SMID Cap Growth Strategy

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Key Takeaways

- SMID growth equities navigated a challenging fourth quarter, as volatile earnings reactions, low-quality rallies and narrow sources of growth continued to define the market environment.
- The Strategy underperformed its benchmark, as strength in industrials was outweighed by headwinds in health care and information technology.
- We believe elevated volatility and widening valuation gaps are creating opportunity, as fundamentals begin to matter more and selective areas of the SMID universe show early signs of stabilization.

Market Overview

SMID growth equities delivered mixed results during the fourth quarter, with the Russell 2500 Growth Index returning 0.3%, outperforming the Russell Midcap Growth Index by over 400 basis points, but underperforming the Russell 3000 Growth Index by approximately 80 basis points. While index-level performance was relatively muted for the quarter, returns masked pronounced dispersion beneath the surface. While the AI investment narrative continues to dominate, with periods of greater and lesser enthusiasm for related equities, the impact of elevated retail trading, an insatiable appetite for a narrow group of sectors with high growth potential, and anemic trends for much of the traditional economy throughout 2025 caused performance distortions throughout the broader asset class.

In the fourth quarter, certain high (albeit early-stage) growth segments, particularly within biotechnology, rebounded sharply following extended periods of underperformance. Many SMID growth companies across technology, consumer and industrial end markets experienced share price volatility that often appeared disconnected from underlying operating results, as the market continued to disproportionately reward momentum and penalize even modest earnings disappointments.

Over the course of 2025, SMID growth investors navigated an uneven environment marked by a frequent reversals and extreme stock reactions. Policy uncertainty, tariff concerns and fears around AI disruption drove sharp drawdowns early in the year, followed by abrupt rebounds tied to shifting policy expectations and renewed enthusiasm for a narrow set of growth narratives. As a result, performance was often dictated by factor exposure and sentiment rather than durable fundamental progress, along with one of the worst years on record for the quality factor, making it particularly challenging for diversified SMID portfolios.

Moreover, many traditional areas of the industrial, consumer, tech, and health care economy continue to be mired in a multiyear slump, although trends do at long last appear to have troughed. Against this backdrop, the current market remains highly selective, but we believe improving earnings visibility in certain areas, a gradual normalization of interest rate expectations and widening valuation gaps are beginning to create a more constructive setup for SMID growth companies with differentiated business models and clear paths to value creation.

Portfolio Performance

The ClearBridge SMID Cap Growth Strategy underperformed its benchmark during the fourth quarter, as a furious rally in biotech stocks and mixed earnings results (including some overreactions) offset solid execution across many portfolio holdings. Health care and information technology (IT) were headwinds to relative performance, while industrials emerged as a notable area of strength.

Health care weighed on relative results, reflecting the strength of the broader biopharmaceutical complex rather than uniform weakness across portfolio holdings. Following an extended period of underperformance, the sector – and particularly biotech and pharmaceuticals - rallied sharply on easing rate expectations, renewed M&A activity and sentiment-driven mean reversion, benefiting many benchmark constituents. While our own biotech holdings contributed positively to performance, the breadth and magnitude of the biotech rally was too much for the Strategy to fully keep up with. Roivant Sciences advanced on continued progress across its clinical pipeline, Insmed is executing on a potential blockbuster new drug launch, and diagnostics player Natera benefited from improving volume growth and reimbursement trends across its oncology testing franchise. Penumbra also contributed positively as adoption of its innovative device portfolio continued to gain share. Doximity, meanwhile, pulled back despite solid operating results amid heightened valuation sensitivity and investor concern around AI-related disruption.

IT also detracted, as software and technology-enabled businesses faced a challenging earnings environment and growing concern around AI-driven disintermediation. The market continued to react disproportionately to earnings results, with modest disappointments leading to sharp share price declines. This dynamic weighed on Wix.com, our weakest performer in the sector as well as on Monday.com, whose work management software platform also faced pressure amid broader skepticism toward software models. Shares of

Teledyne Technologies declined as investors reassessed near-term growth expectations across technology-exposed industrial businesses. However, these headwinds were partially offset by strong performance from Coherent, where sustained demand for optical networking and laser-based technologies tied to data center connectivity and bandwidth expansion supported the stock.

