ClearBridge Investments

SMID Cap Growth Strategy

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Key Takeaways

- Strong investor flows and a relaxing of a multitude of market risks sparked a vigorous finish to the year for equities.
- The portfolio struggled during the market updraft, largely due to weakness in several of our consumer holdings.
- Targeting quality growth companies and thoroughly de-risking them prior to purchase should position the portfolio well for the year ahead.

Market Overview and Outlook

Late 2019 brought a tidy resolution of a multitude of nettlesome issues that had plagued markets just a year ago, giving way to an environment conducive to risk assets. Progress included a phase-one deal with China and lessening of tariff worries; the signing of a new trade deal with Mexico and Canada; a Federal spending authorization package; quiescence at the Federal Reserve; Boris Johnson getting the necessary mandate for an orderly Brexit process; and a modest uptick in U.S. industrial activity after 12–18 months of deceleration.

Markets ripped into the year-end mark as a result, with the Russell 2500 Growth Index up more than 10% during the fourth quarter. Small and mid cap growth stocks were among the best performing areas of the market in 2019, finishing up 32.65%.

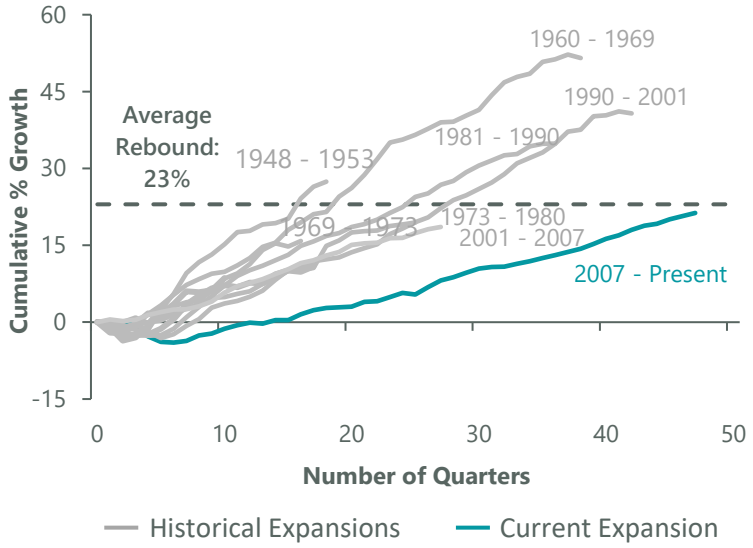
In our view, there are fewer macro overhangs than a year ago, with the caveat that the upcoming U.S. election is a new uncertainty. Last year, we alluded to fears of the "glissade into recession." This year an accommodating Federal Reserve reversed the path of higher short-term interest rates and trimmed rates several times. The inverted yield curve has once again sent a false positive regarding near-term recession risk. The macro threats from the various trade and tariff actions appear to be abating, a definite positive.

What's an equity investor to do with the market at "record highs?" Don't succumb to vertigo. Do recognize that small and mid cap growth stocks and equities generally are part of a well-balanced asset allocation. Stock market values are high by absolute standards, yet compared with paltry fixed income yields, there is good value to be captured in stocks. Yes, the U.S. equity markets increased roughly 30% in 2019, but that came off a depressed 2018 (down 8%–10% for small and mid cap growth

stocks and the broader indexes), leaving two-year returns across market capitalizations more in line with historic norms.

Our economic recovery is lengthy in months off the June 2009 base, yet it is not overextended in real activity. The trough to present level recovery is in line with historic trough to peak norms in real GDP and nowhere near as vibrant as the 1960s expansion or the 1990s (Exhibit 1).

Exhibit 1: Strength of Economic Expansions



Data as of Sept. 30, 2019, most recent available as of Dec. 31, 2019. Source: FactSet, Bureau of Economic Analysis. U.S. economic expansions since 1948.

What could upset financial markets? Apart from exacerbated trade tensions, it is always the unknowable surprise that's understandably most worrisome. A palpable pickup of inflation given tight labor markets. A deterioration of corporate or personal credit, especially a credit market "spark" that creates a wildfire and disturbs the normal functioning of financial markets. Rediscovery of the yawning deficits that plague the Federal budget and the budgets of many states. Social unrest or military actions. Some combination of these and other factors could touch off a market selloff.

We seek to own quality growth businesses and de-risk companies during the period of research and due diligence prior to purchase but also remain cognizant of the importance of ongoing risk management, assessing how exogenous events and factors impact specific parts of the portfolio. Our attention to sustainable business dynamics backed up by robust capital discipline is a critical foundation that we will continue to apply to the existing portfolio and new growth opportunities that our team fosters.

We are optimistic heading into the new year, with good earnings visibility for the stocks we own and the ones we are following. Companies like convenience store chain Casey's General Stores

and cyber security provider Fortinet are going to continue to execute, regardless of the macro backdrop.

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Performance and Positioning

The ClearBridge SMID Cap Growth Strategy underperformed its Russell 2500 Growth Index benchmark during the fourth quarter. The portfolio struggled during the market updraft, largely due to weakness in several of our consumer holdings.

Grubhub, which we have held in the Strategy for several years as it established a leadership position in online food delivery, revealed during the quarter greater than expected competitive pressures in its business. Given the increased spending needed to keep pace in food delivery, the stock sold off sharply and we exited the position. Etsy, which operates an e-commerce and sales support platform geared to entrepreneurs and other small merchants saw its stock drop sharply on earnings guidance that was lower than expected when backing out a recent acquisition as well as the impact of new state sales taxes and merchant's costs to cover free shipping.

Traditional brick and mortar retailers in the portfolio also struggled during the quarter. Core-Mark Holding, a supplier to convenience stores, traded lower due to restrictions on the sale of flavored vaping products. Core-Mark maintains strong fundamentals and should be able to work through this short-term issue as the company raised guidance for the year. Meanwhile, BJ's Wholesale Club, an operator of discount warehouse stores that competes with Costco, was hurt by weaker same-store sales comparisons.

We maintain our holdings in each of these companies as we believe our thesis for owning them remains intact. However, we continue to apply a consistent sell discipline when we lose confidence in the outlook for a name. This was the case in the fourth quarter with Bloom Energy, a maker of fuel cells for power generation. We eliminated the position due to concerns of continued cash burn and the potential for dilutive financing to retire outstanding convertible debt. We also exited a position in Cambrex, a provider of ingredients and services for drug development, ahead of its acquisition by a private equity investor.

Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy underperformed its Russell 2500 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in nine of ten sectors in which it was invested during the fourth quarter (out of 11 sectors total). The primary contributors to performance were the information technology (IT), industrials and health care sectors.

On a relative basis, the Strategy underperformed its benchmark impacted by stock selection and sector allocation. Stock

selection in the health care and consumer discretionary sectors detracted the most from relative performance while an underweight allocation to health care also proved detrimental. On the positive side, stock selection in the IT and industrials sectors contributed the most to relative results.

On an individual stock basis, positions in Carvana, Fortinet, Jones Lang LaSalle, ICON and DocuSign were the greatest contributors to absolute returns in the fourth quarter. The biggest detractors from absolute returns were Grubhub, Etsy, Core-Mark Holding, RealPage and BJ's Wholesale Club.