

TOWLE & CO.

October 22, 2025

“It was the best of times, it was the worst of times...” — *A Tale of Two Cities*

A narrow set of mega-cap tech companies continues to pull the indices higher on the back of artificial intelligence (AI) enthusiasm and aggressive capital spending. The five largest stocks now have a combined market capitalization equal to 60% of U.S. GDP, yet their aggregate revenues represent only 6.5% of GDP and their net income just 1.6%. Simultaneously, small and mid-cap cyclical stocks have been working through a multi-year earnings recession and a long stretch of negative investor flows. Depending on which “city” you inhabit, it has indeed felt like the best of times or the worst of times.

In the third quarter, the Towle Value Composite (TVC) rose 7% net of fees versus 13% for the Russell 2000 Value; both are up ~18% net since March 31, with the benchmark’s recent strength aided by non-earners in today’s risk-on environment. **As ever, we remain focused on what matters for long-term performance.**

TVC returns are highlighted below, alongside benchmark results, with periods greater than one year annualized:

<i>Periods ending 9/30/25</i>	<i>TVC (Gross of fees)</i>	<i>TVC (Net of fees)</i>	<i>Russell 2000 Value</i>	<i>S&P 500</i>
Quarter	7.24	6.98	12.60	8.12
YTD	1.53	0.78	9.04	14.83
1 year	2.60	1.58	7.88	17.60
3 years	8.99	7.91	13.56	24.94
5 years	13.84	12.71	14.59	16.47
10 years	9.29	8.21	9.23	15.30
20 years	7.67	6.60	7.27	10.97
30 Years	11.35	10.25	9.25	10.47
Inception (1/1/82)	14.33	13.20	11.23	12.24

*Returns are preliminary and subject to change. Past performance is no guarantee of future outcome.
Please refer to the last page for additional disclosures.*

Investment Environment

“...it was the age of wisdom, it was the age of foolishness...” — *A Tale of Two Cities*

It is often in the best of times that foolishness quietly takes root. Rising markets and economic enthusiasm can create a sense of inevitability and uninterrupted progress. And yet, history shows that this confidence can also stretch valuations, dull discipline, and test the patience of those who measure value in earnings rather than narratives.

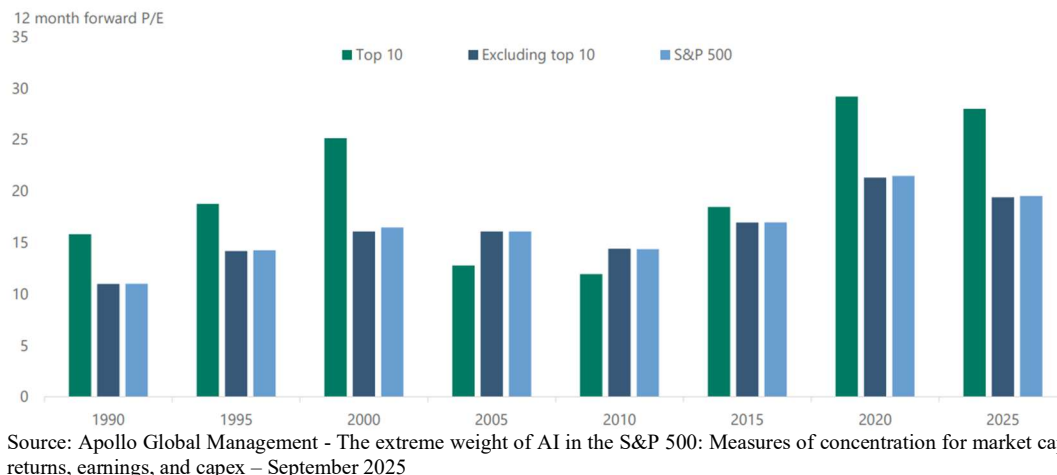
The Best of Times & The Age of Foolishness

At the outset, let us be clear: in all likelihood, AI will be a profoundly transformative technology, potentially unlike anything that has come before it. Yet even transformative technologies are not exempt from speculative excess, and AI today almost certainly trades at valuations ahead of its current economic reality. Nearly every major technological breakthrough—railroad, radio, computers, the Internet, shale oil—stoked a financial bubble alongside its progress. This is not a condemnation, only a recognition that capital markets have historically overshot before settling into reality.

