ClearBridge
A Franklin Templeton Company

Small Cap Growth Strategy

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Key Takeaways

- Similar to the past two years, small cap outperformance relative to large caps did not come to fruition amidst a volatile year that saw market drivers and growth remain tied to a narrow set of themes, although a long-awaited broadening appears to be emerging.
- The Strategy underperformed in the fourth quarter, as strength in industrials and several health care holdings was offset by a biotech rally and overreactions to earnings disappointments in technology. Despite the quarter offsetting a strong start to 2025, we are encouraged by improved relative performance during a difficult period for active managers.
- 2025 proved another energetic stretch of idea generation, as we added 29 new positions and exited 19, selling those lacking idiosyncratic growth levers in order to redeploy capital into promising new growth businesses.

Market Review

In many respects, 2025's market resembled the preceding two years. We entered each with conditions that seemed poised to set the stage for the end to the longest losing streak on record for small caps versus large caps and hopes for a broadening out of growth sectors. However, this turned out to be another narrowly driven year of narratives, strong performance for momentum, low quality and high beta factors, elevated retail trading and challenges for active managers. It is notable that the lowest quintile of return on equity stocks and non-earners in the benchmark were up 23.7% and 27.8%, respectively. This is effectively double the performance of the underlying benchmark, underscoring difficulties for quality-focused managers like ourselves, with less than 20% of small cap growth strategies outperforming for the year.

As has increasingly become the norm, performance and fundamental drivers, on both a micro and macro level, were characterized by extreme volatility in 2025. Following an initial "animal spirits" rally following the Presidential election into January, the market retreated violently through early April amidst government policy uncertainty, Liberation Day tariff threats and AI's "DeepSeek" panic. Just as furiously as markets retreated, however, stocks rallied behind signs of possible deal-making on trades, the passage of the One Big Beautiful Bill and renewed enthusiasm on an insatiable AI capex investment cycle and future payoff. Against this backdrop of uncertainty and

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near-constant reversals, businesses and consumers have been more judicious about spending, with many end markets continuing to see relatively anemic demand trends. Despite these challenges, the overall U.S. economy posted solid growth, with relatively in-check inflation allowing the Federal Reserve to gradually continue its rate cutting cycle over the course of the year.

While our benchmark Russell 2000 Growth Index lagged the Russell 1000 Growth Index by roughly 555 basis points for the full year, it keep pace in the fourth quarter, returning 1.2% versus the Russell 1000 Growth Index's 1.1%. Importantly, the third quarter marked the first time in over a decade that small caps exceeded large caps in earnings growth, reinforcing our view that the earnings backdrop for the asset class is improving even if market prices have yet to fully reflect this shift. With small cap earnings growth forecasted to handily exceed large caps in 2026, and healthy capital markets from both an IPO and M&A perspective, we are constructive on the trajectory for small cap growth stocks.

Performance Overview

After a strong first three quarters of 2025, the ClearBridge Small Cap Growth Strategy lagged the Russell 2000 Growth Index in the fourth quarter. This was largely attributed to a small cohort of difficult earnings results among our information technology (IT) holdings and a torrid rally in biotechnology stocks, with the Russell 2000 Growth Biotech Index returning 28.1% versus the Russell 2000 Growth Index's 1.2%. The biotechnology sector has rebounded strongly behind a variety of positive clinical and commercial outcomes, healthy M&A activity, some performance mean reversion and lower interest rates. Just over half of our relative underperformance in the fourth quarter can be attributed to the biotech and pharmaceutical subsectors, underscoring how difficult it was to keep pace. While health care represented our weakest sector in the quarter, it also produced two of our top individual performers – medical device maker Penumbra and biotech Insmed, both of which continue to see strong commercial execution and growth.

Beyond biotech, we experienced a challenging earnings season with the market continuing its trend of disproportionally punishing disappointments in small cap earnings – further exacerbated by trends in passive and retail investing. We saw this in several of our software investments, particularly security software company Varonis and Wix.com, a website and application creation platform, both of which had minor disappointments that led to material stock price overreactions. We continue to have conviction in the idiosyncratic growth opportunities at each of these profitable and attractively valued businesses, both of which can benefit from the proliferation of AI adoption.

We benefited from stronger performance across investments in the industrials sector. RBC Bearings and FTAI Aviation were contributors to performance as the aerospace sector continues to see strong growth and profitability trends. Additionally, longstanding holding Bloom Energy continued to be one of our top performers, as the company's alternative power solutions are increasingly being called upon to assist electricity-starved data centers.

