



A Franklin Templeton Company



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## Select Strategy

### Key Takeaways

- ▶ The Strategy underperformed in a period where growth lagged value, with weakness in health care and technology the primary headwinds.
- ▶ We continued to upgrade the portfolio for a volatile market environment, initiating six new common stock positions and exiting 12 others while expanding our private market exposure to innovative companies involved in AI and defense.
- ▶ We have improved our investment process by being more cognizant of the opportunity cost of holding an underperforming stock while waiting for a better macro or industry backdrop, and widened our lens for growth, diversifying further from application software, an industry going through immense change with the advent of AI.

### Market Overview

U.S. equities delivered resilient but volatile performance in the fourth quarter. While major indexes remained close to all-time highs, market conditions shifted meaningfully beneath the surface. Momentum-driven themes tied to artificial intelligence (AI), technology and cryptocurrencies extended into the early part of the quarter before reversing, resulting in heightened volatility and greater stock-level dispersion.

The S&P 500 Index returned 2.7% during the quarter, while the benchmark Russell 3000 Index advanced 2.4%. As volatility increased, investors became more selective, rewarding companies with durable fundamentals, innovation-driven growth and strong execution, while penalizing stocks where expectations had moved ahead of near-term fundamentals.

Growth stocks lagged their value counterparts as the AI trade lost momentum and investors began to question when billions of dollars in capital spending would lead to a meaningful return on investment. The Russell 3000 Growth Index gained 1.1% for the quarter, underperforming the 3.8% showing of the Russell 3000 Value Index. The Russell Midcap Growth Index, home to many of the small and mid cap companies we target in the ClearBridge Select Strategy, declined 3.7% for the quarter, trailing the broader market.

The Strategy underperformed the benchmark through a flight to quality that favored larger cap companies. Disruptors in the health care sector bore the brunt of the rotation with Doximity, a digital platform serving physicians, and Surgery Partners, an operator

of outpatient surgery centers, trading sharply lower through heightened volatility.

Software was another area of weakness, with enterprise software maker ServiceNow and marketing software platform HubSpot selling off over fears that large language models could threaten long-term demand. Data security provider Varonis Systems, meanwhile, was hurt by a revenue slowdown as it transitions its business model to the cloud. While we believe these companies are making appropriate investments to augment their software offerings using AI, we significantly reduced our exposure to application software with the sales of Monday.com, Datadog and Klaviyo as the time to monetize these investments is taking longer than anticipated.

Industrials weakness persisted for all but the companies providing infrastructure services or products to data centers such as holdings Comfort Systems and Vertiv. Auto salvage and auction provider Copart fell as volumes at its key insurance customers declined slightly in the second half of the year due to the number of uninsured drivers increasing after several years of massive insurance premium inflation. We believe this is a temporary and self-correcting situation rather than a secular issue and, with Copart having over \$5 billion of net cash and a very attractive valuation, we are continuing to hold shares.

Bright spots during the quarter came from idiosyncratic contributions. Coherent rerated on sustained demand for optical networking and laser-based technologies tied to data center connectivity and bandwidth expansion. Expedia, a global online travel platform, contributed as improved execution in its consumer business complemented continued strength in its business-to-business segment.

### **Portfolio Positioning**

We initiated six new common stock positions in the quarter while exiting 12 others. One of the largest additions was Wingstop, which franchises and operates restaurants offering classic wings, boneless wings and tenders. With best-in-class unit economics driving strong returns for franchisees, the company is leveraging robust unit growth along with menu innovation and innovative technology offering, including a new kitchen display system to aid speed of service to fuel meaningful cash flow compounding.

Other new additions included CompoSecure, in the IT sector, a designer of secure payment cards for banks and fintech companies and cryptocurrency transactions where we purchased both the common stock and participated in a private investment in public equity (PIPE) investment; aerospace and defense contractor BETA Technologies, which specializes in electric aircraft and propulsion systems; and Wix.com, a provider of software tools to develop websites and enable digital applications. We also purchased less-than-truckload (LTL) trucking and logistics provider XPO as a replacement for Saia.

Meanwhile, we increased our exposure to privately held companies with our participation in private placements for OpenAI, the creator of ChatGPT, which ushered in the surge in capital spending on large language models and continues to attract billions in investment for its AI technologies; and Yellowstone Midco, an investment vehicle for space and defense systems.

