Q2 2026 Quarterly Commentary

By Nathan Fredrick, CFA

Performance Summary

The Small Cap strategy underperformed the Russell 2000 in the second quarter. The benchmark surged more than 21%, in a quarter characterized by one of the most powerful risk-on quarters for small caps in recent memory, and while the strategy participated meaningfully in the advance, our commitment to a quality bias and specific health care positioning created a performance headwind. Year-to-date the Small Cap strategy has outperformed the benchmark. We are never satisfied trailing the index, and we address the specific drivers, and the actions we took in response, throughout this letter.

Market Context

The quarter was defined by two forces pulling in the same direction: an accelerating artificial intelligence buildout and a persistent geopolitical oil and gas supply shock. On the first, the AI trade broadened rather than faded. Hyperscaler capital spending continued to climb, utilities across our coverage raised transmission and generation capex plans, and the beneficiaries extended well beyond semiconductors into industrial cooling, grid hardware, and electronic components. On the latter, the disruption in the Strait of Hormuz kept crude and refined product markets dislocated. However, since the mid-quarter announcement of a ceasefire and then the signing of the MOU, the energy and materials sectors have underperformed and a risk-on stock market has resumed.

Beneath the surface, the rally carried a distinctly lower-quality, high-beta character, the kind of tape that historically challenges our process. We also took note of later-cycle signals: a wave of secondary offerings from long-time holders in stocks that had doubled or tripled, and initial public offerings pricing to immediate premiums.

Sector Highlights

Energy was our best-performing sector on a relative basis, driven entirely by stock selection. Our energy holdings gained roughly 12% on average during the quarter while the benchmark's energy stocks declined by about 10%, a spread that reflects our deliberate tilt toward gas compression and services rather than commodity producers. Materials was the second-largest contributor, with our holdings advancing in the mid-teens against a roughly flat benchmark group as our aluminum and specialty chemicals positions benefited from the supply disruptions described above. Financials also added value through selection, led by StoneX (SNEX), and our long-standing overweight to information technology was rewarded from an allocation standpoint as the sector led the market higher, though our technology holdings, up more than 50% in aggregate, modestly trailed an even stronger benchmark technology cohort.

Health care was the largest detractor. The benchmark's health care stocks, led by speculative biotechnology, surged roughly 25% during the quarter, while our profitable, cash-generative health care holdings declined modestly. We do not own pre-revenue biotech as a matter of process, and quarters like this one represent the cost of that discipline. Consumer discretionary selection also proved a headwind, as our holdings declined in a group that rallied sharply. This was driven by Grand Canyon Education (LOPE), which we view as more of a consumer staple.

Top Contributors

StoneX Group (SNEX)

StoneX, our financial services and clearing holding, was the portfolio's largest contributor as shares gained approximately 47% during the quarter. Elevated market volatility stemming from the Middle East conflict drove exceptional trading and clearing activity, and the stock ground steadily higher after quarterly earnings results. With shares having roughly doubled from their lows and valuation approaching the high end of historical ranges, we trimmed the position into strength while keeping it among our largest holdings. We continue to view it as an unusually durable compounder across market environments.

PDF Solutions (PDFS)

PDF Solutions, a provider of yield analytics and data software for semiconductor manufacturers, returned approximately 52% in the quarter. During May, long-time strategic holder Advantest exited its entire 8% stake through an upsized secondary offering, with PDF selling additional shares alongside to fund general corporate purposes and potential debt reduction. We interpreted the heavily oversubscribed deal as a sign of management taking control of its own destiny, and we used the offering-related weakness to add a full percentage point to the position, funded by a sale of Veeco (VECO) to keep our overall semiconductor exposure in check. Late in the quarter we trimmed a portion of the position after the sharp run, consistent with our practice of harvesting gains in extended semiconductor names.

Digi International (DGII)

Digi International, our industrial internet-of-things connectivity holding, gained approximately 55% as demand for connected infrastructure accelerated alongside the broader AI and automation buildout. Given its expansion into one of our largest holdings, we trimmed modestly during the quarter to fund new ideas and maintain sizing discipline.

