Quality Is Forward Looking:

Why Traditional Metrics Can Miss Tomorrow's Best Businesses

For decades, investors have associated quality with a familiar set of characteristics: growing earnings, expanding margins, strong returns on capital, and consistent cash generation. Those traits have historically identified businesses capable of compounding value over long periods of time, and they remain an important part of our investment process today. What has changed is not the definition of quality, but when quality becomes visible.

The rapid adoption of artificial intelligence ("AI") is accelerating innovation across nearly every industry. Companies are developing products faster, automating workflows, improving customer acquisition, and scaling businesses with greater efficiency than was possible even a few years ago. While AI is amplifying this trend, our investment philosophy has always centered on seeking to identify businesses where current financial statements understate future earnings potential. Long before AI became a dominant investment theme, we have identified opportunities in companies making investments that temporarily obscured their underlying economics. AI has not changed that philosophy. It has simply increased the number of businesses exhibiting those characteristics.

Financial statements are designed to measure what a company has already accomplished, and where the business has been. Successful investing, however, depends on understanding where a business is going. That distinction has always been central to our investment process. What has changed is that today's pace of technological innovation is causing future earnings potential to diverge from reported earnings more frequently and by a wider margin than we have historically observed.

Today, a large segment of companies are intentionally depressing current earnings by investing heavily in software development, engineers, automation, cloud infrastructure, and AI capabilities. Under current accounting rules, many of those investments reduce reported earnings immediately, even though they may generate attractive returns for years to come. As a result, companies strengthening their competitive positions can often be excluded by investors when evaluated using traditional quality screens based primarily on historical profitability.

This dynamic is particularly relevant in smaller-cap companies. As of June 30, 2026, nearly 41%[1] of Russell 2000 companies reported negative trailing earnings, a statistic often cited as evidence that small caps are inherently lower quality. We believe the more important takeaway is that reported earnings alone have become an increasingly incomplete measure of business quality.

The challenge for active managers is separating companies that are consuming capital because their businesses are deteriorating from those investing aggressively because their opportunities are expanding. On the surface, both may report little or no current earnings. Fundamentally, they are entirely different businesses.

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[1] Source: FactSet

That distinction has always been central to our investment process. Rather than screening for companies that already exhibit strong accounting metrics, we focus on understanding how businesses are evolving beneath the surface. We spend our time evaluating competitive positioning, management execution, product cycles, customer adoption, capital allocation, and whether consensus earnings expectations accurately reflect what we believe is occurring inside the business. Our goal is not to identify companies that looked high-quality last quarter; it is to identify businesses whose quality will become increasingly evident over the coming quarters and years. This approach has led us to invest successfully in businesses with temporarily depressed reported earnings long before AI became a prevalent investment theme.

Historically, that lens resulted in a modest overweight to companies with negative or minimal current earnings. Over time, our New Opportunities portfolio has typically maintained approximately a 5% overweight relative to the Russell 2500® Growth Index. That modest overweight was never the objective. It was simply a byproduct of identifying businesses whose future earnings power we believed the market was underappreciating. The current opportunity set, however, looks meaningfully different.

As AI adoption has accelerated, we have identified a growing number of businesses where reported earnings significantly understate future earnings potential. That has led to an organic increase in our average exposure to companies with zero or negative trailing net income to approximately 41% of the portfolio, compared to roughly 29% for the Russell 2500® Growth Index. This reflects an expansion of the opportunity set rather than a change in our investment philosophy.

Looking Beyond Today's Earnings - TTM Through 6/30/2026		
	New Opportunities	**Russell 2500® Growth Index**
Average Weight in Companies with Zero/Negative Net Income	41%	29%
Total Gross Return of Zero/Negative Net Income Holdings	106%	52%
Historical Portfolio Overweight	~5%	--
Average Weight in Companies with Positive Net Income	58%	71%
Total Gross Return of Positive Net Income Holdings	55%	27%

Source: FactSet Attribution

Importantly, this should not be interpreted as a preference for unprofitable companies. Quite the opposite. We continue to believe sustainable earnings growth is the ultimate driver of long-term shareholder returns. The difference is that we are identifying more businesses whose future earnings power is materially better than current financial statements imply.

Our attribution results reinforce this philosophy. Over the past 12 months, holdings with little or no current earnings generated gross returns exceeding 100%, more than double the returns of companies with zero or negative net income within the Russell 2500® Growth Index. At the same time, profitable businesses across the portfolio also outperformed through stock selection. The common thread was never current profitability. It was identifying businesses whose future fundamentals differed meaningfully from market expectations. That investment philosophy has been a consistent part of our process since the strategy's inception. AI is simply increasing the number of opportunities where that disconnect exists.

Historically, consensus earnings estimates have relied heavily on extending existing trends. That approach becomes increasingly difficult when businesses can improve productivity, automate processes, or introduce new technologies much faster than history would suggest. Earnings revisions can occur more rapidly, competitive positions can strengthen more quickly, and business models can evolve before traditional metrics fully capture those changes.

In our view, this creates a particularly attractive environment for active management. The smaller-cap universe remains less efficiently researched compared to large-cap markets, analyst coverage is more limited, and information is incorporated into stock prices more slowly. Those inefficiencies have always created opportunities for fundamental investors. The AI investment cycle is widening the gap between reported earnings and future earnings potential, creating more opportunities for the type of forward-looking research that has always defined our investment process. Quality investing has not become less relevant; the ability to identify emerging quality earlier in a company's lifecycle has simply become more valuable.

