



Small Cap Strategy



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Key Takeaways

- ▶ Small cap equities rallied sharply but unevenly in the second quarter, with AI, momentum, high-beta and higher-growth stocks leading before market breadth improved later in the period.
- ▶ The Strategy generated strong absolute returns but underperformed the benchmark, as narrow, momentum-driven leadership in IT and industrials, along with energy weakness, created headwinds.
- ▶ AI remains a powerful investment theme, but elevated expectations and valuations argue for selectivity across small caps.

Market Overview

Small cap equities rallied sharply, but unevenly, in the second quarter, with the Russell 2000 Index returning 21.5%. April and May extended the risk-on trade that has characterized much of the past year, with AI infrastructure theme and quantitative factors such as momentum, high-beta and higher-growth companies leading while quality, value and lower-volatility stocks lagged. However, in June, leadership broadened as large cap technology weakened and small caps extended their recent relative strength.

AI remained the dominant market narrative. We believe the technology's long-term potential is significant, and AI-related capital spending continues to create opportunities across semiconductors, infrastructure, power, cooling and adjacent industrial markets. However, recent price appreciation has raised the bar for future results. In many cases, investors appear to be discounting a high degree of certainty around a still-evolving technology cycle. We believe investing is a probabilistic endeavor, and that the best risk-adjusted returns arise when we envision a future that diverges from the market's expectations. With investors confidently betting on a bullish AI future, the opportunities with a sufficient margin of safety have been difficult to identify.

This backdrop remained challenging for fundamentals-oriented investors, as benchmark returns were concentrated in areas most closely tied to momentum, earnings revisions and AI-related growth expectations. We do not believe the answer is to avoid innovation or AI exposure, but rather to remain selective and true to our investment process, which is rooted in finding gaps between the stock price and the fundamental value of the business under a range of scenarios. Encouragingly, the improvement in breadth late in the quarter, along with the annual Russell rebalance, reduced some of the benchmark's

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more extreme sector, size and factor distortions. We believe broader earnings growth and greater valuation dispersion should create a healthier backdrop for bottom-up stock selection.

Portfolio Performance

Against the narrow performance backdrop that characterized much of the period, the ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the second quarter.

Industrials was the largest relative detractor. Among owned holdings, Primoris Services detracted after first-quarter results showed lower energy segment revenue and margin pressure, including slower renewable energy project activity. The Strategy's lack of exposure to Bloom Energy, a power solutions company tied to the AI and data center infrastructure theme, and whose strong performance reflected the quarter's return concentration in a small group of high-momentum benchmark names, also weighed on performance. Custom Truck One Source helped offset some of this weakness, benefiting from demand for specialty equipment tied to electric utility transmission and distribution and other infrastructure markets.

In information technology (IT), our underweight to the sector weighed on relative performance, though IT holdings also represented four of our top five individual relative contributors. Penguin Solutions advanced as investors recognized its exposure to AI infrastructure and memory-related demand, which drove an increase to the 2026 outlook. Extreme Networks contributed after results alleviated margin concerns and the company moved away from a potential acquisition that had weighed on sentiment. TeraWulf benefited from investor interest in AI-related data center capacity, while Commvault gained as demand for data protection and cyber resilience remained strong.

Energy was another source of weakness as easing geopolitical tensions in the Middle East contributed to a late-quarter pullback in energy prices. Matador Resources and Weatherford International were among the Strategy's biggest individual detractors, with both companies coming under pressure alongside lower commodity prices and more cautious expectations for upstream activity.

Positive contributors came from a variety of sectors. PROG advanced as financials participated in the risk-on rally and investors rewarded improving sentiment toward consumer credit and leasing-related businesses. Apple Hospitality REIT also benefited from the broadening of market leadership late in the quarter. In health care, Bicara Therapeutics rose after reporting encouraging longer-term data for its lead cancer therapy, suggesting the treatment may help patients with a difficult-to-treat form of head and neck cancer.

Portfolio Positioning

We initiated positions in two IT companies. Globant, an IT services company, had been pressured by concerns that AI could disrupt traditional consulting and outsourcing models. We believe those concerns are overstated and that AI could support higher project

volumes, lower delivery costs and improved client demand. We also added Allegro MicroSystems, a fabless semiconductor company focused on sensors and power chips used in automotive and industrial markets. While expectations for AI-related semiconductor companies remain elevated, we believe Allegro offers differentiated exposure to growth in data centers, robotics and electrification.

In health care, we purchased Glaukos and RadNet. Glaukos is a medical technology company focused on glaucoma treatments. We believe earnings are nearing an inflection point as newer, higher-margin products scale, which could lead investors to reassess the company's growth and profitability profile. RadNet operates outpatient imaging centers and has built a digital health business we view as underappreciated. The company should benefit from steady imaging demand, continued share gains and AI tools that could improve the value of its platform.

On the sell side, we exited AeroVironment, a defense company, after the investment case was dented by an accounting issue and a lost government contract. We also sold AGCO, an agricultural equipment manufacturer, as we reallocated away from a more cyclical position. In consumer staples, we exited Inter Parfums, a fragrance company, to fund opportunities with more attractive risk/reward. In utilities, we sold ONE Gas, a regulated natural gas distributor, on valuation and sector exposure considerations.

Outlook

The second quarter highlighted both the opportunity and the challenge in small caps. Strong absolute returns showed how quickly the asset class can respond when risk appetite improves, while narrow leadership in April and May showed that not all rallies are equally fruitful for active management. Improved breadth during June was encouraging and, if sustained, should create a more favorable environment for stock selection.

We expect AI to remain a powerful investment theme, but we are wary of areas where expectations appear elevated and valuations leave little room for disappointment. The central question is not whether AI will be transformative, but whether market prices compensate investors for an uncertain future. We see opportunities among select AI infrastructure beneficiaries, as well as companies where the market may be overstating disruption risk or overlooking durable earnings drivers.

Small caps continue to offer meaningful long-term potential, particularly relative to large caps, but elevated valuations in parts of the benchmark argue for selectivity. Higher dispersion, a broader earnings recovery and greater investor focus on quality, balance sheet strength and cash flow durability would all support our process. We remain focused on owning businesses with improving fundamentals, capable management teams and attractive risk/reward, while maintaining the discipline to trim winners and exit positions when the thesis changes.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the second quarter. On an absolute basis, the Strategy had gains in eight of the 11 sectors in which it was invested during the quarter. The leading contributor was the IT sector, while the energy sector was the primary detractor.

On a relative basis, overall sector allocation and stock selection detracted from performance. Stock selection in the industrials, health care, consumer staples, communication services and consumer discretionary sectors, an underweight to the IT sector and overweight to the materials and energy sectors weighed on performance. Conversely, stock selection in the IT, materials and real estate sectors proved beneficial.

On an individual stock basis, the biggest contributors to relative returns in the quarter were Penguin Solutions, Extreme Networks, Custom Truck One Source, TeraWulf and Commvault Systems. The largest detractors from relative returns were Matador Resources, Weatherford International, Primoris Services, and not owning Credo Technology and Bloom Energy.

In addition to the transactions mentioned above, we initiated positions in Eastman Chemical in the materials sector, Genius Sports in the consumer discretionary sector and WillScot in the industrials sector. We exited positions in Gambling.com in the communication services sector, PAR Technology in the IT sector, Upwork and Parsons in the industrials sector and the abrdn Physical Precious Metals Basket Shares ETF in the materials sector.

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