ClearBridge Investments

Mid Cap Growth Strategy

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Key Takeaways

- Mid cap growth stocks regained comparative performance momentum compared to mid cap value stocks, narrowing the recent gap in returns.
- Strategy performance during the quarter was supported by balanced contributions, with particular strength in health care.
- Pricing power is a key metric we are assessing among our portfolio holdings as we believe inflation is a more serious threat than policymakers are willing to admit. That said, we like our positioning for a period of rising inflation with companies able to push through price increases above input costs.

Market Overview

The second quarter of 2021 brought volatile markets and robust capital raising of about $40 billion in the initial public offering (IPO) market. Growth stocks reasserted themselves in the second quarter after an accelerated run for cyclicals post the COVID-19 vaccine approvals. The benchmark Russell Midcap Growth Index gained 11.1% in the second quarter, outperforming the Russell Midcap Value Index by 540 basis points.

From a sector standpoint, energy (+19.9%) and real estate (+17.6%) were the best performers in the benchmark but account for minimal exposure. Among sectors with broader representation, health care (+13.5%), communication services (+12.9%), financials (+11.7%), information technology (IT, +11.6%) and industrials (+11.3%) also outperformed. Meanwhile, the consumer discretionary (7.7%) and consumer staples (+0.2%) sectors lagged.

While the ClearBridge Mid Cap Growth Strategy trailed the benchmark in the second quarter, we are pleased with its absolute performance (+14.9%) and relative success (+445 bps over benchmark) year-to-date. This has been a challenging overall market to navigate as businesses that were highly advantaged by conditions in 2020 (think all things digital) continue to prosper but face "tough comps" and the dreaded "negative second derivative" of growth. The balance in the Strategy helped this quarter as illustrated by the diversity of contributors including both disruptive growth companies that were last year's strong

performers as well as holdings in more defensive areas of the mid cap market.

DocuSign, for example, delivered first-quarter results that blew past expectations, quelling fears the e-signature provider was simply a COVID-19 beneficiary that would struggle to beat tougher comparisons. Instead, DocuSign highlighted new cloud-based functionality covering the full lifecycle of agreements that doubles its addressable market. The company has already made the investments to expand from its initial business of streamlining the signing of contracts to offer business intelligence and analytics that can help companies run their operations more efficiently. We expect revenues from this new market will begin to ramp up in 2022.

Portfolio balance was illustrated by contributions from both disruptors as well as holdings in more defensive areas.

The Strategy also received strong contributions from several companies in the health care sector. Charles River Laboratories provides products and services to support pharmaceutical and biotechnology clinical research. The market reacted positively to the company's announced acquisition of Vigene Biosciences, a gene therapy development and manufacturing company, which will allow Charles River to expand its cell and gene therapy portfolio. Mettler-Toledo also supports biopharmaceutical research as well as industrial and food service companies as a manufacturer of scales and analytical instruments. The release of a new product line, which can compute weightings at speeds significantly higher than industry standards with a smaller footprint than earlier models, allowed the company to maintain its positive momentum. IDEXX Laboratories, meanwhile, benefited from strong performance in its veterinary products segment as pet ownership continues to increase.

Some of our best performing holdings over the last several quarters took a pause during the strong up market in the second quarter. Stocks that took a breather included Performance Food Group, which declined on negative sentiment toward its planned acquisition of convenience store distributor Core-Mark, as well as Chewy, which gave back some gains over fears that a return of pet owners to brick-and-mortar retailers will threaten the company's e-commerce business. We maintain confidence Chewy will be able to maintain the customer relationships it established during pandemic lockdowns as well as expand into international markets. The Strategy also saw some give back from recent strong performer Casey's General Stores.

Portfolio Positioning

We established five new positions during the quarter across four sectors, supporting our approach of seeking to participate in a broad range of growth opportunities among mid cap companies.

We participated in the IPO of Doximity, a cloud-based telehealth and digital information platform for physicians. The company's registered physicians use the platform to manage their practices, share and access information and provide feedback to health systems. In turn, Doximity's 600+ subscription customers (pharmaceutical companies and health systems) market to an extremely pre-qualified and engaged physician base. We also participated in the IPO of Compass, a real estate technology company disrupting the residential brokerage industry by improving agent efficiency, leading to rapid market share gains.

Within IT, we added positions in Coupa Software, a leader in the fast growing Business Spend Management market with opportunity to double its total addressable market by harnessing B2B payments with its Coupa Pay product; and AppLovin, a leading mobile gaming advertising network in a unique position to utilize its ad expertise to grow its own mobile game business at low user acquisition costs.

Our other new purchase was Oatly, a top market share producer of oat-based milks disrupting the dairy category by displacing almond milk and soy milk with low penetrations in North America, Europe, and Asia. We believe Oatly has an opportunity to increases margins as it brings production capacity in-house.

On the sell side, we closed out of contract research organization PPD following the announcement of its acquisition by Thermo Fisher Scientific and Qualtrics, an experience management software company, where we were unable to build a sufficient position following its successful IPO.

Outlook

Pricing power is one of the key fundamentals we are currently assessing among our portfolio holdings as we believe inflation is a more serious threat than policymakers are willing to admit. The CEOs we engage with every day mention higher inflation as a key concern going forward. When inflation spikes, investors find out quickly who has legitimate pricing power to offset rising raw material and transport costs. The U.S. has not seen real inflation in 40 years, and we are also closely monitoring consumer behavior and how they will react to rising prices.

Current inflation is partly a function of massive liquidity but also the global supply chain and employment disruptions caused by COVID. With goods like semiconductors for autos and other high-end applications scarce and manufacturers struggling to bring on

labor and capacity, the natural response is to raise prices to capture as much value as possible. We also like our positioning for a period of rising inflation with companies like Casey's and Grainger, who are able to maintain strong pricing power and push through price increases above input costs.

Overall economic growth (e.g., +6.4% first-quarter GDP) has been favorable to earnings after a very challenged macroeconomy in 2020. Companies are contending with disrupted supply chains, volatile commodity inputs and select labor shortages. Investors are dimensioning the concomitant trajectory of inflation (transitory or permanent?), the implication for long-term interest rates as well as the ramifications of fiscal spending proposals with limited precedent. All this has happened against a background of encouraging U.S. COVID-19 news (caseloads down, vaccination rates up), although there is still cautious concern about possible negative developments in the fight against the pandemic.

Portfolio Highlights

During the second quarter, the ClearBridge Mid Cap Growth Strategy underperformed the benchmark Russell Midcap 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 IT and health care sectors the leading contributors.

In relative terms, stock selection and sector allocation detracted from performance. Specifically, stock selection in the industrials, communication services, real estate and consumer discretionary sectors and the Strategy's cash position negatively impacted results. On the positive side, stock selection in the health care and IT sectors contributed to relative performance.

The leading contributors to absolute returns during the second quarter included Fortinet, DocuSign, IDEXX Laboratories, Charles River Laboratories and Mettler-Toledo International. Positions in Performance Food Group, Citrix Systems, Chewy, Casey's General Stores and Compass were the greatest detractors from absolute returns.