COLUMBIA THREADNEEDLE INVESTMENTS

Long-term views from a small-cap lens

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Amid ongoing market uncertainty, Columbia Threadneedle's Jeremy Javidi shares his views on three critical economic shifts reshaping markets.

Where to find quality value companies built for growth amid ongoing economic uncertainty? As Senior Portfolio Manager Jeremy Javidi contemplates inflation, tariffs and economic turbulence, he monitors economic trends to seek out companies with exposure to identified themes. From supply chain restructuring to artificial intelligence advances, here are three critical economic shifts that he believes are reshaping markets.

Three critical economic shifts reshaping markets

1. The great supply chain regionalization

What's happening: Companies are executing the most significant supply chain restructuring in decades, with firms reducing China exposure from 20% to under 1% within 12-18 months. This isn't just tariff-driven — it represents a fundamental shift toward regional manufacturing networks prioritizing flexibility over pure cost optimization.

Key insights:

- **The 50% rule:** Manufacturing reshoring to the U.S. requires tariff protection of approximately 50% to overcome 3x cost differentials, meaning current 10% tariffs are insufficient to drive complete reshoring for most industries.
- **Mexico and Southeast Asia are the winners:** These regions are capturing the majority of redirected manufacturing, not the U.S., creating new competitive dynamics.

- **Flexibility trumps location:** Companies with multi-region manufacturing capabilities significantly outperform those locked into single-country strategies, with domestic margins running 10-15 percentage points higher than international operations.

Investment implications: This shift creates sustained demand for companies facilitating supply chain transitions (logistics, manufacturing equipment, regional infrastructure) while penalizing firms with inflexible, China-concentrated operations. The trend is structural, not cyclical, making geographic manufacturing flexibility a permanent competitive advantage. From a portfolio perspective, investments in supply chain restructuring could support a capital expenditure cycle favoring U.S.-focused small caps.

2. AI operational revolution

What's happening: Artificial intelligence (AI) has crossed the threshold from experimental technology to operational necessity, with companies achieving 200+ basis point margin improvements through practical applications. This isn't about ChatGPT or consumer AI, it's about document processing, automated verification and operational efficiency at scale.

Key insights:

- **Accuracy revolution:** Companies report AI process accuracy improvements from 89% to 99.6%, enabling human oversight elimination rather than replacement.
- **Second-order infrastructure demand:** AI computing requirements are driving unexpected demand in traditional industrial sectors, particularly utility infrastructure for data center power needs.
- **Return on investment clarity:** The focus has shifted to quantifiable applications — processing millions of documents monthly, automated field extraction and operational monitoring — with clear payback periods.

Investment implications: This AI revolution creates two distinct opportunities: companies successfully implementing AI for operational efficiency will demonstrate sustainable margin expansion, while traditional infrastructure providers (utilities, industrial equipment) serving AI computing demands will experience unexpected growth cycles. The key differentiator is practical application versus speculative investment. We believe that as AI investment extends beyond the large-cap universe, small caps are well positioned to benefit from these technological advancements.

3. Sector bifurcation and the end of broad economic cycles

What's happening: The economy has fundamentally segmented into distinct performance clusters that no longer move in traditional cyclical patterns. Health care services maintain 95%+ retention rates while agricultural equipment operates at 40% utilization — simultaneously. This represents structural rather than cyclical divergence.

Key insights:

- **Essential versus discretionary split:** Health care, data centers and infrastructure command premium margins (20%+ EBITDA) while traditional cyclical industries face extended downturns with no clear recovery timeline.
- **Consumer threshold reached:** Consumer packaged goods companies have lost pricing power after years of increases, forcing a shift from price to volume strategies — indicating consumers have reached their acceptance limit.
- **Government/defense resilience:** Companies with government exposure significantly outperform purely commercial operations, suggesting public sector spending provides economic stability while private demand remains uneven.

Investment implications: Traditional broad-based economic recovery strategies may fail in this environment. Selective sector exposure becomes critical, with health care services, digital infrastructure, and government-exposed markets demonstrating resilience while discretionary consumer sectors face extended pressure. The bifurcation appears permanent rather than cyclical, requiring fundamental shifts in portfolio construction and economic forecasting approaches. Finding high-quality small-cap value names that are poised to benefit from this shift will increasingly unlock opportunities within the sector.

The bottom line

There is an interconnected impact across these trends. These three shifts reinforce each other — supply chain regionalization requires AI-driven efficiency to maintain competitiveness, while sector bifurcation accelerates as companies with operational advantages (AI implementation, supply chain flexibility) outperform those without. The combination creates a new economic architecture where operational capabilities matter more than traditional financial metrics or cyclical positioning.

The team continually monitors market trends and focuses on long-term investments, seeking quality value stocks with growth potential. Our research-driven, active approach prioritizes high-quality value names poised to grow amid ongoing economic shifts.

SENIOR PORTFOLIO MANAGER

Jeremy Javidi, CFA

Jeremy Javidi is the lead portfolio manager for the U.S. Small Cap Value I and U.S. Small Cap Value II strategies at Columbia Threadneedle Investments. He is responsible for research, stock selection and portfolio construction for the small-cap value mutual funds as well as the strategies' institutional assets.

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Investments in small-cap companies involve risks, including volatility, that are greater than investments in larger, more established companies.

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