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SMID Cap Growth Strategy

Key Takeaways

- ▶ The second quarter was a rollercoaster ride for small and mid cap stocks, as double-digit declines in April driven by tariff and regulatory changes gave way to material market gains in May and June.
- ▶ Despite historically challenging conditions, the Strategy outperformed its benchmark due to contributions from our health care and consumer staples holdings.
- ▶ With valuation and performance for SMID caps relative to large peers near all-time lows and the potential for faster earnings growth later in 2025, SMID stocks are well-positioned for improved performance.

Market Overview

The second quarter was a rollercoaster ride for small and mid cap (SMID) stocks, as double-digit declines in April driven by tariff and regulatory changes gave way to material market gains in May and June. SMID stocks broadly advanced, with the Russell 2500 Index returning 8.6% — in-line with the Russell 2000 Index but trailing the large cap Russell 1000 Index's return of 11.1%. The easing of macroeconomic fears allowed the benchmark Russell 2500 Growth Index to return 11.3%, more than 400 basis points higher than the Russell 2500 Value Index.

The hallmark of the last three months has been reversals — of trade policy, legislative priorities and sentiment. The stock market has grown somewhat accustomed to the administration's trade threats and has taken advantage of signs of possible trade deals and progress with key counterparties to price in more benign outcomes than feared in the immediate aftermath of the proposed tariff policies. More recently, progress on the reconciliation bill could also provide tailwinds to several corners of the economy while extending some of the 2017 tax cuts.

Although businesses and consumers are faced with a still-uncertain set of operating conditions, the underlying macroeconomic indicators are not signaling undue stress, with unemployment, inflation and spending trends at manageable levels. One of the most prominent market narratives remains around the generational potential of generative AI to reshape numerous aspects of business and daily life, albeit with a rapidly evolving technological paradigm of winners and losers. With innovation in the technology sector, as well as in exciting growth markets in health care and industrials (such as space), the

capital markets are gradually thawing with several successful IPOs and hopes of a steady pipeline over the coming quarters.

Portfolio Performance

With potential for faster earnings growth, SMID is poised for improved performance.

Against a backdrop of a violent drawdown and an equally sharp rebound led by lower cap and lower-quality stocks — an environment that has historically proven challenging for our quality-focused, high active share portfolio — the ClearBridge SMID Growth Strategy outperformed its benchmark in the second quarter largely due to contributions from the health care and consumer staples sectors.

Stock selection in health care overcame broad sector headwinds stemming from a myriad of regulatory, tariff and demand challenges. Several portfolio holdings in the biotech sector stood out, largely supported by a combination of positive clinical readouts, commercial execution and strategic M&A. Shares of Insmed, a biotech company focused on therapies for patients with serious and rare diseases, rose following the release of positive Phase 2 data for its treatment for pulmonary arterial hypertension, TPIP, and improved future earnings estimates. As a once-daily dosage, TPIP could supplant the current leading treatment (which requires four daily dosages), leading Insmed to capture significant market share.

The Strategy also benefited from positive performance in its medical device companies, led by Insulet — a manufacturer of insulin delivery systems. The company's stock rose sharply on a combination of strong first-quarter earnings with above-expected revenue growth and margin expansion, as well as the launch of its Omnipod 5 insulin delivery system in four new countries, the new capability to integrate its products with Apple iPhone IOS and accelerating traction within its usage for type 2 diabetes.

Consumer staples was also a fertile ground for positive contributors; e.l.f. Beauty, which has suffered over the past few quarters from lackluster demand and the fear of tariffs, saw its stock rise on investors' positive reception to its acquisition of Rhode, a skin care brand, and better in-channel sales reports suggesting the company is successfully navigating the current challenging demand environment. Meanwhile, Casey's General Stores, which operates convenience stores and gas stations, continues to see the benefits from its aggressive reinvestment in its stores over the past decade, in which it has built its private label brand and broadened its product offerings. This has not only helped improve same-store sales but has also encouraged repeat traffic, allowing the company to buck broader industry trends toward contraction in gas volumes and margins. Finally, the company's strategy of choosing locations in smaller and more remote markets has afforded it stronger pricing power.

Our most meaningful detractor from a sector perspective was information technology (IT), as uneven software and consumer

demand outlooks weighed on companies like Wix.com, which operates a cloud-based web development platform for creators; Globant, which offers studio products for AI adaptations for media, entertainment and other industries; and Teledyne Technologies, which provides enabling technologies for industrial growth markets such as spectrum sensors and digital cameras. Moreover, not owning several benchmark constituents with exposure to AI, quantum computing and other high-momentum themes were headwinds to relative performance in this sector. However, we did see a positive contribution from data protection and security services operator Rubrik — a top contributor — which continued to benefit from customers' increasing prioritization and spending on IT security.