Top Detractors

Grand Canyon Education (LOPE)

Grand Canyon Education, the education services provider, declined approximately 16% and was the portfolio's largest detractor. Our investment thesis remains intact; LOPE's steady, profitable, counter-cyclical enrollment business was simply left behind in a market that rewarded beta and speculation. Enrollment trends and cash generation remain consistent with our expectations, and we continue to hold the position.

Atmus Filtration Technologies (ATMU)

Atmus Filtration, the engine filtration business spun out of Cummins (CMI), fell approximately 10% as read-throughs from the freight market turned mixed, with softer commentary on new truck builds and some margin pressure weighing on sentiment. We continue to like the durable, replacement-driven aftermarket core of the business, but we respected the change in tone and trimmed the position back to a standard weight during the quarter.

LeMaitre Vascular (LMAT)

LeMaitre Vascular, our peripheral vascular device holding, declined approximately 12% in a quarter when nearly everything profitable in small cap health care went down and nearly everything speculative went up. The company's niche leadership, pricing power, and consistent execution are unchanged, and we view the weakness as sentiment-driven rather than fundamental.

Portfolio Changes

New Positions

We initiated a position in **NetScout Systems (NTCT)** in April. Founded in 1984, NetScout Systems, Inc. (NTCT), with a stated mission of **"Guardians of A Connected World,"** has been a technology innovator providing service assurance and cybersecurity solutions based on its pioneering deep packet inspection technology at scale. While high-growth competitors trade at significant premiums, NetScout offers a more attractive valuation for what we view as a durable software business with deeply embedded customer relationships among the Fortune 500. Its deep packet inspection technology is increasingly critical as enterprises navigate complex digital transformations, cloud migrations, and a heightened threat landscape. We view NTCT as a disciplined way to gain exposure to secular technology tailwinds like cybersecurity without paying the speculative multiples found elsewhere in the sector.

In May we established a position in **Middleby (MIDD)**, the commercial foodservice and food processing equipment leader, funded by trims of Modine (MOD) and Kodiak Gas Services (KGS). Middleby delivered its strongest organic growth in two years, with commercial foodservice up nearly 10% and food processing up 25%, repurchased almost 5% of its shares outstanding in a single quarter, and set a July 6 date for the spin-off of its food processing business. We believe the separation will let the market properly value two focused businesses, and we wanted to own the company ahead of that catalyst.

We also added **Lifeway Foods (LWAY)**, the dominant U.S. producer of kefir, giving the portfolio a true consumer staple. Lifeway reported record quarterly sales of $63 million, up 37% and driven by volume rather than price, with gross margin expanding meaningfully on favorable milk costs, and its plant expansion remains on track for completion by year end. Gut health is a durable consumer tailwind, the company commands roughly 80% share of its category, per internal estimate, and shelf space in this industry is extraordinarily hard to win; Lifeway already has it.

Late in the quarter we initiated **Werner Enterprises (WERN)**, one of the largest truckload carriers. A landmark liability ruling now places responsibility for driver safety squarely on carriers with the balance sheets to insure it, a change we believe will force as much as a third of industry capacity, concentrated among small and marginal operators, to consolidate or exit. Large, well-capitalized carriers such as Werner should be the direct beneficiaries through pricing power and share gains. Only two of fifteen covering analysts rated the stock a buy when we purchased it, which is precisely the setup we look for: identifying the inflection before the upgrade cycle begins.

Within energy, we repositioned toward services. We initiated **Oceaneering International (OII)**, a leader in subsea robotics and offshore services, as offshore and subsea capital spending emerges from a seven-year drought and the U.S. rig count climbs; the position was funded in part by our exit of natural gas producer CNX Resources (CNX).

We also purchased **Kaiser Aluminum (KALU)** as roughly two and a half million tons of global aluminum capacity remains offline following the Middle East smelter disruptions, a supply shock we believe supports elevated pricing for well-positioned domestic producers through at least 2027. Also, continued tariffs on aluminum and alumina products will help pricing stay elevated, even if Middle East capacity comes on faster than expected.

