ClearBridge Investments

# SMID Cap Growth Strategy

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## Key Takeaways

- Since the virus outbreak, we have held many conversations with portfolio companies centered on continuity, financial resources and modified operating plans and have reduced positions with heightened financial risk.
- We are confident that companies with strong balance sheets, financial flexibility, pricing power and enduring business models will be in the best shape when we get to the other side of this unprecedented slowdown.
- We were active through the extreme volatility, adding several new positions in health care and technology and adding to others.

## Market Overview and Outlook

There are times when words feel insufficient to adequately capture thoughts and the enormity of events. The 9/11 terrorist attacks and aftermath were one such instance. Now we are confronted by an invisible foe, COVID-19, which has triggered a pandemic, heightened fears of personal safety and caused a global recession and massive U.S. unemployment.

The pandemic sparked historic volatility in the first quarter and the sharpest equity selloff since the Global Financial Crisis. Small and mid capitalization stocks materially underperformed larger stocks from the mid-February market peak and by 10 percentage points for the quarter as measured by the Russell 2500 Index versus the S&P 500 Index. This is unsurprising given the "dash for cash." Growth stocks outperformed value stocks across the U.S. stock market spectrum, and in the SMID cap universe the benchmark Russell 2500 Growth Index (-23.2%) outperformed the Russell 2500 Value Index by over 11 percentage points.

The health care sector (-15.2%) was the best relative performers in the benchmark through a violent period for equities while information technology (IT, -17.9%) also held up better than the overall market. Energy (-66.8%) was the worst performer, hurt by the start of a price war that sent crude oil plummeting by two thirds to finish March at $20 per barrel. Consumer discretionary (-35.5%) and communication services (-25.9%) also underperformed as consumer spending ground to a halt due to social distancing prevention measures.

Lessons learned from the 2008–09 credit crisis left U.S. financial institutions in better condition after the capital building and stress tests of the past decade. Credit spreads have widened materially, and we anticipate financial institutions will work with debtors as covenants are inevitably breached.

### COVID-19 Strategy Actions

ClearBridge Investments invoked its Business Continuity and Operational Risk program mid-March with all systems operating, enabling the SMID Cap Growth team and all supporting employees to function remotely. Our investment process remains constant with a philosophical preference for thoughtfully financed growth businesses that can endure periods of macro dislocation. Competitive advantages may widen during this extraordinary period of national stress.

ClearBridge investment professionals have held a series of conversations with portfolio companies centered on continuity, financial resources (balance sheet) and modified operating plans (revenue disruption, expense mitigation, capital spending, responsibilities to employees and communities). For the next few quarters, the managements of the companies we hold in the portfolio face materially different "facts" compared with when the investments were originally made.

### Portfolio Positioning and Outlook

The impact of the epidemic is highly variable, dependent on end market, supply chain and business model:

- Given our bias for recurring revenue businesses and more conservative capital structures, the Strategy has virtually no direct exposure to several of the most affected industries such as casual dining and gaming.
- As anticipated, many of the "steady Eddie" businesses have held up well, both from an operating and stock market perspective.
- Other stocks proved less resilient either due to i) financial leverage, ii) valuation compression or iii) likely blunted new business momentum. We believe these companies have the financial resources to await a resumption of growth in the core business.
- Most of the companies in the Strategy have moderate-to-middling disruption risk. A few investments benefit from either accelerated behavioral changes (cloud adoption) or consumer stocking (staples). And a few companies have significantly higher risk due to end market exposure (i.e., energy, where the Strategy has modest holdings).

- Most companies in the Strategy are "full speed ahead" on product development and innovation spending. Managements continue to see substantial future opportunities while being careful to plan for inevitable shorter-term disruptions.

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We took advantage of heightened volatility during the quarter to establish three new positions. In health care, we added Bio-Techne, which develops biotechnology reagents and instruments for the global research and clinical diagnostic markets, including the emerging gene therapy and liquid biopsy markets as well as PPD, a top five clinical contract research organization with a differentiated lab business that went public in February. We also initiated a position in HubSpot in the IT sector, which has a cloud-based B2B marketing automation suite that it initially sold to small businesses and has subsequently built into powerful software tools for salesforce automation. We exited Premier in the health care sector due to continued sluggish execution in the health care improvement company's analytics business and to fund other purchases.

We anticipate a volatile and bumpy market ahead. While stocks have rebounded somewhat off the March lows due to policy responses, news over the next few months (infections, mortality, unemployment, company revisions, bankruptcies) will be predominantly somber and sobering.

The recent events and market volatility have most often been described as "unprecedented," while all market participants imagine what the world will be like "when we get to the other side." We do not know how long it will take us to get to the other side, nor do we know for certain what, if anything, will be different when we get there. We are highly confident, however, that companies with the strongest balance sheets, financial flexibility, pricing power and enduring business models will be in the best shape.

### Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the first quarter. On an absolute basis, the Strategy had losses across the 10 sectors in which it was invested (out of 11 sectors total). The consumer staples sector had the least negative returns while the industrials sector was the primary detractor.

In relative terms, the Strategy outperformed its benchmark driven by stock selection. Specifically, stock selection in the consumer discretionary, IT and real estate sectors were the primary contributors to relative performance. Conversely, an underweight to the health care sector and an overweight to consumer discretionary detracted the most from relative returns.

On an individual stock basis, DocuSign, Chewy, Five9, BJ's Wholesale Club and Fortinet were the largest contributors to absolute performance during the first quarter. The greatest detractors from absolute returns were positions in Jones Lang LaSalle, Cornerstone OnDemand, Burlington Stores, Apergy and Copart.