Portfolio Positioning

We initiated a new position in Ryan Specialty Holdings, one of the largest domestic wholesale property and casualty insurance brokerage firms, focused on the excess and surplus markets. The company has historically delivered excellent organic growth through a combination of innovation, a strong sales culture and cyclical exposure to a strong property and casualty pricing environment. Additionally, Ryan Specialty has a successful track record of consistent tuck-in consolidation of its smaller peers. We believe that its strong track record helps separate Ryan Specialty from other insurance brokers with its addition enhancing portfolio diversification.

We also added Duolingo, a leader in online learning whose freemium digital education model offers over 40 languages. The company's app has exhibited rapid growth, both in total number of users as well as its conversion of free to paid subscribers. Additionally, the company is now expanding into new categories, such as math, music and chess, which we believe has the potential to attract further users and swell its total addressable market. Finally, Duolingo has a long history of product innovation, marketing efficiency and attractive profitability and economics.

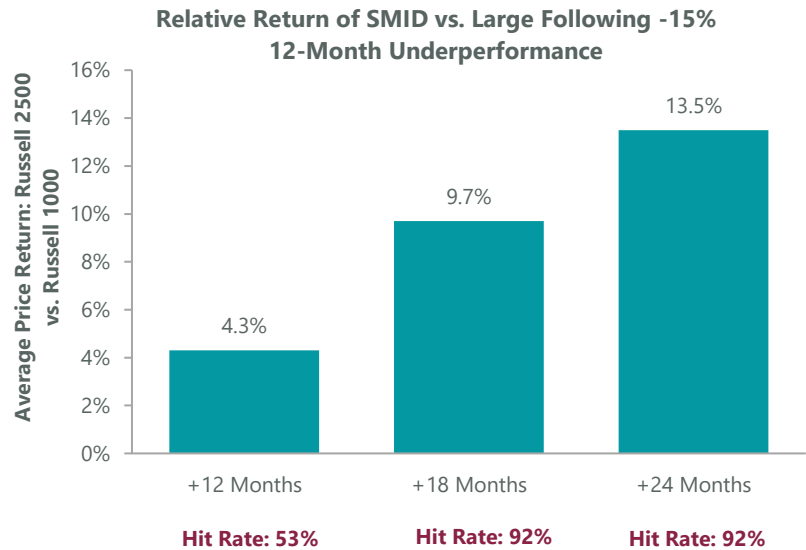
After several quarters of poor performance, we made the decision to exit our holding in Ashland, a specialty chemical company in the materials sector that provides additives and specialty ingredients to customers in the life sciences, personal care and household, and specialty and solvents industries. The company has struggled to overcome the headwinds posed by persistent destocking and divestiture trends over the last few years, and the added macro pressures from tariffs and economic uncertainty, combined with recent management turnover, have reduced confidence in our long-term thesis.

Outlook

While recent performance would suggest the market has grown more sanguine about the impacts from a myriad of macroeconomic

policy and geopolitical considerations, we would highlight that our discussions with management teams present a more uncertain outlook, corroborated by mixed quantitative and qualitative macroeconomic indicators. For businesses, consumers and investors the most consistent predictable factor is unpredictability, with major policy and geopolitical priorities and rapid technological innovations influencing narratives and outlooks. We are mindful of the risk that there could be air pockets caused by the changing tariff environment and anticipate another choppy earnings season ahead. Against this backdrop, the portfolio’s focus on companies with idiosyncratic growth and profitability drivers, as well as self-funded balance sheets, along with its owning a balanced spectrum of growth businesses, should position us well for a variety of market outcomes. With valuation and performance for SMID caps relative to large cap peers near all-time lows, coupled with the potential for faster earnings growth later in 2025, we believe small and mid cap stocks are well-positioned for improved performance (Exhibit 1).

Exhibit 1: SMID Cap Snapback



Russell 2500, Russell 1000, reflective of period from 1979 – present, as of June 30, 2025.
Sources: FactSet, Russell.

Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the second quarter. On an absolute basis, the Strategy had positive contributions from eight of the 10 sectors in which it was invested (out of 11 sectors total). The largest contributors were the industrials and IT sectors, while the materials and energy sectors detracted.

On a relative basis, overall stock selection contributed to performance. Stock selection in the health care, consumer staples and energy sectors benefited performance. Conversely, stock

selection in the IT, financials and materials sectors, as well as a lack of exposure to the utilities sector weighed on performance.

On an individual stock basis, the biggest contributors to relative returns during the quarter were APi Group, BWX Technologies, Wingstop, Chewy and Rubrik. The largest detractors from returns were Burlington Stores, ICON, BJ's Wholesale Club, Wix.com and Tradeweb Markets.

In addition to the transactions mentioned above, we initiated new positions in Rhythm Pharmaceuticals and Ensign Group in the health care sector and UMB Financial in the financials sector. We also exited positions in Vertiv in the industrials sector, Sarepta Therapeutics in the health care sector, EQT in the energy sector and Tradeweb Markets in the financials sector.

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