While dissatisfied with the fourth quarter's performance, we are encouraged by improving contributions from the newer investments initiated as part of our repositioning efforts over the past several years. Several of these positions have grown to become top holdings and tailwinds to performance, particularly in biotech, where we managed to add modestly to relative performance for the full year despite the benchmark's biotech constituents being up over 40%.

Portfolio Positioning

2025 was another active year for new idea generation, while we also endeavored to maintain our sell discipline in businesses where fundamentals have changed or idiosyncratic catalysts are lacking. With a gradual reopening of capital markets, along with dynamic trends across many end markets, we continue to find ample opportunities to identify high-quality investments across the spectrum of growth from compounders to hyper-growers.

We established 29 new investments in 2025 and exited 19 existing positions (14 due to stock-specific considerations, four due to takeovers and one sold as it grew beyond our target market capitalization range).

During the fourth quarter we initiated four new common stock investments: Protagonist Therapeutics, Simpson Manufacturing Company, BETA Technologies, and Dyne Therapeutics.

- **Protagonist Therapeutics** is a biopharmaceutical company that currently has two internally discovered, clinically derisked drugs likely to launch with their partners in the near future, which we believe offer blockbuster potential — particularly an oral version of a well adopted injectable mechanism treating a range of immunology and inflammation conditions.
- **Simpson Manufacturing** is a leading building products company focused on connectors, truss plates and fasteners used in residential construction. With a dominant share in its core markets, attractive margins and opportunities to expand into adjacent categories, Simpson has steady compounding potential over time, in our view.
- **BETA Technologies** is an aerospace and defense company developing electric aircraft, propulsion systems and charging infrastructure for government, logistics and commercial applications. Its vertically integrated model, lower operating cost structure and focus on conventional takeoff aircraft provides multiple avenues for long-term growth.

- **Dyne Therapeutics** is a biotechnology company developing late-stage RNA-based therapies for muscular dystrophy conditions. With limited existing treatment options and encouraging early data, upcoming clinical milestones represent meaningful potential value creation opportunities.

We also exited six positions: Avidity Biosciences (which was acquired by Novartis), Installed Building Products, Glaukos, Biohaven, Qualys and Duolingo.

Outlook

Looking ahead to 2026, we are optimistic about the backdrop for the small cap growth stocks after several years defined by very narrow leadership and extreme performance dispersion between the “haves” and the “have nots”. Outside of businesses tied to the AI infrastructure buildout and a few other early-stage growth markets (defense tech, space, bitcoin, quantum computing, etc.), many traditional industrial, software, consumer and health care end markets have seen false starts in returning to sustained growth. A broadening of growth leadership — particularly across the previously mentioned industries — would likely benefit diversified, quality-focused portfolios like ours.

While we do not anticipate any material diminution in the investments in the AI infrastructure buildout in the near term, we are increasingly optimistic that 2026 could mark a period where the productivity and monetization benefits of AI become more visible across a wider set of industries. Several of our holdings are actively leveraging AI to improve efficiency, offer new products or offer solutions to secure and manage the critical data that AI will be utilizing. As proof points emerge, the beneficiaries of AI adoption could see share price tailwinds.

Capital markets appear to be accelerating, with IPO activity improving after a multiyear lull and M&A volumes rebounding—an environment historically favorable to our Strategy. Recent M&A transactions, including the proposed take-private of Clearwater Analytics, highlight that sophisticated buyers (in this case the former PE owners) are opportunistically deploying capital at what they view as depressed valuations, reinforcing our confidence in the underlying value of many small cap businesses.

While we acknowledge that the past year represents one of the most challenging stretches for active management on record, history suggests that such periods of extreme factor dislocation and prolonged underperformance often set the stage for improved forward returns. With small cap earnings growth set to eclipse large cap peers, and relative valuations still at attractive levels, we believe the asset class is poised for stronger performance.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy underperformed its benchmark in the fourth quarter. On an absolute basis, the Strategy posted gains in four of the eight sectors in which it was invested (out of 11 sectors total). The primary contributor to performance was the health care sector, while the IT and consumer staples sectors detracted the most.

Relative to the benchmark, overall stock selection and sector allocation effects detracted from performance. Stock selection in the health care, IT and consumer staples sectors and an overweight to the consumer staples sector weighed on returns. Meanwhile, stock selection in the industrials, consumer discretionary and energy sectors benefited performance.

On an individual stock basis, the largest detractors from relative returns were Wix.com, Varonis Systems, Trex, Surgery Partners and e.l.f. Beauty. The biggest contributors to relative returns were Penumbra, Insmed, Bloom Energy, RBC Bearings and not owning Stride.

In addition to the transactions listed above, the Strategy initiated a new position in Yellowstone Midco, a private placement in the industrials sector.