Harris | Oakmark

3Q 2026 U.S. EQUITY MARKET COMMENTARY

A conversation with investors

September 30, 2026

Each year, we compile responses to a series of questions received from clients and prospects on topics they find most relevant. We are pleased to share this year's discussion with you. Thank you for your interest in Harris | Oakmark, and I hope you find this Q&A useful.

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Performance

Given the strong performance of value stocks this year, especially midcaps, why has Harris | Oakmark not participated more fully?

The value indexes have benefited significantly from AI infrastructure companies—manufacturers of computers, memory, semiconductors and related products. While many of those companies had lower P/Es and could have qualified for our portfolio, we were uncomfortable forecasting that their dramatic increases in earnings were permanent rather than cyclical. More than half of the Russell Value Index's performance this year has come from those AI-related names.

If current earnings prove durable, those stocks may continue to be good investments. If the earnings prove cyclical, they are unlikely to perform well. Because we haven't had enough conviction that they are durable, we have deemed them too risky for investment. So far this year, that has been a big missed opportunity.

As an aside, at the end of June, Russell moved most of the AI infrastructure companies from the Russell Value Index into the Russell Growth Index. So, if we are right to avoid those stocks, any eventual declines will hurt the Russell Growth Index rather than causing the Value Index to round-trip its gains.

Moving to market cap, let's set some definitions. When we say Harris | Oakmark buys large companies, we mean "large" in fundamental terms, not simply in stock market capitalization. For the most part, we limit our universe to companies that rank among the 250 largest in the U.S. in sales, EBIT or shareholders' equity. That produces a list of about 350 companies because most companies that are large on one measure are also large on the others. We believe defining "large" based on business fundamentals creates a lower-risk universe than defining it solely by market capitalization.

Morningstar, however, defines large based on market capitalization. Its large-cap category currently begins at roughly $90 billion because companies above that threshold collectively represent about 70% of the U.S. market's capitalization. The next 20% is considered mid-cap, which currently extends down to roughly $15 billion.

Our U.S. Large Value Strategy portfolios hold approximately 50-60 securities with a market cap focus of $10 billion and above at the time of purchase. Because so much market capitalization is now concentrated in large technology companies, the very large businesses we own, such as General Motors, Delta Air Lines and Nike, are classified as mid-cap stocks. In fact, the majority of our portfolio, according to Morningstar, now qualifies as mid-cap because our very large businesses have very low P/Es. But that isn't the portion of the mid-cap indexes that has performed so well. The strongest-performing mid-cap stocks have tended to be smaller businesses with exciting potential—and therefore high valuations—which simply isn't what we own.

Has recent underperformance led to any changes in research, portfolio construction or risk management?

We've recently built out a quantitative team to analyze our historical results and look for ways to extract even more value from our research. Their finding that seems most actionable to me so far is that we have treated our research as though we are directionally right on most of the stocks we own, rather than recognizing that we are very accurate on some and add little value on others.

Effectively, we haven't adjusted those probabilities as much as we should have based on business results after we purchased a stock. I'd equate it to trying to pick the winning team in a baseball game but ignoring the new information that one team is ahead 3-0 after two innings.

Factoring in that new information, we are now less likely to add to positions when fundamental developments have been inconsistent with our thesis. Likewise, we are less likely to trim positions when the fundamentals are tracking as expected but the stock hasn't yet reached our sell target.

Investment philosophy & valuation

What is the most misunderstood aspect of the Harris | Oakmark investment philosophy?

I think there is still a general perception that, as value investors, Harris | Oakmark is limited to buying below-average businesses. It is obvious to us that price determines whether a stock is a value, and at the right price, any company can be a value stock. While the Harris | Oakmark U.S. Large Value Strategy includes many companies we would consider average businesses selling at large discounts, our largest holdings—Salesforce, Airbnb and Intercontinental Exchange—have track records more typical of growth businesses, but are selling at prices we believe represent good value.

How do you think about the cost of missing opportunities due to your valuation discipline?

We worry a lot about forecast errors in the companies we own because those mistakes can result in lost capital and reduce the probability of our clients meeting their financial goals. Our valuation discipline always rules out a lot of stocks, especially those that are in vogue at the time. We don't worry about missing the ones that happen to go higher. If we viewed our primary risk as tracking error—how much our performance differs from a given index—then we would worry more about what we don't own.

