

ClearBridge Investments



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Small Cap Growth Strategy

Key Takeaways

- ▶ Small cap growth stocks endured a disconcerting year of profound instability for society and the U.S. economy to follow up a very strong 2019 with even better performance in 2020.
- ▶ The Strategy underperformed for the quarter as a major market rotation after “Vaccine Monday” provided a bid to more cyclical stocks, those positioned for a reopening of the economy and small cap biotechs.
- ▶ Remaining squarely attentive to identifying great new companies, we made nine new investments during the quarter including participating in three IPOs and two private placements.

Market Overview: Cultivating New Growth Ideas Amidst Transition

Last year we advised investors, “don’t succumb to vertigo” as the small cap growth equity market reached record highs after a 28.5% increase during 2019.

At that time, no one could have foreseen the coming events of the year just past including: 1) a lethal and virulent pandemic, 2) wrenching nationwide social justice protests, 3) a resolved though still-contested national election, and 4) manic levels of capital raising by U.S. corporations. And yet, quite implausibly, small cap growth stocks, as measured by the benchmark Russell 2000 Growth Index (R2000G), did even better with a 34.6% return in 2020.

Merrill Lynch’s market legend Bob Farrell once quipped, “The market usually does whatever makes the most people most uncomfortable.” Morgan Stanley’s Barton Biggs’s similar and more colorful expression of that sentiment was “We forget that Mr. Market is an ingenious sadist, and that he delights in torturing us in different ways.”

As we’ve remarked in these commentaries and in conversations, the ClearBridge Small Cap Growth Strategy is not guided by our views of “the market.” The portfolio is populated with a high active share, concentrated accent on companies with innovative products and services, capital adequacy and focused leadership. During 2020, company managements have had to lead through some of the most trying circumstances of our investment careers.

This year's Strategy performance was marked by three phases:

- **Phase 1:** A euphoric overall market march to highs in February followed by a rapid and nauseating plunge of equities, hitting bottom in late March, during which the Strategy held serve versus the benchmark.
- **Phase 2:** The recovery from late March until "Vaccine Monday" (November 9) when the efficacy of Pfizer/BioNTech's vaccine was joyously revealed. The Strategy handily outperformed during this period as the opportunities and operating dynamics for a number of portfolio companies were accelerated materially.
- **Phase 3:** Vaccine Monday through year end, when the Strategy underperformed as an investor rotation toward value/cyclical/reopening/biotech/the smallest of the small investments combined with a rapid market ascent (Russell 2000 Index +20.7% since Vaccine Monday) led to a forfeit of about half of Phase 2's outperformance.

Overall, this has been an investment year with rewarding returns during a disconcerting year of profound instability (political, social, economic, health, climate). We are mindful of our extraordinary good fortune and are ever-thankful for those who have ministered to the afflicted and needy during these times which presented great challenges to many.

Portfolio Positioning

After substantially outperforming during the first three quarters of the year, the Small Cap Growth Strategy lagged its Russell 2000 Growth Index benchmark during the fourth quarter, bringing the full year outperformance to approximately 900 basis points. The Strategy typically lags in vigorous "up markets," (as most recently seen in the fourth quarter of 2019) so we were not surprised at the fourth-quarter underperformance largely due to:

- A major move in the small cap biotech industry (up 34%) in which the Strategy has limited investments.
- Strong quarterly flows into small cap ETFs, which benefit disproportionately from lower-capitalization and lower-quality small cap stocks.
- The "recovery trade" favoring companies most disadvantaged by COVID-19, to which the Strategy had limited exposure.

During 2020 we remained squarely attentive to identifying great new companies. We made nine new investments in the fourth quarter and 25 for the year, of which 22 remain in the Strategy at the close of the year. The initial public offering (IPO) market continues to be a rich source of new investments, and we participated in three IPOs during the quarter (Allegro

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MicroSystems, Certara and Hydrofarm Holdings) and nine for the year and continue to hold eight of them. Many of the positions are modestly sized and we anticipate increasing them over time assuming continued strong execution by management of the businesses. We also committed capital to three modest-sized private placements, two occurring in the fourth quarter, in payroll services (Paycor) and life sciences (Caris Life Sciences).

We bade farewell to several very successful long-time holdings due to growth of capitalization. Those exits included the fourth-quarter sales of document management and signature verification software vendor DocuSign, in which the Strategy participated in a pre-IPO private placement during 2015; Livongo Health after its acquisition by Teladoc Health; and Copart, which provides service to the wholesale auto auction and parts salvage businesses, earlier in the year. We trimmed a number of other holdings, again due to ascending capitalization, including medical technology provider Insulet, Internet web design source Wix.com, fabless semiconductor design firm Monolithic Power, industrial manufacturer Idex and online educational resource platform Chegg. Proceeds from these portfolio actions were redeployed into new investments.

Portfolio Highlights

During the fourth quarter, the ClearBridge Small Cap Growth Strategy underperformed its Russell 2000 Growth benchmark. 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 IT, health care and industrials sectors the leading contributors.

In relative terms, overall stock selection and sector allocation detracted from performance. Specifically, stock selection in the health care, IT and consumer staples sectors was the primary headwind to results, while stock selection in the communication services and industrials sectors and an overweight to consumer staples also hurt performance. Conversely, stock selection in the financials sector, an overweight to IT and an underweight to the real estate sector contributed to relative results.

The leading contributors to absolute returns during the fourth quarter included Inphi, Fox Factory, Hubspot, Trupanion and Western Alliance Bancorp. Positions in Bandwidth, BJ's Wholesale Club, Vroom, Penumbra and Silk Road Medical were the greatest detractors from absolute returns.

In addition to the transactions mentioned above, we initiated positions in ChampionX in the energy sector, Hamilton Lane in the financials sector as well as Omnicell and Quanterix in the health care sector. We closed positions in Hudson in the consumer discretionary sector and AssetMark Financial in the financials sector.

CLEARBRIDGE SMALL CAP GROWTH STRATEGY

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