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## Mid Cap Strategy

### Key Takeaways

- ▶ Mid cap stocks retreated in the second quarter, as investors continued to narrow their focus to a small handful of AI and bitcoin beneficiaries at the expense of the broader market.
- ▶ The Strategy underperformed its benchmark as detractors in the technology and industrials sectors overcame positive contributions from our holdings in consumer staples and materials.
- ▶ With greater uncertainty on economic and political fronts, and mounting concerns over market concentration, we believe the benefits of our philosophy of active management and diversification and our focus on strong corporate fundamentals will only become more evident.

### Market Overview

The second quarter proved a challenging one for the mid cap market, as investors continued to narrow their focus on a small handful of AI, bitcoin and other “big picture” stocks, while economic deceleration and a higher-for-longer interest rate outlook weighed on the rest. The result was a broad retreat, with seven of the 11 Russell Midcap Index sectors posting negative returns and a -3.35% decline for the overall index. Against this challenging backdrop, growth stocks only slightly outperformed value stocks for the quarter, with the Russell Midcap Growth Index returning -3.21% versus the -3.40% return of the Russell Midcap Value Index.

From a sector standpoint, utilities (+3.80%) generated the best performance in the benchmark, followed by communication services (+2.69%), information technology (IT, +1.17%) and real estate (+0.45%). Energy (-0.38%) and financials (-3.12%) also outperformed the broader benchmark. Conversely, the consumer staples (-9.06%), health care (-8.45%), materials (-8.06%), consumer discretionary (-5.98%) and industrials (-5.14%) sectors underperformed.

After two years the long-awaited economic soft landing has finally appeared, manifesting as a prolonged economic deceleration. Given the market highs and hurdles for corporate earnings coming off a strong first quarter, this deceleration challenged even the best-executing companies to continue a beat-and-raise cadence. This was further complicated by a growing prospect of higher-for-longer interest rates, which had widespread implications across sectors, including delayed business spending, a deteriorating outlook for industrials and non-residential construction and additional pressure on discretionary consumer spending. Add to that increased

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uncertainty surrounding the upcoming U.S. election and its implications on tax rates, tariffs, the economy and inflation, and it is no wonder that companies are espousing a more conservative outlook to the disappointment of investors.

However, it is not all doom and gloom for mid caps, and we are seeing plenty of reasons to feel optimistic. First, we believe many sectors that felt the pain of destocking trends in 2023, such as life science R&D, specialty chemicals and software, are seeing these headwinds dissipate. This should leave them exceptionally well positioned to beat weaker year-over-year comps in the second half of 2024. Additionally, the IPO and capital markets have begun to rebound, albeit slowly, providing new investment opportunities and idea generation. In fact, this quarter saw our first IPO participation since the capital markets fervor of 2021 with data security provider Rubrik. Finally, elevated market concentration has resulted in a wide field of oversold mid cap stocks, many exhibiting strong revenue growth rates, which we believe can compound through this short-term weakness to become bigger and better companies on the other side.

Stock selection in the IT sector was the leading detractor from relative performance, with our high-quality software holdings hurt by constrained client spending and a focus on how to maximize the benefits of AI integration. For example, shares of software-as-a-service development company Freshworks fell due to a weaker spending environment for small and medium-size businesses as customers continue to push out spending amid economic uncertainty. An obtuse explanation by management about the impact from AI on the company also pressured the stock. Rather than a threat, we believe that the ongoing development and rollout of AI will create a tailwind for this already strong company and, after speaking with management, we continue to believe that Freshworks's customer service and related sales offerings are optimally positioned to gain market share once customers' purse-strings open.

Stock selection in industrials also weighed on performance as macro uncertainty and higher-for-longer interest rates has led to weaker industrial and construction activity. This included Regal Rexnord, a leader in manufacturing specialty electrical components and systems, including industrial powertrain solutions, power transmission components, electric motors and air moving products. Likewise, Atkore, which manufactures electrical, mechanical and safety products like conduits, cables and mechanical pipes, saw revenue slide as declining input costs were passed through to customers — a not unnatural occurrence in this type of market. However, in both cases, we believe that these companies are oversold, and remain fundamentally strong businesses with excellent cash flow yields. We anticipate many of these macro headwinds will dissipate in the second half of 2024 and into 2025 and allow these companies to continue to build on their strong idiosyncratic drivers.

Relative performance was lifted by positive stock selection in the consumer staples sector, primarily from Casey's General Stores. An operator of gas stations and convenience stores, Casey's is now reaping the rewards of its aggressive reinvestment in its stores over the past decade, building its private label brand and broadening its product offerings. This has not only helped boost improve same-store sales but 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. As a result, the company continues to execute strongly, and we believe it will continue to be a long-term compounder for the portfolio.

Financials, and particularly our insurance holdings, continued to build on their strong first-quarter performance. In addition to benefiting from a hardening insurance market as demand outpaces supply, companies like Arch Capital have been able to take advantage of the shift in investor perception from imminent rate cuts to a higher-for-longer environment to realize higher reinvestment returns on their assets. We believe that this supportive macro environment, combined with capital discipline, inflation in excess of the rising costs of litigation and solid underwriting have helped Arch Capital and Hartford Financial Services increase their returns on equity.

### **Portfolio Positioning**

We initiated a new position in online pet retailer Chewy in the consumer discretionary sector. We believe the company has exited a period of tough comparables achieved during COVID-19 and that the decline in pet products spending has begun to stabilize. The company's initiatives in warehouse automation, pharmaceutical services and private label products are strong catalysts, and Chewy has built a loyal base through peerless customer service to improve its margins as customer growth inflects positively.

Rubrik, meanwhile, is a next-generation data storage, backup and recovery provider showing strong, double-digit subscription revenue growth. We believe its cloud-based offerings have resonated with its Fortune 500 customer base, positioning it well to continue to take share from legacy data backup providers. The introduction of new AI data security products could offer an additional revenue source to Rubrik's business.

We trimmed several holdings during the period including cloud-based compliance and regulatory software company Workiva. Although we believe Workiva remains a product leader in back-office software, we believe that more selective customers will lean toward investments in the broader enterprise software solutions. As a result, we used the proceeds from our trimming to initiate a new position in Dynatrace, which operates an application observability platform for multicloud environments.

## Outlook

While we believe certain sectors, such as those that suffered from destocking headwinds in 2023, will see improvement in the second half of the year, most expectations for better results and the economic boon from rate cuts have been pushed out into 2025. With greater uncertainty on both the economic and political fronts, and mounting concerns over market concentration in such few stocks, we believe the benefits of our philosophy of active management and diversification and our focus on strong corporate fundamentals will become more evident going forward.

## Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index during the second quarter. On an absolute basis, the Strategy had losses in nine of the 11 sectors in which it was invested during the quarter. The lone contributors were the communication services and financials sectors, while the industrials and IT sectors detracted the most.

On a relative basis, overall stock selection and sector allocation effects detracted from performance. Specifically, stock selection in the IT, industrials, real estate and consumer discretionary sectors and an overweight to the consumer staples sector weighed on performance. Conversely, stock selection in the consumer staples, financials, materials and communication services sectors benefited performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Casey's General Stores, Pinterest, Clean Harbors, Arch Capital and AppLovin. The largest detractors from absolute returns were Regal Rexnord, Atkore, WillScot Mobile Mini, Avantor and CoStar.

In addition to the transactions listed above, we initiated a new position in Mohawk Industries in the consumer discretionary sector and exited a position in Endeavor, in the communication services sector, ahead of its buyout by private equity investor Silver Lake.

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