

# ClearBridge

## Investments

## SMID Cap Growth Strategy



**Brian Angerame**  
Managing Director, Portfolio Manager



**Aram Green**  
Managing Director, Portfolio Manager



**Matthew Lilling, CFA**  
Director, Portfolio Manager



**Jeffrey Russell, CFA**  
Managing Director, Portfolio Manager

### Key Takeaways

- ▶ While mean reversion led to a September rally for value stocks across U.S. equity markets broadly, growth outperformance persisted among mid caps.
- ▶ We remained active in seeding the Strategy with new growth names across five sectors, positioning for a variety of post-pandemic outcomes.
- ▶ Stock market multiples are high by absolute standards. Yet compared with paltry fixed income yields, there is still good value to be captured in mid cap growth stocks.

### Market Overview and Outlook: Positioning to Promote Future Growth

What a nine months we've experienced, with manifold uncertainties clearly in sight:

- The COVID-19 (C-19) pandemic (over 208,000 known domestic casualties)
- Economic shutdowns in the U.S. and elsewhere
- A flash recession that exceeded the Great Depression in speed and severity
- Speedy, coordinated fiscal and monetary policy response which led to a brisk, if incomplete, recovery with roughly half the jobs lost at the depth recovered
- High velocity capital-raising by corporates given the uncertainty of the C-19 disease progression
- Police shootings and high-level social protest causing America to re-examine its diversity and inclusion efforts
- Political dissension about the outcome of the looming November national elections as well as the composition and size of the U.S. Supreme Court
- A C-19 super-spreader event in the Rose Garden leading to the hospitalization of the president
- The acceleration of a variety of secular trends relating to digital experience (telemedicine, work-from-home, cloud adoption)

If we were focused solely on these macro factors, our heads would assuredly be spinning. That's why we concentrate on companies and their opportunities as well as capable management execution throughout the many abnormal challenges.

Despite a sharp selloff among information technology (IT) and Internet names to start September, growth stocks maintained their leadership in the third quarter with the benchmark Russell 2500 Growth Index gaining 9.4% for the quarter, outperforming the Russell 2500 Value Index by nearly 600 basis points.

Many strategists and investors question the durability of that trend and we're the first to admit mean reversion could happen any time, as we've experienced some sharp daily reversals. Indeed, during September, the Russell 3000 Value Index outperformed the Russell 3000 Growth Index; but at least in the SMID universe, growth outperformance persisted.

Growth stocks continued to lead despite earnings during the second quarter declining by roughly one third. While earnings will still be lower year over year for the next two quarters, the gradient is positive and underwritten by GDP, which may increase as much as 30% or more sequentially versus the second quarter.

Consumer discretionary (+16.5%), industrials (+14.4%) and consumer staples (+12.9%) were the best-performing sectors in the benchmark. Energy (-4.5%) and utilities (-3.8%) and were the worst-performing sectors, while communication services (+2.2%), financials (+4.3%), real estate (+5.2%) and materials (+6.4%) also lagged.

Overall, companies have adapted rapidly to 1) protect their employee's safety, 2) serve their clients, 3) be thoughtful about their community responsibilities, and 4) ensure their capital adequacy.

### **Portfolio Positioning**

With the macroeconomic backdrop highly uncertain, our activity level remained high during the third quarter as we seek to position the SMID Cap Growth Strategy for a post-COVID-19 environment. We added six positions across four sectors:

- We were most active in health care, adding three new companies. Charles River Laboratories is the leading provider of outsourced preclinical services for biopharmaceutical research and development. Charles River is benefiting from the biotechnology funding environment and the increased usage of outsourcing for clinical work by drug companies. Avantor also supports clinical research as a provider of reagents and similar products and chemicals for biotechnology companies. Neurocrine Biosciences, meanwhile, is a biotechnology company targeting treatments for neurological and endocrine conditions including Parkinson's disease.
- Everbridge, in the IT sector, is a SaaS provider of enterprise software to automate and accelerate operational response to critical events to keep people safe and drive business

continuity. Customers span corporates, governments and health care organizations. Everbridge has numerous opportunities in front of it to sustain a long runway of growth including, the late 2018 rollout of its platform offering Critical Event Management (CEM), which bundles together its suite of services and surpasses the point solutions/manual operations used by most potential customers.

- Purple Innovation, in the consumer discretionary sector, is a mattress maker operating a direct-to-consumer business that has taken off due to its superior marketing technology and the quality of its internally manufactured, unique, purple-colored “hyper-elastic polymer” products.
- Performance Food Group, a consumer staples name we purchased last quarter in several other small and mid cap strategies, is a supplier to the food service industry that we believe has the technology to cater to changing restaurant customer preferences and the balance sheet to fund acquisitions or take share from weaker local players.

The Strategy’s exit of commercial real estate broker and operator Jones Lang LaSalle reflected headwinds in the office market as companies balance work-from-home with future office space needs.

## Outlook

With so little visibility in markets and the economy, we see resolution of COVID-19 and the election as the two biggest unknowns in the near term. Yet we manage the portfolio without conscious or explicit macro tilts. Instead, our investment process is grounded by derisking individual investments; returns are from a concentrated portfolio that embeds a variety of growth rates.

Stock market multiples are high by absolute standards. Yet compared with paltry fixed income yields and a 10-year Treasury yield below 1%, there is still good value to be captured in stocks. U.S. unemployment is receding, forward inflation expectations appear quiescent and fixed income and equity capital availability is ample.

Ongoing risk management remains of paramount importance, assessing how exogenous events and factors can affect specific investments in the Strategy. Our attention to sustainable business dynamics, backed up by robust capital discipline, is an elemental ClearBridge philosophy that we will continue to apply to the existing portfolio and new growth opportunities that we foster.

## Portfolio Highlights

During the third quarter, the ClearBridge SMID Cap Growth Strategy underperformed the benchmark Russell 2500 Growth Index. On an absolute basis, the Strategy had gains across nine of the 10 sectors in which it was invested during the quarter (out of 11 sectors total), with the consumer discretionary and health care sectors the leading contributors.

In relative terms, underperformance was primarily due to stock selection, while sector allocation effects were positive. Specifically, stock selection in the IT sector was the primary drag on results. Meanwhile, stock selection in the consumer discretionary and communication services sectors and an overweight to consumer discretionary contributed to relative performance.

The leading contributors to absolute returns during the third quarter included Carvana, DocuSign, Copart, Insulet and Mettler-Toledo. Positions in BioMarin Pharmaceutical, Fortinet, New Relic, Neurocrine Biosciences and Monro were the greatest detractors from absolute returns.

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