ClearBridge
A Franklin Templeton Company

SMID Cap Growth Strategy

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Key Takeaways

- Equity markets generated strong returns in the fourth quarter, bolstered by declining bond yields and a resurgence of optimism that the U.S. economy could achieve a soft landing.
- The Strategy outperformed its benchmark, as strong drivers in our IT and consumer discretionary companies helped overcome headwinds to our consumer staples holdings.
- With rate hikes likely behind us and historical and relative valuation metrics attractive, conditions are aligning for SMID growth stocks to see strong performance.

Market Overview and Outlook

Equity markets generated strong returns in the fourth quarter, bolstered by declining bond yields and a resurgence of optimism that the U.S. economy could indeed achieve a soft landing. This helped to further broaden market participation among SMID stocks, with the Russell 2500 Index returning 13.35% compared to the 11.96% return of the large cap Russell 1000 Index. Despite SMID growth stocks underperforming their value peers in the fourth quarter, with the benchmark Russell 2500 Growth Index returning 12.59% versus the 13.76% return of the Russell 2500 Value Index, growth stocks solidified their outperformance over value for the year by nearly 300 basis points.

We entered 2023 anticipating the pace of inflation could moderate following the Federal Reserve's historic interest rate increases. While investors have cheered the moderation in consumer and wholesale prices, the equity markets were characterized by volatility and unexpected megatrends.

The year began with the unprecedented depositor runs that meant financial failure for multiple storied financial franchises and pushed others to the brink. Rapid policy response with varying levels of depositor protection and liquidity programs staved off draconian repercussions for the broader financial ecosystem. Questions remained for smaller, innovative companies that relied on several of the failed institutions for external capital.

Two major themes captured the attention of both the general public and investors: generative artificial intelligence (AI) and GLP-1 treatments for diabetes and obesity. With the impressive capabilities from OpenAI's ChatGPT, a subsequent massive investment to develop rival models and the concomitant infrastructure build in data centers/GPU-heavy AI servers, public market capital has chased the beneficiaries of generative AI and sold perceived disrupted businesses.

With the early August headlines surrounding the cardiovascular benefits of the GLP-1 drug class, a similar rush ensued into the large cap manufacturers of those drugs, along with significant media attention around the potential new penicillin of our generation. There was much debate over the far-reaching consequences of significantly curbing appetites and a more fit populace. Pundits speculated on the growth rates for medical device companies, restaurants and food distributors and manufacturers. The November release of more detailed data from the SELECT study paints a more balanced picture of the impact of GLP-1s on the rest of the health care sector, but lingering enthusiasm and a resurgence in biopharmaceutical M&A has fueled a rally in biotech stocks, an area of the market we have historically remained underweight.

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Bond yields have been volatile, with the U.S. 10-year Treasury bouncing between 3.5% and 4% to start the year, rising 170 bps from May lows to October peaks near 5%, before declining dramatically in the final two months of the year behind softening inflation data and a dovish interpretation of the Fed's rate hold in December. This rate volatility was at times exacerbated by extreme dysfunction in Washington and Congress's inability to pass a budget, as well as the tragic geopolitical conflict in the Middle East.

2023 saw extreme divergence in performance between large cap and SMID indexes, with the S&P 500 Index gaining 26.29% for the year compared to a 17.42% advance for the Russell 2500. With rate hikes likely behind us and historical and relative valuation metrics attractive, conditions are aligning for SMID stocks to see strong performance. We saw signs of this rebound in the fourth quarter, with the Russell 2500 rising 13.35% to top the S&P 500's 11.69% advance.

The ClearBridge SMID Cap Growth Strategy outperformed the benchmark in the fourth quarter with strong stock selection in the information technology (IT) and consumer discretionary sectors overcoming detractors in the consumer staples sector.

Within IT, AI trends continue to positively impact order trends at data center and technology hardware companies to the benefit of companies like Monolithic Power Systems, our top-performing holding during the quarter. Enthusiasm supplying power management for Nvidia's AI GPUs supported both strong 2023 performance and a robust future outlook. This strong demand also translated into positive performance for industrials holding Vertiv, a leader in power and thermal management and related tools and systems used by data centers. However, we continue to monitor the sustainability of such trends, as well as their valuations, on a case-by-case basis. As a result, we trimmed the position size of both of these investments, following strong stock performance.

