ClearBridge Investments

# Small Cap Strategy

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## Key Takeaways

- Gains in the portfolio's financials and health care holdings drove a strong quarter of returns.
- We have become less comfortable with the current high expectations for future returns embedded in many IT and health care stocks, which is a change from previous years.
- Our portfolio has become more tilted toward valuation factors, although we remain overweight earnings quality as well, which historically has cushioned the blow in a market correction.

## Market Overview and Outlook

A year ago, the Russell 2000 Index had just fallen sharply. We were delighted with the opportunity to buy stocks at better prices. It didn't last long, however. The first quarter of 2019 saw a sharp rebound, and the year closed strongly with the benchmark up almost 10% in the fourth quarter. Our Strategy was fortunate to outperform in the quarter and the year, thanks largely to gains in financials and health care holdings. Our consumer discretionary names did not fare as well, and cash was a drag in this scorcher of a year.

As we have said many times, we assess market expectations for a company — what needs to be true about future growth and return on capital to justify the current valuation — against our own expectations based on our fundamental assessment of the company and its competitive strategy. That may seem like an obvious statement, but often one hears something very different from investors in media appearances. They often say something like, "We don't foresee anything fundamental that will derail the economy, so stocks should continue to go higher." Not only does that presume that one would be able to foresee a major problem that the market is missing, but it also ignores how expectations in the market have changed following the rise in 2019.

The Russell 2000 rose 25.5% in 2019 with dividends reinvested. It has now risen 12.2% annually since 2012. The small cap Russell 2000 Growth Index has outperformed the Russell 2000 Value Index in six of those eight years, including each of the last three years, during which growth outperformed by more than 27 percentage points. The growth index is now near its highest forward P/E multiple since the dot-com bubble, while the value multiple is near its 20-year average. As the narrative of slow,

steady economic growth has taken hold, growth has been valued at a premium and momentum has outperformed valuation significantly. That means expectations — how a company must perform in the future to be worth what it's trading for now — have risen most in those areas, primarily information technology (IT) and health care.

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The result of this growth-driven market has been that active management, broadly speaking, has significantly underperformed in small cap core. According to Morningstar, the Russell 2000 has bested active small cap core managers by more than 160 basis points (1.60%) per year over the last three years, beating about 75% of active funds.[1] Active funds tend to be significantly underweight growth, most notably in health care/biotechnology, which has been the best-performing sector since 2016, returning double the benchmark. IT has seen similar returns, far outpacing all other sectors.

Against this backdrop, it has become more challenging to identify attractively valued growth stocks. Our portfolio has become more tilted toward valuation factors, although we remain overweight earnings quality as well, which historically has cushioned the blow in a market correction. We have been overweight IT for most of the last six years, but now we are underweight. We remain underweight health care, as we have long been, though stock selection is much more important than sector exposure in health care, given its low intra-sector stock correlation. One such pick, Intra-Cellular Therapies, won FDA approval for its schizophrenia drug in the fourth quarter, which helped our strategy outperform in the quarter, despite the 30% appreciation of the biotechnology industry.

We are certainly not offering a forecast that growth will underperform value. But we have become less comfortable with the current expectations for future returns embedded in many IT and health care stocks, which is a change from previous years. We remain focused on identifying potentially undervalued investment opportunities and are still finding new ideas in those sectors, but in general they are carrying high expectations. It is increasingly risky to assume that market trends will continue unabated.

### Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed the Russell 2000 Index, the Strategy's benchmark, during the quarter.

On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested for the quarter. The primary contributors to the Strategy's performance were the health care, financials and IT sectors. The utilities, energy and consumer staples sectors were the main laggards.

[1] Based on the iShares Russell 2000 ETF performance. Source: https://www.morningstar.com/etfs/arcx/iwm/performance, accessed Jan. 7, 2020.

On a relative basis, the Strategy outperformed its benchmark due to stock selection, partially offset by sector allocation. In particular, stock selection in the health care, communication services, financials, IT and industrials sectors contributed the most to relative returns. Meanwhile, stock selection in the consumer discretionary and materials sectors detracted from relative performance, as did an underweight to the health care sector.

On an individual stock basis, Amarin, Intra-Cellular Therapies, Gray Television, HealthEquity and Murphy USA were the largest contributors to absolute performance. U.S. Concrete, K12, U.S. Silica, Aaron's and Cooper-Standard were the greatest detractors from absolute returns.

During the quarter we initiated new positions in R1 RCM in the health care sector, Brigham Minerals in the energy sector, Oxford Industries and Everi in the consumer discretionary sector and Tronox in the materials sector. We also eliminated several positions, the largest of which were Continental Building Products in the industrials sector, Q2 in the IT sector, Cooper-Standard in the consumer discretionary sector as well as Palomar and Radian in the financials sector.