wobbe | Joe Hanzlik | Blair Brumley, CFA | Ben Kim, CFA

For more information, contact a member of our Sales Team:

(314) 530-6729 or sales@confluenceim.com

See Territory Map on the Confluence website for sales coverage

DISCLOSURES

Figures 1-4: data as of 6/12/2026, reflecting constituents of the iShares Russell 1000 Value ETF (IWD); Figure 5: data as of 5/22/2026; Figure 6: annual data as of 12/31/2025.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. Information is published for educational/illustrative purposes only and should not be construed as individualized advice or a recommendation. Information is based upon sources and data believed to be accurate and reliable. Forecasts of financial market trends are subject to change without notice. Opinions, estimates, and forward-looking statements are as of a certain date and subject to change without notice. Opinions expressed do not constitute investment, legal, tax, accounting or professional advice.

Confluence Investment Management LLC is an independent Registered Investment Advisor that was founded in 2008. References to investment history prior to 2008 occurred while the investment team was affiliated with a prior firm and the Portfolio Management Team members were the primary individuals responsible for selecting the securities to buy and sell.

Always consult an adviser regarding the legal, tax, and financial suitability of securities investing. Such information should not be relied upon for, or in connection with, the making of investment decisions and does not constitute a solicitation or an offer to buy or sell securities or recommendation of any investment strategy. The investments or strategies discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Investing in securities involves the risk of loss of the amount invested that investors should be prepared to bear. There can be no assurance that any investment objective will be achieved or that any investment will achieve profits or avoid incurring losses. Investor results will vary, and past performance is not indicative of future results, which will fluctuate as market conditions change.

Please refer to our current written disclosure statement for a description of the risks associated with our investment strategies. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses. Investor results will vary, and past performance is not indicative of future results, which will fluctuate as market conditions change. A copy of Confluence's current written disclosure statement discussing our business operations, services, and fees is available upon request.