## Outlook

Catalysts appear to be coming together to support an extended and broadening equity market upswing as we enter the new year. The U.S. economy has consistently defied expectations over the last five years, and we see no reason why that resilience won't continue. While myriad risks exist, fiscal stimulus from the One Big Beautiful Bill is coming online, corporate earnings look solid and the consumer in aggregate has not showed signs of rolling over. In addition, visibility on tariffs continues to improve and the Federal Reserve remains clearly in easing mode. We believe much lower rates are not needed for a broadening of performance in equity markets; rates just need to gradually move to a normal level with lower levels of volatility.

We expect the macro backdrop to remain bumpy but have positioned the portfolio to perform well in a variety of market and economic scenarios. With a balanced approach, we own stocks with organic growth drivers and strong management teams that have the proven ability to execute regardless of macro conditions. Unlike certain "style-pure" peers, we have the flexibility to own companies over long periods of time and through business cycles as they compound cash flows significantly and grow from emerging disruptors into larger and steadier compounders.

With that said, after a period of underperformance we have improved our investment process by 1) increasing our sell discipline by being more cognizant of the opportunity cost of holding an underperforming stock while waiting for a better macro or industry backdrop, and 2) as discussed earlier, we have widened our lens for growth, diversifying further from application software, an industry going through immense change with the advent of AI.

We are strong believers that innovation and secular trends endure — in fact they usually emerge from soft patches in the economy even stronger; this has been demonstrated in prior years performance (e.g., SaaS coming out of the Global Financial Crisis, e-commerce and digital services in COVID). We are leaning in and picking our spots with companies going "on sale" with examples being:

- Rubrik (data back-up and resiliency with emerging AI tailwind)
- AppLovin (advertising technology platform for application gaming)
- Kratos Defense (unmanned weapon and surveillance systems)
- Caris Life Sciences (diagnosis and treatment of cancer using AI and machine learning)

- Charles Schwab (digital trading, broader asset allocations including higher-fee crypto assets)
- Vulcan Materials, United Rentals (onshoring/reshoring with duopoly market positioning)
- Comfort Systems, Vertiv, Coherent, Vistra (AI infrastructure buildout)
- MercadoLibre, Shopify, Global-E, GXO (global and cross-border e-commerce)

Exhibit 1: Concentration Leads to Broadening



As of Dec. 31, 2025. Source: ClearBridge Investments, Atlanta Fed, Bloomberg Finance.

While the market broadening that began last summer has experienced fits and starts, we believe this cycle of wider leadership beyond the Magnificent Seven is still in the early innings. As Exhibit 1 demonstrates, when the top 10 weights in large cap indexes like the S&P 500 have historically made up an outsize share of the benchmark, equal-weighted versions of such benchmarks have handily outperformed the traditional cap-weighted versions over the next five years. Combine this with economic leadership in the Trump administration that brings capital markets experience to policy making, which we believe will lead to lighter regulation and improve the environment for M&A activity, and we believe conditions are particularly beneficial for active managers like ourselves investing in companies down the market cap spectrum.

Should the leadership rotation continue and expand further, multiples for SMID stocks should experience positive mean reversion closer to normal valuations, providing another catalyst for the portfolio.

### Portfolio Highlights

The ClearBridge Select Strategy underperformed its Russell 3000 Index benchmark during the fourth quarter. On an absolute basis, the Strategy saw contributions across three of the 11 sectors in which it was invested. The main contributors were the health care and real

estate sectors while primary detractors were the industrials, IT and consumer staples sectors.

Relative to the benchmark, overall stock selection detracted from performance. In particular, stock selection in the health care, industrials, IT, consumer staples, communication services and financials sectors and an underweight to communication services weighed on results.

Conversely, stock selection in real estate and an overweight to health care contributed to performance.

On an individual stock basis, the primary relative detractors were MercadoLibre, ServiceNow, Performance Food Group, Doximity and not owning Alphabet. The leading contributors were Coherent, Expedia, Charles River Labs, Lam Research and not owning Meta Platforms.

In addition to the transactions mentioned above, we added a position in Premium Brand Holdings in consumer staples. Among our sales were exits from managed care provider UnitedHealth Group, casual footwear retailer Crocs, consumer products maker Colgate-Palmolive, consumer banking fintech Chime Financial and Firefly Aerospace, a provider of launch services for space missions that went public in the third quarter.

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