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Select Strategy

Key Takeaways

- ▶ Diversified contributions across the defensive consumer staples sector, disruptors in the growthier communication services and IT sectors and idiosyncratic strength in the more cyclical industrials sector drove Strategy outperformance.
- ▶ We initiated eight new positions in the quarter, highlighted by the addition of two leading biotechnology companies and participation in several successful IPOs, as capital markets activity began to pick up in an environment of improving policy visibility.
- ▶ The market showed signs of broadening with small caps besting their larger cap peers. Also working in the favor of SMID stocks, the group's earnings per share growth continues to improve and is forecast to catch up with mega cap leaders in the next year.

Market Overview

U.S. equities continued their upward momentum in the third quarter, with the S&P 500 Index up 8.1% and the benchmark Russell 3000 Index increasing 8.2%. Investor optimism was fueled by better-than-feared tariff outcomes, the passing of the One Big Beautiful Bill Act in July, anticipated interest rate cuts — the Federal Reserve delivered with a 25-bps cut in September and signaled further easing — and robust corporate earnings.

Growth stocks led across larger market caps, with the Russell 3000 Growth Index (+10.4%) outperforming its value counterpart by nearly 500 basis points. The Russell 2500 Growth Index, home to many of the small and mid cap companies we target in the ClearBridge Select Strategy, rose 10.7% for the quarter, outpacing the broader market.

The Strategy outperformed the benchmark for the second straight quarter and was again paced by balanced contributions across the defensive consumer staples sector, disruptors in the growthier communication services and IT sectors and idiosyncratic strength in the more cyclical industrials sector.

Performance Food Group (PFGC) drove our consumer staples contribution with the food services company boosted by news of an activist investor advocating for a potential acquisition by rival U.S. Foods, speculation that highlighted PFGC's positive attributes and market share gains. Discount supermarket chain Grocery Outlet and convenience store and gas station operator Casey's General Stores were also solid contributors in the sector.

Social media platform Reddit in communication services reported higher as advertising revenue jumped 84% year over year, according to second-quarter results released at the end of July. Active advertisers increased 50% and the company made significant progress in its international expansion with daily active users growing 32%.

Within IT, mobile app user acquisition and app monetization platforms provider AppLovin saw its shares double due to strong second-quarter earnings and growing optimism around its emerging e-commerce business, which is expected to launch in the fourth quarter. We believe AppLovin's AI-driven demand generation capabilities remain best in class, positioning the company for incremental cash flow growth.

Diversified contributions also came from industrials holdings such as L3Harris Technologies, a defense contractor that benefited from heightened demand for spending on air and missile defense as well as appetite for investment in communication and space capabilities. AI-indexed HVAC holding Comfort Systems, meanwhile, is seeing steady demand as a provider of cooling systems to AI data center buildouts by hyperscalers.

Performance headwinds were centered in the consumer discretionary and financials sectors. Latin America e-commerce provider MercadoLibre sold off as the company is extending its free shipping and reducing merchant fees to deal with increasing competition in key markets like Brazil. These initiatives, while potentially boosting volume, could weigh on near-term profitability. The company has also been hurt by profit taking after a strong first half and continues to deliver stellar revenue growth. Not owning Tesla also detracted as the EV maker surged on optimism over its robotaxi launch.

Shift4Payments, which rebounded following Liberation Day lows in April, saw a strongly negative reaction to slightly disappointing second-quarter results. The provider of payment processing software to merchants missed quarterly estimates for volume, revenue and earnings. We took advantage of the dislocation to add to our position. Despite the near-term headwinds, Shift4Payments raised its full-year guidance for revenue, volume and operating income.

Application software makers ServiceNow, Fortinet, HubSpot and DocuSign endured losses due to rising concerns that generative AI could disintermediate their business models. We believe, however, that such risks are overblown and could take years to threaten the complex, mission-critical functions these companies provide to enterprises. Workflow software leader ServiceNow was down despite strong quarterly results and healthy forward guidance as AI monetization has begun to pick up.

Portfolio Positioning

We initiated eight new positions in the quarter while exiting five others. Increasing our biotech exposure, we purchased Regeneron

Pharmaceuticals and Vertex Pharmaceuticals. Regeneron markets leading treatments in the areas of ophthalmology, dermatology, oncology and cardiology. Shares have been pressured over the last year on downward sales revisions for its legacy Eylea injectable for wet age-related macular degeneration. The company's latest results, however, indicated a surge in sales of a new version of Eylea and strong global sales of dermatitis treatment Dupixent that helped Regeneron top revenue estimates.

Vertex is a high-quality biotech with a leading franchise in cystic fibrosis that we have been following for some time and have owned in several other portfolios. We see pain as its next big opportunity, with some disappointments in the timing of clinical trials for chronic pain enabling us to establish a position at what we view as a moderate valuation relative to its pipeline.