Industrials were the clear bright spot for the portfolio, as several longstanding holdings continued to deliver differentiated performance amid an uneven demand backdrop. We are sensing growing investor optimism around possible "green shoots" in long-delayed short-cycle industrial end markets, which could further support performance. RBC Bearings continues to perform strongly with a healthy aerospace end? demand environment augmented by strong operational execution driving gains in the share price. Elsewhere, improving visibility around infrastructure and data-center-related investment supported gains in Bloom Energy, as rising electricity requirements boosted demand for its alternative power solutions. Safety and specialty services provider APi Group also delivered solid results, reflecting steady execution and exposure to services and regulatorily mandated inspections that have proven more durable even as broader industrial conditions remain uneven.

Portfolio Positioning

During the quarter, we initiated positions in IonQ and Rigetti Computing, both of which operate in the emerging quantum computing space. While still early in their respective development cycles, each company is addressing what we believe is a very large long-term opportunity. IonQ offers quantum hardware and software solutions with a differentiated trapped-ion approach, while Rigetti focuses on superconducting quantum processors and integrated quantum computing systems. With ample capital resources and increasing commercial and government interest in quantum technologies, we believe these investments provide exposure to a potentially transformative growth area within the SMID universe.

We also initiated a position in Construction Partners, a construction and maintenance company focused primarily on asphalt paving for public infrastructure projects. With exposure to high-growth states, a focus on smaller, lower-risk projects and a history of disciplined execution, the company is well-positioned to deliver attractive organic growth while supplementing results through accretive acquisitions over time.

On the sell side, we exited several positions as part of our ongoing effort to refine the portfolio and reallocate capital toward higher-conviction opportunities. We sold Floor & Décor, a specialty flooring retailer, amid persistent softness in end markets beyond the company's control, and AAON, an HVAC manufacturer, following a rebound in the share price despite inconsistent execution and uncertainty around the benefits of recent capacity expansions. We also exited Light & Wonder following its relisting to the Australian exchange, which reduced its suitability for the portfolio, and Avidity Biosciences, a biotechnology company, after it was acquired by Novartis.

Outlook

In many respects, 2025 tested SMID growth investors' patience, as market leadership shifted rapidly and returns were often driven by factor exposure and short-lived narratives rather than steady fundamental progress. This environment proved particularly challenging for diversified quality-focused SMID portfolios, with strong company-level execution frequently overshadowed by abrupt sentiment shifts and uneven participation across sectors.

Looking ahead, we believe the environment taking shape is more constructive. Elevated dispersion, improving capital markets activity and early signs of stabilization in select end markets are beginning to reward differentiation over momentum. For SMID growth, volatility has created opportunities to upgrade portfolios toward businesses with clearer growth runways, stronger balance sheets and more durable demand profiles. While uncertainty is likely to persist, periods like this have historically marked a transition toward markets where fundamentals matter more, and we believe disciplined stock selection and thoughtful portfolio construction offering exposure to a broad spectrum of growth businesses position the Strategy well for the period ahead.

Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy underperformed its Russell 2500 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had positive contributions from three of the 10 sectors in which it was invested (out of 11 sectors total). The largest contributors were the health care and industrials sectors, while the IT sector was the chief detractor.

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

On an individual stock basis, the biggest detractors from relative returns were Doximity, Wix.com, e.l.f. Beauty, Trex and Houlihan Lokey. The largest contributors were Coherent, Natera, Roivant Sciences, Burlington Stores and Penumbra.

In addition to the transactions mentioned above, we initiated a position in Netskope in the IT sector, Protagonist Therapeutics in the health care sector, Legence in the industrials sector and Somnigroup International in the consumer discretionary sector. We exited a position in Knife River in the materials sector.