ClearBridge Investments

Small 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, with small caps leading the way.
- The portfolio's differentiated health care positioning was a headwind during the quarter due to a lack of exposure to surging early stage biotech stocks.
- We actively repositioned the portfolio in 2019, making 18 new investments – many of which were IPOs – that we expect to increase over time assuming continued strong execution.

Market Overview and Outlook

What a difference a year can make. It's as if Marie Kondo decluttered the investment landscape and ridded investors of a host of concerns which gave none of us joy. In the latter half of 2018, a hornet's nest of negative trends worried investors: tariff and trade conflicts, cost pressures, Washington budget dysfunction, decelerating macro stats and rising short-term interest rates.

Late 2019 brought a tidy quasi-resolution of a multitude of those nettlesome issues:

- A phase-one deal with China (almost signed) and lessening of tariff worries
- An agreement between the White House and House Democrats on USMCA terms
- A Federal spending authorization package
- Quiescence at the Federal Reserve
- Boris Johnson getting the necessary mandate for an orderly Brexit process
- A modest uptick in U.S. industrial activity after 12–18 months of deceleration

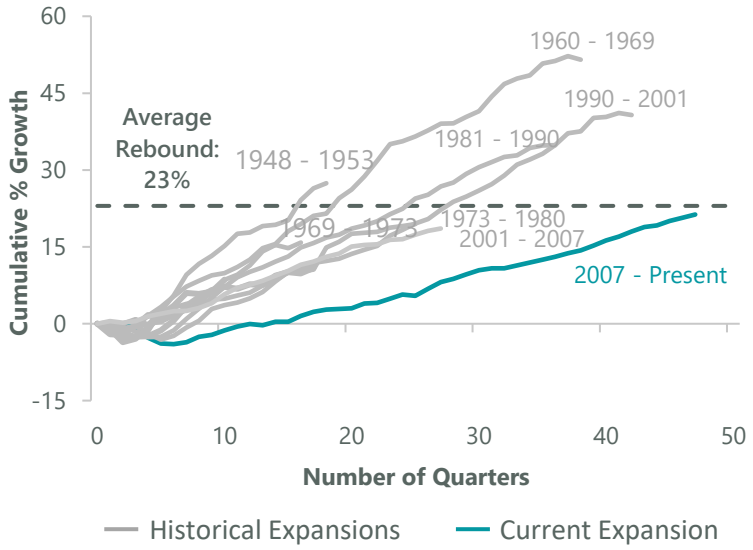
Markets ripped into the year-end mark as a result, with the Russell 2000 Growth Index up more than 11% during the fourth quarter, powered in part by strong ETF flows over the past two months.

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 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 4%–5% for the broader indexes and 9% for small cap growth stocks), 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.

Consumer balance sheets are in ruddy good shape. While corporate financial leverage is comparable, by some measures, to the last peak, U.S. banks are now in much better shape than during the Great Recession. Unemployment is at multidecade lows and labor absorption is picking up.

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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.

Performance and Positioning

After mostly keeping pace during the first three quarters of the year, the ClearBridge Small Cap Growth Strategy underperformed its Russell 2000 Growth Index benchmark during the fourth quarter, bringing the full year to a relatively modest 300 bps underperformance. The portfolio struggled during the fourth quarter market updraft, largely due to:

- A major move in the small biotech industry (+32.3%) in which the Strategy has virtually no investments
- Strong quarterly flows into small cap ETFs, which benefit disproportionately lower capitalization and lower-quality small cap stocks

The bulk of the underperformance was due to the health care sector. Several takeovers of biotech companies by major pharmaceutical companies reignited excitement in the group, which is subject to extremes of optimism and pessimism. Also, the Strategy typically lags strong "up markets," (as most recently seen in the fourth quarter of 2016), so we're not surprised at recent performance.

During 2019 we remained squarely attentive to identifying great up-and-coming businesses. We made 18 new investments with a disproportionate focus on the health care sector as four health care holdings were acquired during the year (athenahealth, Medidata Solutions, Genomic Health, Cambrex). The initial public offering (IPO) market continues to be a fertile source of new investments, and we participated in eight IPOs this year of which seven remain in the portfolio. Many of the positions are modestly sized and we expect to increase them over time assuming continued strong execution by management of the business.

We bade farewell to several holdings during 2019 due to growth of capitalization including Internet security vendor Fortinet and financial services firm SVB Financial. We also trimmed a number of holdings due to capitalization, including car auction and salvage provider Copart and diabetes care device maker Insulet.

Portfolio Highlights

On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the fourth quarter (out of 11 sectors total). The primary contributors to performance were the health care and information technology (IT) sectors.

In relative terms, the Strategy's underperformance was a result of both stock selection and sector allocation. Specifically, stock selection in the health care and consumer staples sectors, an underweight to health care and an overweight to IT hampered results. On the positive side, stock selection in the financials and IT sectors and an underweight to the real estate sector aided relative performance.

The biggest contributors to absolute returns during the fourth quarter included National Vision Holdings, Penumbra, Surgery Partners, Progyny and Chegg. Positions in Grubhub, BJ's Wholesale Club, Core-Mark Holding Company, Revolve Group and Aerojet Rocketdyne Holdings were the greatest detractors from absolute returns.

During the fourth quarter, the Strategy added six new positions, sold out of three positions and saw another three companies leave due to corporate actions. In addition to the transactions mentioned earlier, the Strategy established positions in Progyny and Silk Road Medical in the health care sector, Iridium Communications in the communication services sector, Lattice Semiconductor in the IT sector, Hain Celestial Group in the consumer staples sector and Insperity in the industrials sector. We also exited Grubhub in the consumer discretionary sector and Twilio in the IT sector.