In addition, we initiated positions in **Stevanato Group (STVN)**, a leading global provider of drug containment, drug delivery, and diagnostic solutions to the pharmaceutical, biotechnology, and life sciences industries. The stock sold off following the launch of oral GLP-1s, which many believe will end the need for injectable forms. Experts believe an expanding GLP-1 TAM, coupled with varying use cases, will necessitate ongoing need for injectable forms. Indeed, 25% of drugs approved in 2025 were biologics which will require injectable devices. This market overreaction offered an attractive entry valuation of 12.5x FY2026E EBITDA vs. STVN's historic multiple of 20X and its nearest comp West Pharmaceutical (WST) at approximately 22–25x.

Reductions and Sales

Several sales reflected valuation and sizing discipline in names that had performed well. We reduced Veeco in stages throughout the quarter, both to fund the PDFS addition and to systematically harvest gains into semiconductor strength; the pending Axcelis combination will also lift the combined company beyond our core market cap range. We trimmed Adeia (ADEA) repeatedly as the shares rerated, with 2026 estimates now largely reflecting the benefits of its AMD license agreement, and we pared StoneX, Digi International, Modine, Kodiak Gas Services, and Atmus for the sizing and funding reasons described earlier in this letter.

We exited **Perella Weinberg (PWP)** after the boutique advisory firm announced a workforce reduction of roughly 10%, a signal that the M&A drought for smaller independent advisors is likely to persist while activity remains concentrated among the largest banks. We sold **Talkspace (TALK)** following shareholder approval of its pending cash acquisition, which effectively capped the remaining upside. We exited **BioHarvest Sciences (BHST)**, a small residual position, as we consolidated the portfolio's consumer staples exposure around Lifeway. We also sold **Warby Parker (WRBY)** and **Canada Goose (GOOS)** during the quarter as we redeployed capital into the new positions described above. WRBY is a name we like, though we believe a lot of AI hype was built into the stock around the glasses launch. The unveiling of the glasses was somewhat underwhelming and we would potentially underwrite the stock again at lower levels.

Notable Holdings and Themes

PDF Solutions (PDFS)

Superior Business

Founded in 1991, PDF Solutions (PDFS) enables the digital transformation of semiconductor manufacturing. Its solutions generate and integrate data across the supply chain. Today, by incorporating AI, they also drive fast improvements in yield, quality, and efficiency.

The complexity of the semiconductor supply chain has intensified over the years due to technological advances and global expansion. PDFS's solutions address key manufacturing and R&D challenges:

- Innovations in 3D semiconductor architecture
- Increased complexity of chips in the wafer fab and assembly
- Systems providers rather than components makers

PDFS's software applications connect the physical world of semiconductor manufacturing with the digital world of design, planning, tracking, monitoring, reporting, etc. In fact, PDFS's software resides on most semiconductor manufacturing equipment today. Its innovative solutions enable its customers to enhance yield and time-to-market, the two main goals of semiconductor manufacturing, which aims to serve ever-changing and fast-growing markets with high capital intensity.

Exceptional Management Team

PDFS continues to be founder-led:

- **Kimon Michaels, Ph.D., Executive VP, Products and Solutions, Director, and Co-Founder,** has served as Vice President of Products and Solutions since July 2010. He remains the technology visionary of the company.

- **John K. Kibarian, Ph.D., President, Chief Executive Officer, Director, and Co-Founder** has served as President since November 1991 and has served as Chief Executive Officer since July 2000. He and **Adnan Raza, Executive VP, Finance and Chief Financial Officer,** who joined PDFS in Jan 2020, run the business.

Valuation

From a financial perspective, PDFS has experienced and should continue to experience TAM expansion as its solutions bring efficiency to semiconductor manufacturing. Operating model improvement should follow as recurring software revenue expands gross and operating margins. We expect 20% revenue growth with earnings growth of 20-25%. PDFS traded at 25X earnings and 6X revenue at purchase, a reasonable valuation for a high ROIC recurring revenue business growing at >20%/year.

Responsible Business

PDFS has a strong handprint. Its solutions bring efficiency to a capital-intensive business that consumes a lot of energy and water. The efficiency brought to manufacturing has the potential to reduce the negative footprint of the semiconductor business.

PDFS does not have a significant environmental footprint, given it is primarily a developer of software. The company's human capital is its greatest asset, making its UNGP-aligned human rights policy an important protector of its safe, inclusive, respectful, and equitable corporate culture. The company has a strong employee engagement and development program. Importantly, PDFS has a robust cybersecurity risk management program, overseen by its Board.