Strong balance sheets, capable management teams, durable competitive advantages, and disciplined capital allocation remain essential characteristics of successful businesses. What we emphasize is that those characteristics cannot always be identified by looking exclusively at historical earnings or returns on capital. Increasingly, they require an assessment of how businesses are investing today to create competitive advantages tomorrow.

Ultimately, our responsibility as active managers is not to identify the companies that already look like high-quality businesses. It is to identify the companies that are becoming high-quality businesses before that evolution is fully reflected in consensus expectations or reported financial results. That has been the foundation of our investment process for years. Artificial intelligence has not changed that discipline. It has expanded the universe of companies where disciplined, forward-looking fundamental research can add value, and we believe the opportunity to identify those disconnects remains one of the most durable potential sources of excess return in today's smaller-cap market.

	Annualized, as of 6/30/26				
	1 Year	3 Year	5 Year	10 Year	Since Inception
New Opportunities - Gross	73.67%	40.53%	20.12%	24.72%	20.64%
New Opportunities – Net	72.43%	39.50%	19.23%	23.70%	19.64%
Russell 2500® Growth Index	32.94%	16.40%	4.99%	12.56%	10.82%
New Opp (gross) vs Benchmark	40.73%	24.13%	15.13%	12.16%	9.82%

Investors in Hood River's New Opportunities (f/k/a Small/Mid-Cap Growth) strategy acknowledge and agree that (I) any information provided by the Firm is not a recommendation to invest in the strategy and that the Firm is not undertaking to provide any investment advice to the investor (impartial or otherwise), or to give advice to the investor in a fiduciary capacity in connection with an investment in the strategy and, accordingly, no part of any compensation received by the Firm is for the provision of investment advice to the investor and (II) Hood River has a financial interest in the investor's investment in the strategy on account of the fees and other compensation the Firm expects to receive from the client.

Hood River Capital Management LLC, a Delaware limited liability company, is a registered investment adviser under the Investment Advisers Act of 1940. The Firm offers investment advisory services to individuals, pension and profit-sharing plans, trusts, estates, corporations, as well as other institutional clients. Hood River has an arms-length service level agreement with Mar Vista Investment Partners, a registered investment adviser, to provide back and middle office services. For purposes of compliance with GIPS®, Hood River has defined itself to not include bundled/WRAP fee accounts in the firm's assets. Hood River maintains a complete list and description of firm composites and a list of broadly distributed pooled funds, which is available upon request.

On 01/01/13, Brian Smoluch, Robert Marvin and David Swank formed Hood River to manage a small-cap growth strategy. Brian Smoluch, Robert Marvin and David Swank were dual employees until 05/31/13 when all of the assets under their management at Roxbury Capital Management transitioned to Hood River through a sub-advisory arrangement. On 1/20/15, Hood River finalized an agreement that put 100% of its equity in the hands of Hood River's three Principals, divided equally among them. All assets under management are managed by Hood River. Hood River claims compliance with the Global Investment Performance Standards (GIPS®). GIPS® is a registered trademark of the CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Benchmark returns are not covered by the report of independent verifiers. ACA served as the verifier, conducted a verification and examined the composite's performance history that was ported over to Hood River prior to 1/1/13.The New Opportunities composite was created in 2014 with an inception date of 12/31/14. On 3/15/26 the name of the composite changed from Small/Mid-Cap Growth to New Opportunities. All returns are based in U.S. dollars and are computed using a time-weighted total rate of return. The composite is defined to include all fully discretionary, taxable and tax-exempt portfolios with no minimum or maximum account value managed in accordance with Hood River's New Opportunities strategy and that paid for execution on a transaction basis. The New Opportunities strategy seeks long-term capital appreciation by investing in a portfolio of up to 120 stocks, generally new stock purchases are within the range of market capitalization for stocks in the index, exhibiting strong growth characteristics and attractive valuation relative to underlying profitability. The results in the column marked net of fees for the periods 01/01/15 through 9/30/18, include a standard management fee applied to any non-fee-paying portfolio for performance calculation purposes.

The benchmark is the Russell 2500® Growth Index, defined as a broad index featuring 2500 stocks that cover the small and mid-cap market capitalizations. The index has a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities. The Russell 2500® Growth Index is designed to measure the performance of those Russell 2500 companies with higher price-to-book ratios and higher forecasted growth values. The dispersion in gross-of-fee composite returns shown herein was measured using an asset-weighted standard deviation formula.

Performance results presented reflect the reinvestment of dividends and other earnings. Gross performance is net of all transaction costs. For all periods ending on or after January 1st, 2021, net returns are calculated using a model fee, which reflects the deduction of 1/12th of 0.75% from monthly gross returns and excludes any custodial fees. For periods from 2015 through 2020, where actual investment management fees were higher than the model fee, net returns are calculated using the actual fees incurred by the portfolio(s) in the composite. Actual results may differ from composite results depending upon the size of the portfolio, investment objectives and restrictions, the amount of transaction and related costs, the inception date of the portfolio and other factors. Policies for valuing investments, calculating performance, and preparing GIPS® composite reports are available upon request.

Information is provided as supplemental to the New Opportunities GIPS® Composite Report. A New Opportunities GIPS® Composite Report is available upon request by contacting Hood River directly at 561-484-5699 or via email at info@hoodrivercapital.com. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.