



Mid Cap Growth Strategy



Brian Angerame
Managing Director,
Portfolio Manager



Jeffrey Bailin CFA
Director, Portfolio
Manager



Aram Green
Managing Director,
Portfolio Manager



Matthew Lilling CFA
Managing Director,
Portfolio Manager

Key Takeaways

- ▶ Mid cap growth stocks declined in the second quarter, as economic deceleration and the prospect of a higher-for-longer interest rate environment weighed on growth stocks.
- ▶ The Strategy underperformed its benchmark as detractors in the industrials and IT sectors overshadowed positive contributions from our consumer staples holdings.
- ▶ Rather than chase near-term winners, we continue to follow our philosophy of investing in companies with great businesses models, strong growth prospects and stellar balance sheets.

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 the benchmark Russell Midcap Growth Index returning -3.21%, slightly ahead of the Russell Midcap and Russell Mid Cap Value Indexes, which returned -3.35% and -3.40%, respectively.

From a sector standpoint, utilities (+11.25%) generated the best performance in the benchmark, followed by the communication services (+10.83%), energy (+4.98%) and information technology (IT, +0.89%). The financials (-2.61%) sector posted negative performance, but still outperformed the broader benchmark. Meanwhile consumer staples (-10.61%) was the biggest detractor, followed by materials (-10.23%), health care (-8.85%), industrials (-5.45%), real estate (-4.88%) and consumer discretionary (-4.25%), all of which underperformed the overall Russell Midcap Growth Index.

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 nonresidential construction and additional pressure on discretionary consumer spending. Add to that increased uncertainty surrounding the upcoming U.S. election and its

We believe that these companies can compound through headwinds to become bigger and better on the other side.

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.

Additionally, mid cap growth stocks were not immune to the broader market trends toward consolidation. In fact, the rebalancing of the benchmark Russell Midcap Growth Index has resulted in its greatest concentration in recent memory, with historically oversize exposure to IT hardware companies, the perceived beneficiaries of buildouts in data centers and AI. While we have some exposure to these broader trends through companies like Monolithic Power Systems, which makes semiconductor-based power electronics, the uncertainty surrounding the demand and timeframe for AI means balancing short-term performance with longer-term risk management concerns.

However, it is not all doom and gloom for mid growth stocks, 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.

Stock selection in the industrials sector was the leading detractor from relative performance, as the prospect of a higher-for-longer interest rates environment weighed on investors' outlooks for industrial and nonresidential construction. This included our holding in WillScot Mobile Mini, the North American leader in turnkey modular space and portable storage solutions. The company's stock price pulled back amid a decline in nonresidential construction starts and a less optimistic outlook for short-cycle industrials. However, WillScot continues to have high cash flow yields and a strong order backlog, which should help the company to weather near-term headwinds.

Stock selection in IT also weighed on 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. Our largest detractor in the sector was Workday, which provides software for enterprise functions including human resources, talent management, finance and resource planning. As spending-conscious clients have broadly reprioritized spending away from back-office software, Workday issued a more conservative full-year revenue guidance to the disappointment of investors.

The Strategy's relative performance benefited from positive stock selection in the consumer staples sector, primarily driven by our top-performing stock, 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 be a long-term compounder for the portfolio.

Portfolio Positioning

Our largest new position during the quarter was Clean Harbors in the industrials sector. The company provides environmental and industrial services which include the transportation, treatment and disposal of hazardous and non-hazardous waste, resource recovery, wastewater treatment, landfill disposal and waste incineration. Clean Harbors' unique assets, such as landfills and incinerators, leave it well positioned as a leader in an industry categorized by very few players and a substantial regulatory moat. The company's high value, high price product mix has resulted in strong fundamentals, while long-term trends such as nearshoring and the increasing regulation around the PFAS chemical creates a long growth runway for the company. Finally, we believe Clean Harbors stands to gain even greater market share after the recent acquisition of a competitor.

Rubrik, meanwhile, is a next-generation data storage, backup and recovery provider showing 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 exited our position in health care company Stevanato, which makes products and processes to provide integrated solutions for biopharma and healthcare. The company has struggled with broader industry headwinds including a delayed destocking and difficulty navigating a recovery from the COVID-19 pandemic. Our conviction in the company's management team was further weakened after they announced an additional equity offering and subsequently reduction of Stevanato's full-year guidance. Ultimately, we elected to exit the position in favor of other opportunities with greater risk/reward profiles.

Outlook

Despite the challenges of the second quarter, mid cap growth stocks continue to outpace both the broader mid cap market and mid cap value stocks on a year-to-date basis. 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 Growth Strategy underperformed its Russell Midcap Growth Index benchmark during the second quarter. On an absolute basis, the Strategy had gains across three of the 10 sectors in which it was invested during the quarter (out of 11 sectors total). The leading contributor was the communication services sector, while the industrials and health care sectors were the largest detractors.

On a relative basis, overall stock selection detracted from performance. Specifically, stock selection in industrials, real estate and IT sectors weighed on performance. Conversely, stock selection in the health care and consumer staples sectors benefited performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Monolithic Power Systems, Pinterest, Casey's General Stores, Palo Alto Networks and AppLovin. The largest detractors from absolute returns were Five Below, CoStar, WillScot Mobile Mini, Charles River Laboratories and Stevanato.

In addition to the transactions mentioned above, we initiated new positions in Celsius in the consumer staples sector, Chewy and Deckers Outdoor in the consumer discretionary sector, Raymond James in the financials sector, Vertiv in the industrials sector and Vistra in the utilities sector. We exited positions in ServiceNow in the IT sector, Americold Realty Trust in the real estate sector, Etsy in the consumer discretionary sector, Spotify Technology in the communication services sector and Shockwave Medical in the health care sector. During the period, portfolio holding Pioneer Natural Resources, in the energy sector, was acquired by Exxon Mobile whose shares we did not retain.

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