The “Magnificent Seven” and their ecosystem have delivered staggering equity and economic performance. Few need a reminder how rewarding it has been to own NVDA, AMZN, MSFT, and GOOG in recent years. OpenAI, still private, just hit a \$500B valuation as part of a deal to let insiders sell shares. This surge in equity value is no accident – AI investor demand has been extraordinary.

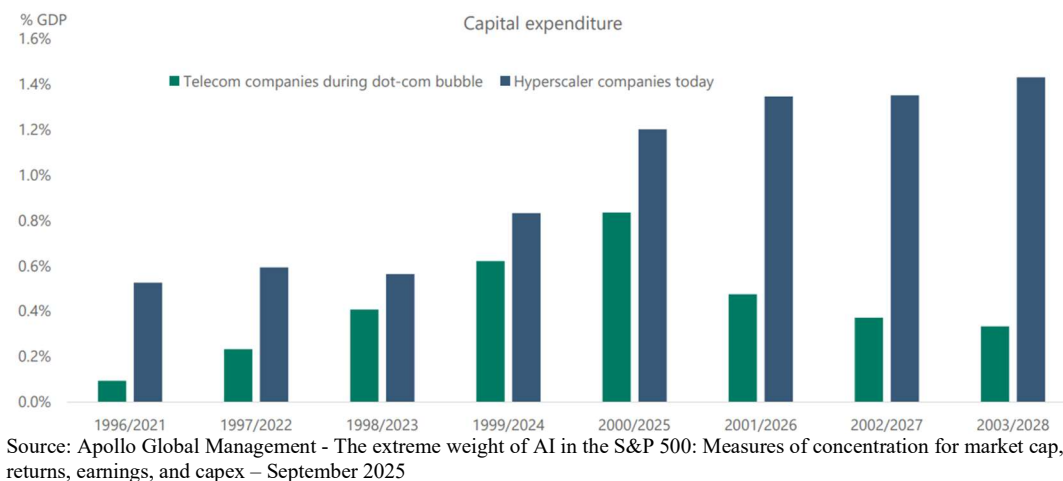
Unsurprisingly, the Buffett Indicator (an economy-wide P/E ratio) now sits at all-time highs, driven by investor optimism. **Various other valuation measures also point to overheating. Apollo Global Management’s Torsten Slok notes that on a forward P/E basis today’s S&P 500 is more expensive than in 2000:**

The AI bubble today is bigger than the IT bubble in the 1990s



But the go-forward profitability math is starting to change. Hyperscaler capital expenditures have surged to levels not seen since prior bubbles (see chart below). According to some measures, the AI buildout has accounted for half of recent U.S. GDP growth. But whether that capex will deliver healthy returns is debatable. **Estimates suggest GPUs, which make up roughly half the cost of a new data center, have a useful life of only about three years. Unlike the railroads of the late 1800s or the fiber networks of the early 2000s, much of today’s AI infrastructure is short-lived and will demand replacement in a few short years.**

Capital expenditure share of GDP much higher for hyperscalers today vs telecom companies during dot-com bubble



Maybe this time is different – but history counsels caution. We feel the market’s current AI underwriting rests on several dubious assumptions: rapid and sustained monetization of massive capex outlays, abundant inputs (especially power), and muted competitive response even as many build capacity at the same time. If returns on incremental capital prove merely *good* rather than *extraordinary*, valuations will likely compress where expectations are highest and re-rate upward where expectations are lowest. That, historically, is when value has caught up.

Interdependence is also extreme. In the first half of 2025, 35% of NVIDIA's revenue came from just two customers. In Q3, NVIDIA pledged a \$100B equity investment in OpenAI, which then signed a \$300B contract for Oracle's cloud infrastructure after which Oracle committed \$40B to buy NVIDIA chips. Diversification is fleeting and the system appears quite sensitive to a single point of failure. What happens when data center profitability falters under the weight of overcapacity?

To be clear, we are not anti-technology. We favor companies that don't require perfection – protecting client capital and ours through prudence, longevity, and alignment. AI may be transformative, but transformation does not guarantee valuation immunity.

History teaches that the best of times often breed foolishness. Recent years have offered plenty of examples: NFT and meme-stock manias, SPAC booms and crypto busts, leverage blowups like Archegos, bank failures such as SVB and First Republic, and speculative detours through metaverse land grabs, celebrity tokens, and zero-day option frenzies. We've seen crypto-treasury companies trade at twice the value of their holdings, multi-billion-dollar bankruptcies linked to dubious financing (First Brands), and multi-billion-dollar capital raises for companies with no revenue or business plan (Thinking Machines). Each episode reflects a collective suspension of judgment – the fuel of financial bubbles.

