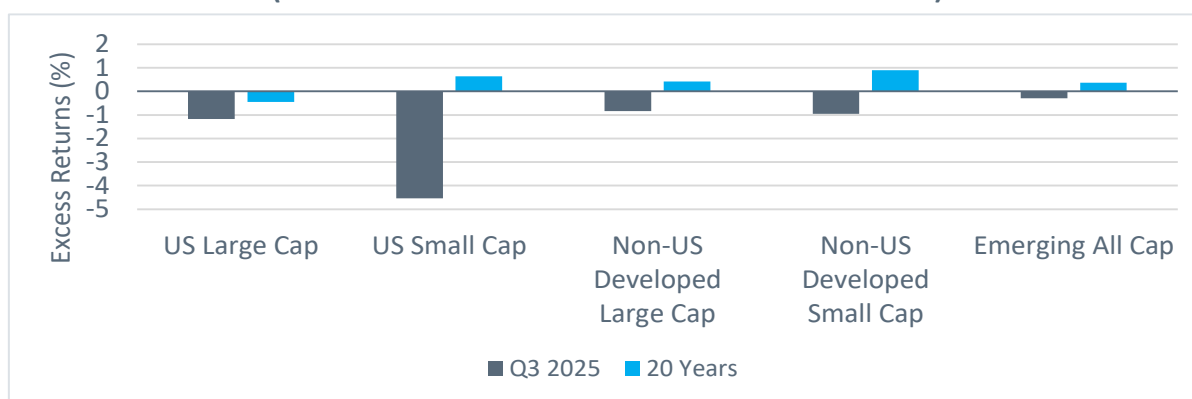


The Low-Quality Stock Rally in Q3 2025

The third quarter of 2025 was characterized by unusually sharp underperformance by active management across multiple equity asset classes. The chart below includes the net excess returns across equity regions, as reported to eVestment, for Q3 and the trailing 20-year period. In short, active management did not fare well during the quarter.

**Figure 1: Poor Q3 Active Results
(Median Excess Returns vs. Preferred Benchmarks)**

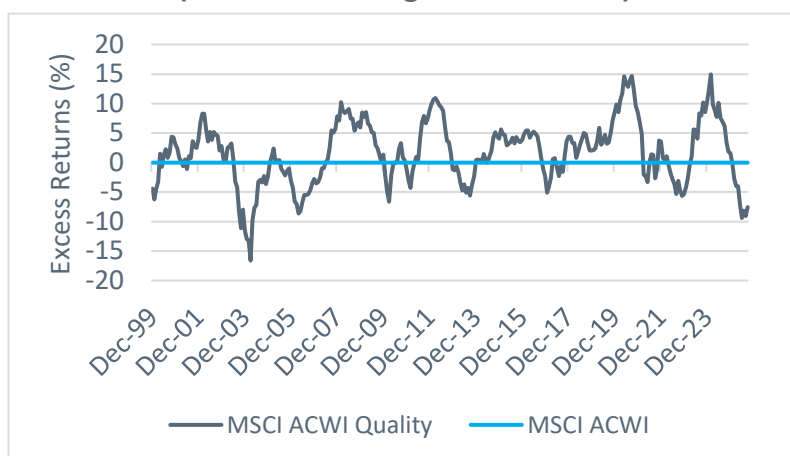


Source: eVestment. As of September 30, 2025. Performance is net of fees and is annualized for the trailing 20-year period.

Traditional quality factors—such as high return on equity, strong balance sheets, and stable earnings—lagged, while low-quality equities outperformed. This dynamic highlighted a market regime in which investor behavior leaned more heavily toward momentum-driven and valuation-insensitive positioning. As shown in the following chart, the MSCI ACWI Quality has now heavily trailed the MSCI ACWI for the trailing 12 months following Q3. The quality indices from MSCI seek to track the performance of high-quality stocks as identified by high return on equity, strong earnings stability, and low financial leverage.

In Q3, there was a notable improvement in market sentiment following a period of elevated macroeconomic uncertainty earlier in the year. During the quarter, enthusiasm surrounding artificial intelligence, automation, and industrial re-onshoring continued to drive capital flows into select growth-oriented

**Figure 2: MSCI ACWI Quality vs. MSCI ACWI
(12-Month Rolling Excess Returns)**



Source: eVestment. As of September 30, 2025.

industries. Additionally, a perceived shift from the Federal Reserve toward a more accommodative policy stance, combined with a rate cut, served as further support for Q3 conditions. Many investors viewed this as supportive for positive market trends, leading to tightening credit spreads and a broad rally across risk assets.

When has this happened before?

Several prior episodes provide useful context for evaluating the Q3 2025 environment, three of which are summarized below.

Dot-Com Bubble Rebound (1999–2000)

During the late stages of the dot-com bubble, unprofitable and speculative internet companies surged dramatically. The rally was fueled by technological optimism, easy liquidity, and momentum trading. The subsequent crash highlighted the risks of relying on sentiment-driven returns.

Post-GFC Rally in Low-Quality Financials and Cyclical (2009–2010)

Coming out of the Global Financial Crisis, some of the highest returns were concentrated in distressed financial institutions, high-leverage cyclical companies, and deeply discounted industrials. While part of this rally was supported by a genuine earnings recovery, a substantial portion was sentiment-driven and reversed as fundamentals normalized.

Early Pandemic Speculative Surge (2020–2021)

In the aftermath of the COVID-19 shock, unprecedented liquidity injections triggered a boom in unprofitable technology companies, meme stocks, SPACs, and other early-stage innovators. Retail enthusiasm and ultra-low rates drove flows into companies with limited earnings visibility. Many of these stocks experienced sharp declines in 2022 as interest rates were hiked to combat inflation.

What could happen next?

While the low-quality rally delivered strong short-term returns in Q3, its durability is uncertain. Historically, rallies led by companies with weak fundamentals have tended to fade unless supported by a sustained improvement in earnings or macroeconomic conditions. Many outperforming companies can remain unprofitable, with challenged balance sheets and limited cash flow visibility. Their valuations imply optimistic expectations that may be difficult to meet in the future. Additionally, the speed of the rally raises the risk of sharp reversals if sentiment shifts or liquidity tightens.

However, if the economy maintains moderate growth while rates fall, lower-quality cyclicals could remain supported and outperform longer than some expect. Relative valuations between large- and small-caps remain wide, which may support extended small-cap participation—even if low-quality leadership moderates. Overall, the sustainability of this recent trend remains highly dependent on macro policy, earnings stabilization, and investor risk appetite.

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