Outlook

Heading into the second quarter, we found ourselves navigating the immediate aftermath of the energy and materials shock discussed in our prior letter. As we noted at the time, the escalation of tensions in the Middle East had introduced meaningful uncertainty into the outlook, and we responded by repositioning the portfolio toward more defensive ground. Implicit in that decision was a key risk: that returning to a more constructive stance would require, at minimum, a slowing in the rate of bad news, if not outright improvement on the ground.

That improvement arrived faster than we anticipated. The announcement of a ceasefire, followed by the signing of a memorandum of understanding, triggered a sharp reversal in sentiment even though little had fundamentally changed in the region itself. Oil prices and several materials prices retraced a significant portion of their earlier gains. In hindsight, the resolution may have been simpler than the market's initial reaction implied: most economies carried sufficient strategic reserves to absorb the shock, and the consumer, bolstered by stronger year-over-year tax refunds, proved more resilient than we had anticipated in our Q1 outlook.

As a result, we enter the current period less bearish on the consumer than we were three months ago. At the same time, the market has begun to unwind a portion of the artificial intelligence trade that dominated leadership earlier in the year. While we believe that trade has run considerably, we continue to see durable value in the picks-and-shovels businesses that sit underneath it — infrastructure and enabling technology providers with staying power independent of any single cycle. Our new position in PDF Solutions (PDFS) reflects this view. We consider our overall technology weighting appropriately sized for now but would look to add opportunistically on further weakness.

We are also increasing our exposure to consumer staples, which offer a way to maintain some consumer exposure while retaining a defensive posture. Separately, the broad-based sell-off in consumer discretionary names since the onset of the conflict has created what we view as attractive entry points in select businesses whose long-term fundamentals remain intact.

Healthcare represents another area of incremental portfolio activity. Biotech has been a persistent outperformer within the sector, a dynamic that has been difficult to keep pace with given our concentration in medical technology names, which have lagged. We are increasingly seeing signs of a broader rotation into the sector as a whole, and we intend to position the portfolio to benefit from that shift over the coming quarter.

On energy, we believe the recent sell-off has overshot to the downside relative to the underlying fundamentals in the Middle East, which have not meaningfully changed. We see potential value emerging as the group stabilizes, though we would prefer greater clarity, and for valuations to more fully reflect a resetting reality, before committing additional capital.

Taken together, we would characterize our stance as cautiously optimistic. As some of the more speculative artificial intelligence-related trades continue to unwind, we anticipate a rotation into higher-quality businesses that lagged the broader market earlier in the year — a dynamic we believe plays to the strength of our core investment philosophy.

Closing Remarks

Quarters like this one test the patience that quality investing requires, and we appreciate yours. Our process of owning superior businesses with superior management teams at attractive valuations does not bend to whatever the market happens to reward in a given quarter, and we believe that consistency is exactly what will serve the portfolio when the current speculative leadership inevitably narrows. We are grateful for your trust and confidence.

Nathan Fredrick, CFA
Portfolio Manager

(Disclosures and strategy largest contributors and detractors on next page).

RIVERWATER PARTNERS

Small Cap Strategy
Largest Contributors and Detractors — Q2 2026

5 Best - Absolute Contribution

Ticker	Company	Avg. Weight	Contribution
SNEX	StoneX Group Inc.	5.17%	2.74%
PDFS	PDF Solutions, Inc.	2.44%	1.99%
DGII	Digi International Inc.	4.10%	1.95%
VECO	Veeco Instruments Inc.	1.97%	1.94%
PLPC	Preformed Line Products Company	4.38%	1.93%

5 Worst - Absolute Contribution

Ticker	Company	Avg. Weight	Contribution
LOPE	Grand Canyon Education, Inc.	2.78%	-0.49%
ATMU	Atmus Filtration Technologies, Inc.	3.54%	-0.37%
LMAT	LeMaitre Vascular, Inc.	2.82%	-0.37%
CNX	CNX Resources Corporation	2.47%	-0.37%
PWP	Perella Weinberg Partners Class A	1.74%	-0.16%

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