The point is not moral or intellectual superiority – it's risk calibration. Prices can outrun fundamentals for a while, but reality eventually reasserts itself. **Discipline matters most during periods of rapid change and investor enthusiasm.**

The Worst of Times & The Age of Wisdom

While the “best of times” has favored large-cap growth, the “worst of times” remains a more fitting description for small-cap value. If this is also the “age of wisdom,” OpenAI CEO Sam Altman offered a candid dose of it during an August 2025 dinner with reporters. Reflecting on investor enthusiasm surrounding artificial intelligence, Altman stated:

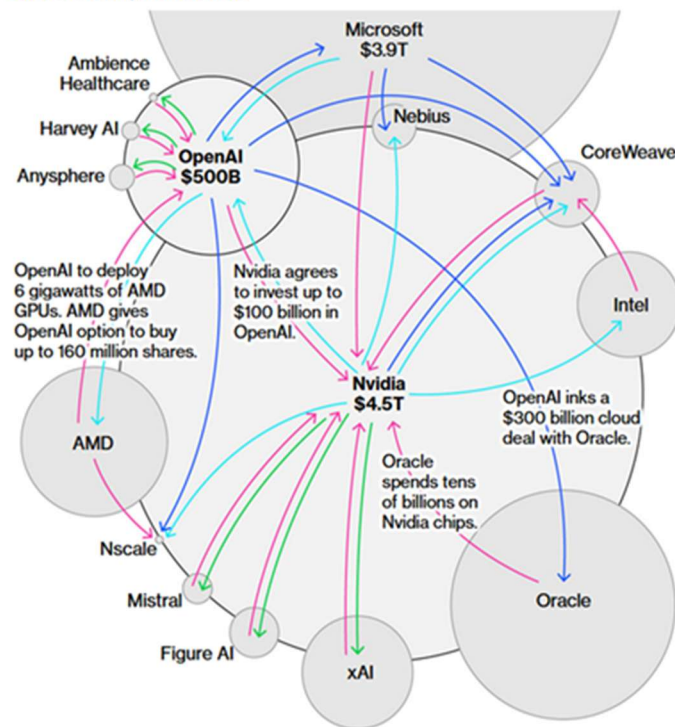
“When bubbles happen, smart people get overexcited about a kernel of truth. ... Are we in a phase where investors as a whole are overexcited about AI? My opinion is yes. ... Someone is going to lose a phenomenal amount of money. But that doesn't mean the underlying thing isn't real. AI is going to be transformative.” - Sam Altman, quoted by Alex Heath and Emma Roth, The Verge, August 15, 2025.

Altman's observation captures a timeless market truth: prudence returns only after excess runs its course. Today, we believe wisdom means balance – and attention to undervalued asset classes left behind.

Towle & Co. continues to live and breathe small-cap value. The past two years have been marked by earnings contraction, tighter credit, wage inflation, and higher rates that compressed margins and valuations. Fundamentals have been pressured, and ownership has thinned. Yet we see an outlook that is brighter than sentiment implies. Research from Royce

How Nvidia and OpenAI Fuel the AI Money Machine

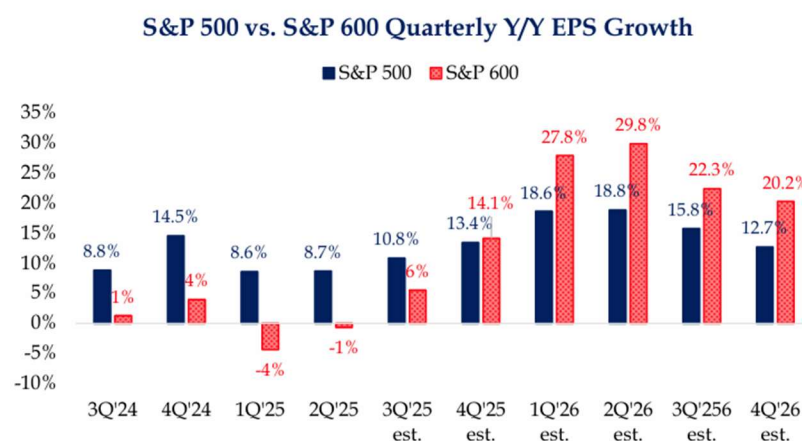
Hardware or Software Investment Services Venture Capital
Circles sized by market value



Source: Bloomberg News reporting

Investment Partners and from Strategas Securities projects small-cap earnings growth surpassing large caps in 2026–27 – the first sustained period of relative outperformance in years.

