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Canadian Small Cap Strategy

Key Takeaways

- ▶ Small cap performance was strong in the second quarter as broad gains across the S&P/TSX Small Cap Index drove an 11.8% total return.
- ▶ Tariffs continued to dominate the macro backdrop though their impact began to recede as the quarter progressed. The new government in Canada and ongoing volatility in the oil market further influenced the macro environment.
- ▶ The Strategy performed well on an absolute basis but trailed the benchmark due to negative stock selection in industrials and utilities.

Market Overview

The second quarter proved volatile for equity markets, with the VIX index hitting levels not experienced since the onset of the COVID-19 pandemic. Canadian small cap investors had to contend with the fallout from U.S. President Trump's "Liberation Day" tariff announcement and the subsequent news flow from trade deal negotiations; volatility in the energy market from OPEC+ volume increases and the Israel-Iran conflict; a new federal government in Canada; and the ongoing implications of the AI revolution.

Trade policy remained the biggest driver of equities in the quarter. The S&P/TSX Small Cap Index dropped by 12.9% from the start of the quarter to a post-Liberation Day low on April 8. The index then went on to rally by an impressive 28% off the low, setting a new all-time high on June 17, as the trade dispute between Canada and the U.S. appeared to be approaching an amicable outcome and North American economies weathered the uncertainty better than initially expected.

Energy markets added to the volatility. OPEC+ began unwinding its prior voluntary production cuts in April and has since brought back 960,000 barrels per day of production into an already well-supplied market, causing oil prices to steadily decline in April and May. The outbreak of hostilities between Israel and Iran injected a geopolitical risk premium into the market in June, which was partially unwound as the fighting eased toward the end of the quarter.

Domestically, a new Canadian government spurred cautious optimism around a more supportive policy environment. Initiatives such as the removal of internal trade barriers, investments in the Canadian Armed Forces and the passing of Bill C-5 — intended to

speed up the approval of major “national interest projects” — have all been well-received. Although businesses are not excessively optimistic about the outcome, the completion of the Trans Mountain Expansion Project pipeline and the start of LNG Canada joint venture underscore the impact that these sorts of major projects can have on the Canadian economy.

The robust performance of the Canadian small cap index was broad based, with all 11 sectors posting positive returns during the quarter. More cyclically oriented sectors — industrials, financials, materials and consumer discretionary — led performance. Defensive sectors such as real estate, consumer staples, communication services and utilities posted otherwise strong quarters but lagged the overall index.

Exhibit 1: Sector Performance Broadly Positive

S&P/TSX Small Cap Composite Index Sector	2Q 2025 Total Return
Communication Services	7.0%
Consumer Discretionary	17.5%
Consumer Staples	6.2%
Energy	4.7%
Financials	20.5%
Health Care	2.2%
Industrials	22.6%
Information Technology	7.7%
Materials	15.2%
Real Estate	6.4%
Utilities	10.4%
S&P/TSX Small Cap Composite	11.8%

Performance in Canadian dollars as of June 30, 2025. Source: FactSet, Standard & Poor's.

Canadian index returns were supported by the strength in the Canadian dollar. The loonie was up 5.4% versus the U.S. dollar during the quarter and is well off its February low. In Canadian dollar terms, the S&P/TSX Small Cap Index outperformed the Russell 2000 Index in the quarter, with the Canadian small cap index up 11.8% versus the U.S. small cap index up 2.8%.

The ClearBridge Canadian Small Cap Strategy's absolute performance was strong in the quarter; however, it underperformed the benchmark. An underweight in the strong materials sector and negative stock selection in the industrials, utilities and energy sectors weighed on relative performance. The Strategy was supported by positive performance in consumer staples, financials, information technology (IT) and health care.

Portfolio Positioning

Volatility early in the quarter allowed us actively to shift from more defensive equities into cyclicals that we believed the market was overly punishing. Our defensive posturing going into the quarter allowed us to be buyers of risk on terms where we viewed risk/reward to be stacked in our favor.

We added to industrials, materials and energy stocks that traded sharply lower following the U.S. tariff announcements such as Capstone Copper, Methanex, North American Construction, Enerflex, Bird Construction, ADENTRA, Richelieu Hardware, Colliers International and Descartes System. We trimmed our defensive positions in AltaGas, ATCO and Empire Co that performed better during the volatility early in the second quarter. We also trimmed our positions in Major Drilling and Sandstorm Gold, rotating into base metal exposure that traded lower on the recession fears.

We also added Pet Valu to the portfolio through a secondary offering. Pet Valu is Canada's largest specialty pet retailer, operating 830 stores primarily through a franchise model. The Strategy owned Pet Valu in 2021 and exited as the stock surpassed our view of intrinsic value at the time. The company has since expanded its reach into Quebec, invested in its distribution network and simplified its ownership structure. The equity traded lower in early 2025 on fears of consumer weakness and ongoing normalization of pet-related demand in a post-COVID environment. We viewed the secondary offering from Pet Valu's private equity sponsor as an attractive level to re-enter the name under a more simplified ownership structure. With the major investments in its distribution centers behind it and an improving same-store sales outlook, we expect Pet Valu to materially grow free cash flow and earnings in the coming years.

Outlook

Our investment approach is a bottom-up strategy that prioritizes identifying and capitalizing on market inefficiencies, using our proprietary research and taking advantage of time arbitrage through our long-term investment horizon. This approach is supported by our patient culture, enabling us to make well-informed decisions when expectations and underlying fundamentals diverge.

We remain steadfast in our commitment to our investment style, diligently seeking out businesses that exhibit prudent capital allocation practices, durable competitive advantages and the ability to generate sustainable growth under appropriate capital structures.

Markets appear to have largely moved on from "Liberation Day" and are no longer pricing in a worst-case outcome from trade disputes. While the extreme downside from U.S. tariffs is less likely than a quarter ago, their ultimate impact on global trade remains unknown.

Canadian investors will need to assess the impact of tariffs, which are settling in at a meaningfully higher level than a year ago. The impact on inflation, employment and output will likely be negative but the effects on Canadian small cap equities will vary. Regardless of how events unfold, we believe that high-quality growth companies — with appropriate capital allocation policies, capital structures and durable competitive advantages that produce above-average returns — will be well prepared to weather the uncertainty. Moreover, these companies will be well-positioned to be proactive in improving their competitive positions in volatile markets.

Portfolio Highlights

The ClearBridge Canadian Small Cap Strategy underperformed its S&P TSX Small Cap Index benchmark in the second quarter. On an absolute basis, the Strategy posted gains across all 10 sectors in which it was invested. The primary contributors to absolute returns were the materials, financials and industrials sectors.

Relative to the benchmark, positive sector allocation effects were offset by negative stock selection. In particular, stock selection in industrials, utilities and energy, an underweight to materials and an information technology overweight detracted from performance. On the positive side, stock selection in consumer staples and financials, an overweight to industrials and underweight to health care contributed to results.

Among individual securities, the leading relative contributors to performance were Propel Holdings, Kinaxis, Hudbay Minerals, Empire Co and Lundin Mining. The largest detractors from relative performance were Descartes Systems, PHX Energy Services, AltaGas, Methanex and Enerflex.

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