Do higher inflation and interest rates affect your valuations? Do they lead you to prioritize dividends? Are there certain environments that lead you to weight macro factors more heavily?

One of our primary valuation tools is a discounted cash flow model—effectively summing the cash a company is expected to return to its shareholders from now through forever, while assigning less value to cash flows that are further in the future. The discount rate we use is based on adding a risk premium to what could be earned by investing in bonds. Higher inflation usually leads to higher bond yields, and higher bond yields reduce our estimated values. But higher inflation also tends to increase expected earnings growth, providing a meaningful offset.

If you apply the concept of duration risk in bonds—the idea that it is riskier the longer you have to wait to get your money back—to equities, higher interest rates tend to penalize higher-multiple stocks more than companies that return cash sooner. So, higher rates make us prefer companies that return cash through share repurchases or dividends over companies that invest in their own growth far into the future.

Harris | Oakmark analysis focuses much more on the company level than the macro level. Our macro forecast is always that the world will be "normal" in seven years. Typically, that isn't different enough from consensus to influence our holdings. However, during periods of extreme pessimism, such as the Global Financial Crisis or the COVID-19 pandemic, believing that the world will return to normal within seven years can make us meaningfully more optimistic than other investors.

How do you think about periods when market performance appears increasingly disconnected from underlying business fundamentals, and what does that mean for long-term, fundamental investors?

If you extrapolate those disconnects far enough into the future, you reach an unsustainable conclusion: infinite prices for some businesses and zero for others. So, we invest with the conviction that business fundamentals and stock prices eventually have to converge, and we view those disconnects as opportunities.

With so many investors showing a preference for stocks with positive price momentum, it does seem that fundamentals and stock prices can diverge longer than they used to. That's one reason we strongly prefer companies that are eager to take advantage of low prices by repurchasing undervalued shares. When companies repurchase shares that cost less than fair value, they increase the per-share value for remaining shareholders and can help turn a surplus of shares for sale into excess demand to buy.

With profit margins at historically high levels for some of the market's strongest-performing companies, how do you estimate intrinsic value? Could today's valuation risk be less about elevated multiples and more about unsustainable margins?

First, for the broad market, we think the modest increase in profit margins relative to previous levels is sustainable. Most companies have benefited from lower tax rates, economies of scale and better cost control, which we believe are sustainable drivers of higher margins.

But when we look specifically at AI-related businesses, some have benefited from an abrupt increase in profit margins. For many semiconductor companies, margins that historically were closer to 10% are now expected to reach 30% or more, with Micron's projected 2027 EBIT margins above 80% vs. its historical high-single digits. Most of those companies don't trade at sky-high P/E ratios. In fact, even Nvidia sells at only 11 times consensus calendar 2028 earnings.

What we find difficult is estimating what "normal" recurring earnings are likely to be. Most of these companies are making more than twice the income they made a couple years ago, and some much more, such as Micron at 10 times. I can understand why investors driven by FOMO view not owning them as risky—if earnings "just" stay where they are, the stocks will probably be good investments. But if these are cyclical peak earnings, the downside could be substantial.

The most important risk for us is that our clients don't achieve their financial goals. So, we often ask, "Is the probability high that this investment can deliver at least a 10% return for the foreseeable future?" Because many of today's market leaders have volatile earnings or very short histories, we can rarely answer that question with a comfortable "yes."

Why Harris | Oakmark today?

Why should investors allocate to Harris | Oakmark today after years of U.S. large-cap growth dominance?

Trends tend to reverse. The spread between low and high P/E stocks has become unusually large. Below-average P/E stocks outside the technology sector—which make up most of the Harris | Oakmark U.S. Large Value portfolio—tend to be viewed as "anti-AI" and often move in the opposite direction of the AI stocks that are heavily weighted in indexes and growth strategies. As a result, the U.S. Large Value Strategy's correlation with the market is now as low as it has ever been.

Passive investing, concentration & diversification

How do you think about the continued shift toward passive investing in U.S. large-cap equities? With many investors favoring passive exposure, where do you believe active management still adds value?