Interest rate relief also had a strong impact on more cyclical companies and those with ties to general consumer spending. For example, consumer discretionary holdings and discount retailers Burlington Stores and Five Below both rose during the quarter thanks to improving outlooks. Five Below, a specialty value retailer for products including apparel, accessories, novelty items, décor, cosmetics and accent furniture, rebounded from being one of the third quarter's worst-performing stocks. We believe both Five Below and Burlington are particularly well-positioned for an economic environment where consumer budgets are being tightened but demand for discretionary goods remains stable.

The Strategy's consumer staples holdings, particularly BJ's Wholesale Club, weighed on performance. After being one of the third quarter's strongest performers, BJ's stock pulled back in the fourth quarter after the company issued a more conservative outlook and guidance for its 2023 year due to changes in consumer behavior and disinflation. We remain confident in the company's consistent membership growth, higher productivity due to new store openings and digital strategy.

Portfolio Positioning

We used the fourth quarter as a period of reflection and evaluation, eliminating positions where we felt our thesis was weakening while adding to new and existing holdings we felt were positioned well for years to come. Ultimately, this resulted in us initiating four new positions and exiting four others.

We added a new position in Hamilton Lane, in the financials sector. The company is a fast-growing alternative investment manager with the vast majority of earnings coming from stable management fees, and we believe its history of controlling operating expense growth will help lead to strong earnings growth.

We also initiated a new position in Medpace, in the health care sector, which provides clinical research-based drug and medical device development services. Medpace is a full service, one-stop shop for emergent biotech customers, and the company's specific customer focus should allow it to continue to capture and grow market share within the industry.

We exited our position in United Rentals, in the industrials sector, an equipment rental company for general construction and industrial equipment. Despite being a long-term holding and having a history of strong stock price performance, we sold the stock because the company's market capitalization exceeded a level that we judged appropriate for a SMID strategy.

Outlook

Our investment approach evaluates businesses without any macro tilt, focusing on companies that can compound high levels of growth in large markets without depending on macro tailwinds. We focus on durable returns and ample access to capital to fund high-growth investment opportunities.

We believe several trends are relevant heading into 2024:

- Significant infrastructure, stimulus and mega-project funding bills have been passed. Entering the year there are signs that many public and private projects are poised to begin or accelerate, which should drive growth for a number of industrial and technology markets.
- M&A transactions could accelerate. With greater certainty on funding costs and availability as well as stability in labor markets and supply chains, we have begun to see a pickup in strategic and financial buyer activity as private equity players seek to deploy record amounts of dry powder and larger businesses look for growthier assets.
- As corporate spending behavior changed in recognition of the market realities of 2022 and 2023, corporate leaders are now seeking out a balance of efficiency and responsibility as they return to potentially more growth-oriented postures. We do not anticipate the profligate spending of prior years to return and would anticipate solutions like outsourcing, platform consolidation and leveraging technology (like early generative AI applications) to be favored avenues to shrewdly fund necessary investments in a higher cost of capital environment.

Having spent the fourth quarter reflecting on our performance over the last year, we approach 2024 confidently and believe we are well-positioned for the new year. Although we think that optimism surrounding the soft landing narrative and the prospect of rate cuts has helped embolden the market, the fourth quarter also proved how quickly and decisively sentiment and outlooks can change. As a result, we continue to carefully evaluate the risk/reward potential of each of our portfolio holdings and the volatility each contributes to the portfolio. We firmly believe our process of building a portfolio of high-quality companies with strong balance sheets and compelling long-term growth prospects will help us to successfully navigate whatever challenges the new year brings.

Portfolio Highlights

During the fourth quarter, the ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth benchmark. On an absolute basis, the Strategy had gains across eight of the 10 sectors in which it was invested (out of 11 sectors total). The IT and industrials sectors were the largest contributors, while the energy sector detracted.

In relative terms, overall stock selection contributed to performance while sector allocation effects detracted. Specifically, stock selection in the IT, consumer discretionary and financials sectors benefited performance. Conversely, stock selection in the consumer staples, industrials, real estate and health care sectors weighed on performance.

The leading contributors to absolute returns during the fourth quarter included Monolithic Power Systems, Wingstop, Trex, Burlington Stores and Five Below. Meanwhile, ChampionX, Fox Factory, BJ's Wholesale Club, Shoals Technologies and Sarepta Therapeutics were the greatest detractors from absolute returns.

In addition to the transactions listed above, we initiated new positions in Sarepta Therapeutics in the health care sector and Guidewire Software in the IT sector. We exited positions in Maravai Lifesciences in the health care sector, Fox Factory in the consumer discretionary sector and New Relic in the IT sector.