ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- The Russell 2000 Value Index partially closed its multiyear gap with the Russell 2000 Growth Index in the quarter, with value falling 3.0% compared to growth declining 5.7%.
- As long as it's "risk-on" in the oil patch, it will remain difficult to keep up with the highly levered, high-beta names, though we found opportunity there in a low-cost producer that has always run with no debt and measured depletion.
- The small cap IPO market is a volatile one, as last quarter's leader became this quarter's laggard. However, a new IPO in the IT sector showed strong performance. We believe both are poised for long-term success.

Market Overview and Outlook

Small cap stocks delivered negative returns in the third quarter, with the Strategy coming in slightly below the Russell 2000 Index's -4.4% return. The Russell 2000 Value Index partially closed its multiyear gap with the Russell 2000 Growth Index in the quarter, with value falling 3.0% compared to growth declining 5.7%. However, growth has still outperformed value by almost 700 basis points since 2016. This small move did not change the market's barbell status: companies with high sales growth and low or no profitability remain extremely expensive relative to historical levels, while companies generating strong current cash flows carry roughly normal valuations. We believe this difference will close over time, likely due to a combination of a significant valuation correction in growth stocks and appreciation of value stocks. The catalyst for this change is unknowable, but with wage growth increasing and worker shortages across every sector of the economy, higher inflation than we have seen in decades is not out of the question. Inflation would increase the time value of money and reduce the present value of cash flows that prop up expectations for money-losing companies. While we do not invest based on macroeconomic forecasts, we use them as informative inputs in our evaluations, which is a necessary prerequisite for buying stocks that rely on substantial terminal values to justify their price.

The quarter had some headwinds for many of our consumer discretionary holdings, particularly recent IPO 1stDibs.com,

which fell after a strong second quarter. Much of the decline came solely from a correction in the massive gain 1stDibs.com had on the last day of the second quarter, not based on anything fundamental. However, the company launched a low-cost, new non-fungible token (NFT) platform for selling digital art, which we believe will add value over time. The opportunity for recovery in its interior-design business and international expansion make us optimistic about the company's future. We believe 1stDibs.com is well-positioned for long-term success in high-end, high-touch online collectibles commerce.

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Elsewhere in the consumer discretionary sector, however, Murphy USA, which operates a chain of retail gas stations, continued to produce excellent financial results despite pressure on fuel volumes. The company's exceptionally low fuel breakeven points relative to peers has allowed it to earn much better margins on fuel than it can when gas is in high demand, because competitors need to raise prices more to remain profitable when volumes fall. In addition, strong uptake in its customer loyalty program is driving merchandise purchases even as fuel volumes remain low, and cost discipline is keeping operating costs low. We continue to believe Murphy is one of the best-run companies in the U.S. and that it remains attractively valued.

Our underweight to oil exploration and production companies (E&Ps) hurt performance, as they outperformed the rest of the energy sector. The market has become enamored of E&Ps, especially those with a lot of debt, because of skyrocketing oil prices and new-found spending discipline among U.S. public producers, which is keeping a lid on production growth. This unique moment in time, where demand is relatively low but supply even lower, has helped companies reduce their debt, but it is not sustainable. Private U.S. oil producers are rapidly increasing production, but OPEC can change this dynamic by press release, bringing production back to 2019 levels. Furthermore, depletion rates are likely to force further spending in 2022–2023, as the cheap-and-easy wells begin to dry up. We did find the opportunity to add to our energy holdings during the quarter, with the addition of Magnolia Oil & Gas, a low-cost producer that has always run with no debt and measured depletion. But, as long as it's "risk-on" in the oil patch, it will remain difficult to keep up with the highly levered, high-beta names.

The Strategy benefited from its underweight in health care, which made the most negative contribution in the benchmark. Within health care, however, biotechnology company Amarin had a strong quarter. Amarin received approval for its lead drug in the EU and is launching its sales effort in Germany. The company has cut costs from its U.S. business, where a tragic patent ruling undermined Amarin's intellectual property and allowed generics to enter the market before it was established. Now, with no

companies promoting icosapent ethyl in the U.S., sales have stalled, resulting in Amarin being profitable, but Americans unnecessarily left without a lifesaving drug. The European opportunity is large enough to account for a much higher valuation than Amarin currently enjoys.

The Strategy also benefited from the strong performance of TaskUs, a recent information technology (IT) IPO. TaskUs's very strong second-quarter results (the first since its IPO in June, in which we participated) highlighted the long-term revenue growth and free cash flow generation opportunities for TaskUs. Each of its segments (digital customer experience, content security and AI operations) address large and growing markets. Strong execution shows that TaskUs is likely to grow alongside existing customers, add new customers and add lines of business served. Unfortunately, much of this gain was offset by a big drop in the second quarter's strong IPO performer, 1stDibs.com, a reminder of the volatile world that is small cap IPOs.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed the Russell 2000 Index, the Strategy's benchmark, during the third quarter.

On an absolute basis, the Strategy posted losses in nine of 11 sectors in which it was invested for the quarter. The primary contributor to the Strategy's performance was the IT sector. The consumer discretionary and health care sectors were the main detractors of performance.

On a relative basis, the Strategy underperformed its benchmark due to stock selection, while sector allocation was a positive contributor. Stock selection in the consumer discretionary, consumer staples, real estate and energy sectors detracted from performance. Conversely, stock selection in the IT, materials and communication services sectors and an underweight to the health care sector generated positive returns.

On an individual stock basis, TaskUS, Murphy USA, Switch, BRP Group and Rapid7 were the largest contributors to absolute performance. The primary detractors were 1stDibs.com, Metromile, Real Matters, Covetrus and Urban Outfitters.

During the period, we initiated new positions in Sovos Brands in the consumer staples sector, Thoughtworks in the IT sector and Sterling Check in the industrials sector. We closed positions in SOC Telemed in the health care sector, QuinStreet in the communication services sector, Macy's in the consumer discretionary sector and Evoqua Water Technologies in the industrials sector. During the quarter, portfolio holding Acies Acquisition Corp, a special-purpose acquisition company (SPAC), merged with target company Playstudios, in the communications sector, whose shares we retained.