I think passive investing has made a lot of sense for many investors. When the S&P 500 or Russell Value were well-diversified indexes, owning them passively was a very inexpensive

way to participate in the growth of the U.S. economy. Active management offered the possibility of either earning higher returns than the index or reducing risk.

Today, the S&P 500 and Russell Value are no longer the broadly diversified indexes they once were. Stocks that are classified as technology, or previously were, now dominate the indexes. That may not hurt returns, but it does increase risk. Active management today, in addition to its historical potential benefits, can help diversify a portfolio that has become more concentrated than an investor wants.

Market performance & outlook

What would need to happen for value to outperform over the next 3-5 years?

That's a tough question because growth and value are not homogeneous categories. Let's start with the AI stocks, which have experienced enormous earnings growth but tend to have below-market P/Es. Some would call them value stocks, others would say growth. If their massive growth proves to be cyclical, I think those stocks would perform poorly.

For the rest of the market, we think the spread between low and high P/E stocks is wider than can be justified by differences in earnings growth. While investor behavior is hard to predict, we know that prices eventually follow fundamentals. So, if earnings growth rates regress toward average levels, I would expect P/E multiples to begin converging as well, which would benefit Harris | Oakmark and most other value investors.

But companies don't have to stand by idly and wait for that to happen. Self-help can be a factor. We see an increasing number of low P/E companies reducing their share counts at double-digit annual rates, while higher-multiple companies are issuing shares through IPOs and acquisitions. Those activities tilt the supply/demand balance in favor of the lower-multiple stocks.

After years of the market continuously going up are we due for a market crash or the very least a correction?

At a quick glance, it is easy to conclude that the S&P 500 is overvalued. Its P/E is elevated relative to historical averages—about 20 times forward earnings estimates compared with a historical average of about 16 times. However, its expected growth rate is also elevated, currently about 10-12% compared with 8-10% historically. We think those two factors roughly offset each other, making current multiples reasonable.

But that doesn't mean the market can't decline. On average, the market experiences a 10% correction every one to two years, and about half of those corrections ultimately become 20% declines. We don't believe corrections are predictable, so we don't attempt to time the market.

What do you believe has driven the prolonged period of growth outperforming value?

Normally, when giant businesses experience unusually high growth, they attract competition, and eventually that competition drives the giant company's growth back to average levels. But over the past decade, that didn't happen with large technology companies such as the Magnificent Seven. Earnings growth not only failed to regress—it accelerated.

We looked at what consensus expectations were in 2019 for the Magnificent Seven's 2026 earnings and compared them with today's consensus estimates. The current expectation for 2026 is roughly double what it was then! We have never seen such large companies experience that kind of acceleration in growth.

So, we attribute a lot—but not all—of growth stocks' outperformance to incredibly strong fundamental performance. We don't expect those fundamentals to repeat over the next decade. If we are right, we would expect the P/E gap between today's high and low P/E stocks to narrow, which would generally be positive for value investors.

Portfolio positioning & holdings

Where are you finding value in energy?

The Harris | Oakmark U.S. Large Value Strategy currently holds two energy names, ConocoPhillips (COP) and Targa Resources (TRGP), which together total less than 6% of the portfolio. That is about half the exposure we had a year ago. The Iran War pushed oil prices up this year to levels we don't believe are sustainable. Energy stocks performed well, and several reached our valuation targets and were sold.

We neither target a specific weighting for any industry, nor do we worry about an index's weighting. Instead, we focus on each investment's risk/return profile. We continue to hold Conoco and Targa because we believe they remain undervalued and that both are exceptionally well-managed.

Do you expect the financials to get rerated via multiple expansion or will earnings continue to grow and multiples remain static?

We believe our financial stocks, like the rest of our portfolio, are priced so that the combination of modest growth, dividends and share repurchases should produce a return of at least 10% annually. So, we don't need multiple expansion to produce a decent return.

However, we also believe their business fundamentals deserve higher multiples. While we wait for other investors to reach that conclusion, most of our companies are taking advantage of their current prices by reducing shares outstanding.