In addition, structural tailwinds appear to be building: industrial reinvestment, grid expansion, and infrastructure spending – all benefiting small-cap suppliers, logistics firms, and service providers. AI is also lowering operating costs for many smaller operators, boosting efficiency in legacy industries. Cyclically, 2026 may bring a consumer-driven uptick, aided by events like the World Cup and America’s 250th anniversary, while China’s capacity discipline should reduce dumping pressure on U.S. producers. Investment flows are turning too, with family offices shifting from private equity toward public markets, including the first small-cap inflows since January.



Source: Strategas, Bloomberg, Data as of 9/24/25

We do not need heroics for future returns to improve; simply a return to more normal conditions, ongoing cost discipline, and a modest revival of investor interest could create the opportunity for compelling performance. Our focus remains on well-capitalized businesses with high earnings potential, positioned to thrive as the cycle turns. **While recent years have tested our patience, they have also reinforced our discipline. Wisdom, after all, is rarely forged in easy markets.**

Quarterly Portfolio Review

This section has been removed for compliance reasons to exclude discussing specific securities transactions.

Process Evolution: Capital Efficiency in Practice

Throughout our history, we have remained firmly rooted in the timeless principles of value investing. While we continue to focus on companies trading at depressed multiples to revenue and earnings potential, the lessons along the way have heightened our resolve to continually refine and strengthen our investment process, ensuring it evolves with changing markets.

Following years of deep research and firsthand experience, we’ve come to appreciate an important insight: within the low-valuation universe, companies that attract investor interest – evident in constructive stock price behavior and often grounded in genuine business strength – can deliver outsized returns. These are the companies that pair attractive valuations with discipline, financial resilience, and consistent execution. When such characteristics align, they can transform undervaluation into an attractive compounding advantage for investors.

We are carefully and deliberately integrating this understanding into our security selection process. In practice, we believe this will foster a meaningful improvement in the efficiency with which we deploy capital. By investing in businesses exhibiting constructive stock price behavior, our research indicates great potential reductions in common value pitfalls: catching falling knives, buying companies with perpetually deteriorating fundamentals, and remaining invested in names that fail to appreciably progress over time.

Balancing attractive valuations with evidence of sponsorship aims to strengthen our discipline, sharpen the timing of our entry points, and deploy capital towards businesses demonstrating both fundamental improvement and market recognition. **This evolution, grounded in years of study and observation, represents a significant refinement in our investment process and a deliberate step toward our goal of compounding value more effectively for our investors.**

Looking Ahead

“I see a beautiful city and a brilliant people rising from this abyss...” — *A Tale of Two Cities*

After two particularly difficult years, the ingredients that drive forward returns may be lining up: financing costs have eased at the margin, credit markets are functioning, operating leverage is turning from headwind to tailwind, and a multi-year industrial reinvestment cycle is underway. Layer in practical AI implementation as a potential structural cost reducer and a 2026 upturn in domestic consumption, and the conditions appear to be in place for small-cap earnings to deliver meaningful upside surprises. **With entry valuations still discounted and expectations low, we think the asymmetry versus large-cap stocks is incredibly favorable.**

Again, we don’t need the megacap/AI complex to fail for this to work. If perfection at the top simply gets repriced to “very good,” history suggests multiples compress where expectations were highest and re-rate where expectations were lowest. In such periods, breadth has tended to improve, neglected profitability begins to earn attention, and portfolio rebalancing can favor prior underweights as flows gradually reconnect with fundamentals.

We will stay true to our process, buying stocks mispriced relative to their profitability potential. **We are comfortable letting base rates, mean reversion, and capital scarcity – not froth, narrative, and ever-elevating expectations – do the heavy lifting. Side by side with you, we are staying the course.**



We are pleased to announce that Brooke McMahon has been named Chief Operating Officer of Towle & Co. Since joining the firm in 2021, Brooke has played an instrumental role in launching new investment products, improving firm operations, building out the team, and enhancing client service and communications. She oversees day-to-day business operations and already serves on the firm’s Management and Risk Committees. The firm and our clients benefit greatly from her steady leadership, commitment, and energy. Keeping up with Brooke is a difficult task, and, like most of us at the firm, her title has also struggled to keep pace! We are thrilled and grateful for Brooke.

Christopher D. Towle
James M. Shields, CFA
Peter J. Lewis, CFA
G. Lukas Barthelmess, CFA

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