Vistra is the largest competitive power generator in the U.S. with a 41 GW fleet of power plants diversified by geography and fuel sources including natural gas, coal, nuclear and renewables. We believe the company is well-positioned to benefit from tightening market conditions in its primary PJM (Pennsylvania, New Jersey, Maryland Interconnection) and ERCOT (Texas) power markets. We also see the potential for federal subsidies for nuclear plants and long-term contracting with hyperscalers to improve visibility and lower EPS variability across the industry.

We participated in the IPO of Firefly Aerospace, a provider of launch services for the commercial space industry. The company's \$1.1 billion backlog and collaborations with major aerospace and defense contractors Northrop Grumman and Lockheed Martin give us confidence in the company's growth outlook. We also participated in the IPO of design software firm Figma but exited the position after the shares rose sharply in its debut.

We exited ICON, a leading contract research organization (CRO) serving biopharmaceutical and medical device customers, as the headwinds from biotech funding challenges, government funding uncertainty and other regulatory changes have grown in 2025, lowering our confidence in the timing of a recovery for the CRO business.

Payroll and human resources software provider Paylocity has struggled in an environment of lower rates and sluggish employment trends. We like health savings account provider Health Equity better in the corporate benefits space and added to that as we sold down Paylocity.

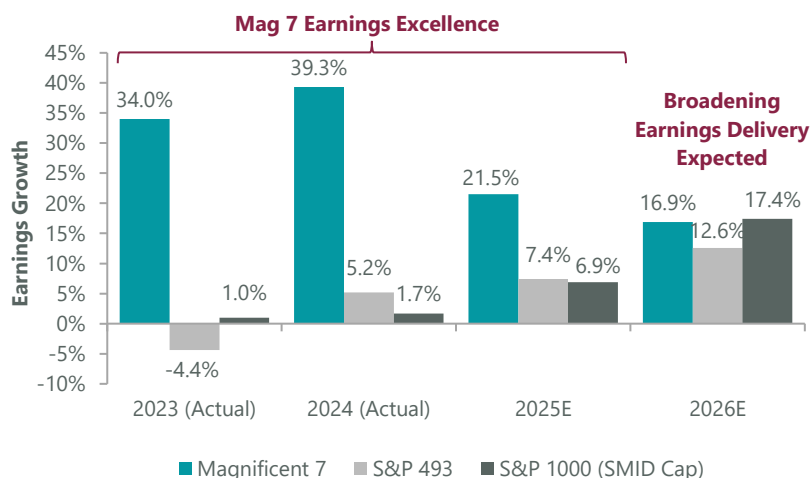
The sale of Adobe, a developer of cloud software for marketing and related creative applications, was motivated by concerns about high levels of existing penetration of Adobe's product suite and competitive risks. Adobe is an example where AI lowered barriers to entry and commoditized parts of its business, which ultimately may threaten how many people are using the company's products.

Outlook

The market's extended rally off the early April lows on improving trade sentiment validates our view that the solution to the global tariff problem rests in the hands of the president, whose stance can quickly be reversed, as was seen with an early October selloff as the China trade war heated up again. Similarly, 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, and business activity needs more clarity on tariffs. The Fed has begun moving in that direction with regard to rates and tariff clarity has steadily improved.

The long anticipated broadening of market leadership showed signs of progress in the third quarter with the small cap Russell 2000 Index meaningfully ahead of larger cap indexes. Also working in the favor of SMID stocks, the group's earnings per share growth continues to improve and is forecast to catch up with the Magnificent Seven in the next year (Exhibit 1).

Exhibit 1: Closing the Gap



The term "consensus" within the capital markets industry refers to the average of earnings estimates made by professionals. Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of Sept. 30, 2025. Sources: FactSet, S&P.

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.

Portfolio Highlights

The ClearBridge Select Strategy outperformed its Russell 3000 Index benchmark during the third quarter. On an absolute basis, the Strategy saw contributions across eight of the 11 sectors in which it was invested. The main contributor was the IT sector while primary detractor was the financials sector.

Relative to the benchmark, overall stock selection contributed to performance. In particular, stock selection in the consumer staples and communication services sectors, an overweight to IT and an underweight to financials drove results. Conversely, stock selection in consumer discretionary and financials, an overweight to consumer staples and an underweight to communication services detracted from performance.

On an individual stock basis, the primary relative contributors were AppLovin, Reddit, Comfort Systems, Shopify and L3Harris Technologies. The leading detractors were positions in MercadoLibre, ServiceNow, Fortinet and not owning Alphabet and Tesla.

In addition to the transactions mentioned above, we added positions in Kratos Defense & Security Solutions and Casella Waste Systems in industrials as well as Netskope and Monday.com in IT. We also sold Constellation Brands in consumer staples and Gitlab in IT.

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