For the banks specifically, we believe investors are still overestimating the risks by not giving them enough credit for their much higher capital ratios and more conservative lending standards compared with the pre-Global Financial Crisis era. We think banks deserve P/E ratios comparable to electric utilities, yet they currently trade about four P/E points lower.

Nike has significantly underperformed in recent years. What do you believe the market is missing that could serve as a catalyst for a turnaround?

Nike (NKE) has been a horrible stock, losing about 80% of its value relative to the S&P 500 over just the past three years. Fortunately, we didn't buy it until last year, so we avoided most of that decline. However, it has been a poor performer for us too.

Nike's biggest issues appear to be increased competition in China and poor decisions by prior management regarding product distribution. Effectively, Nike tried to bypass some of its most loyal customers—shoe retailers—by going directly to consumers. Two years ago, longtime Nike veteran Elliott Hill returned as CEO. We own the stock because we believe he can mend fences with retailers and begin returning Nike to its storied past.

Nike stock now sells for less than 10 times what the company earned in 2024, creating significant upside if Hill succeeds in turning the business around.

I would love to know the thesis on Corebridge!

I'm happy to share it, but first I want to explain that my prior-quarter reference to nobody wanting to hear our story on Corebridge Financial (CRBG) was meant simply as an example of how much attention AI is capturing and how little interest there is today in many of the companies we own. Most people seem to care more about our rationale for not owning investments that have performed very well than they do about the investments we actually own!

Corebridge sells life insurance and provides retirement services. The stock trades for $33. Consensus estimates for 2028 earnings are about $6.50 per share, putting the P/E at just over 5 times. The company returns most of those earnings to shareholders through a 3% dividend and share repurchases that have reduced its share count by more than 10% in each of the past three years. As a reminder, even if net income is flat, a 10% decline in share count increases EPS by about 11%. That seems very attractive to us given the low P/E ratio.

Further, in July the company announced its intention to merge with Equitable Holdings before the end of the year. Equitable is about the same size as Corebridge, so the merger would roughly double the combined market capitalization from $15 billion to $30 billion. Since the share count would also roughly double, that alone doesn't change per-share value. But larger companies have tended to trade at higher multiples, so we believe greater scale could modestly increase the P/E investors are willing to pay.

Second, the combined company would be more diversified, adding wealth management and asset management businesses, which we believe should reduce risk and could also support a higher P/E. The company also expects to achieve $500 million of annual cost synergies, which, if realized, would increase earnings by roughly 10%, in addition to potential revenue synergies. Finally, the larger company has a better chance of eventually being added to the S&P 500, which could increase demand for the shares.

We have no illusions about Corebridge deserving an average market P/E of more than 20 times. But if its P/E rose to just 8 times and EPS grew 10% annually for three years, the stock would roughly double.

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We often ask ourselves, "Does this stock have a high probability of returning at least 10% per year?" We ask that because if our portfolio returns 10% annually, we think our clients will be on track to meet their long-term financial goals. With any company, there is always the risk of a surprise. But based on what we know today, it is easy for us to answer that question with a resounding "yes."

Thank you

We appreciate your enthusiasm and the great questions we received. As always, thank you for your interest in our portfolios.

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Harris | Oakmark

About Harris | Oakmark

Harris | Oakmark is a global investment manager dedicated to delivering value-driven strategies through a highly active, disciplined and long-term approach. For more than 50 years, we have focused on managing high-conviction portfolios designed to generate competitive results across market cycles. Combining deep expertise and a client-first mindset, we help individuals and institutions achieve their meaningful financial goals.

Average annualized total returns (%)

	QTD	YTD	1 yr	3 yrs	5 yrs	10 yrs	Since inception
U.S. Large Value Strategy Gross of Fees	4.04	3.96	9.14	16.56	11.14	14.06	13.55
U.S. Large Value Strategy Net of Fees	3.84	3.38	8.33	15.71	10.34	13.25	12.47
Russell 1000 Value Index	2.61	19.27	23.81	20.07	11.92	11.43	10.33
S&P 500 Index	2.30	12.75	15.74	22.89	13.79	15.33	10.94

Returns for periods less than one year are not annualized. Composite inception: 08/31/1991

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The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. This index is unmanaged and investors cannot invest directly in this index.

Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. This index is unmanaged and investors cannot invest directly in this index.

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