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Small Cap Growth Strategy

Key Takeaways

- ▶ Despite volatile markets and an uncertain, macro-driven landscape, the Strategy handily outperformed its benchmark, gaining traction from new ideas and repositioning work and from tailwinds across several sectors.
- ▶ Stock selection in information technology and industrials were the largest contributors to relative performance, partially offset by modest weakness in consumer discretionary and financials holdings.
- ▶ The impact of tariffs and policymaking has clouded visibility, and we anticipate continued volatility given the pace of headline policy changes.

Market Overview

Following the initial “animal spirits” post-election rally, stock market performance in the first quarter of 2025 was volatile. While January started relatively strongly for most corners of the stock market, the combination of dents in the major narrative market driver (i.e., AI, precipitated initially by concerns following reporting around the DeepSeek model) along with increasing concerns around the policy changes from the new administration led stocks to pull back meaningfully.

Last year’s pattern of large caps outperforming small caps has continued, although growth leadership has given way to value amid the preference for defense. Interestingly, the benchmark Russell 2000 Growth Index (-11.12%) and the Russell 1000 Growth Index (-9.97%) performed similarly. Meanwhile, the Russell 2000 Value Index was down just -7.74%, while the Russell 1000 Value Index was up a modest +2.14%. The Russell 2000 Growth Index has declined roughly 18% from its post-election highs last year and ended the quarter down over 15% from its year-to-date high watermark in late January.

Following publicity around the newer DeepSeek model architecture, investors began questioning potential returns on investment and monetization of generative AI initiatives and debating the timeframe in which orders might decelerate. Consequently, we have seen air come out of the sector-crossing narrative (and investment) tailwind around generative AI. Simultaneously, policy and regulatory noise has hit a fever pitch as the new administration installs its leadership and begins pursuing its policy goals in rapid, sometimes contradictory fashion. In particular, the threat of tariffs, concerns around funding cuts and possible major regulatory changes have

created uncertainty for buyers of goods and services, to say nothing of public investors. Meanwhile, the Federal Reserve has also signaled a digestion period following last year's rate cuts, with various headwinds around key indicators, including inflation trends, employment and economic growth. As such, it seems premature to anticipate meaningful tailwinds from monetary policy action.

With this many crosscurrents, it is unsurprising to see volatile market performance. While our touchpoints with public and private management teams underscore that it is too early to determine the near-term path for many sectors of the economy, there remains potential for some of the proposed changes to serve as long-term economic tailwinds (i.e., deregulation, reshoring). We remain focused on identifying idiosyncratic investment opportunities with multiple ways to win and secular drivers to allow for compounding of strong returns over time.

Portfolio Performance

Amid this challenging backdrop, the ClearBridge Small Cap Growth Strategy posted strong relative performance, handily outperforming its benchmark in the first quarter. We were encouraged by contributions both from new names added in 2024, the acquisition of multiple portfolio holdings by strategic buyers and balanced tailwinds to performance from longtime holdings across steady compounders, middle growers and hyper-growth companies. While we saw a small handful of companies that had cyclical headwinds in 2024 rebound to start 2025, we similarly saw some of our stronger performers from last year give back gains, in some cases despite unchanged or continued strong fundamental results.

We are gratified to see that the work undertaken in 2024 to improve our relative underweight to biotech has been a positive contributor to relative performance. The Strategy overcame the headwind from a still-sizable relative underweight in biotech, outperforming the benchmark and with strong idiosyncratic stock performance — six out of our 10 holdings in the industry were relative outperformers.

Overall stock selection benefited relative performance, particularly in sectors like IT and industrials, which were buoyed by some of our higher-quality compounders and idiosyncratic growth stories including longstanding holding RBC Bearings in the industrials sector. Within IT, exposure to mission critical software company Clearwater Analytics, Intapp and Varonis in security software contributed to relative outperformance.

The consumer discretionary sector was one area of general weakness, as a combination of high expectations, difficult comparisons and concerns around consumer spending weighed on names like beauty company e.l.f Beauty and cross-border commerce enabler Global-e Online. Several other companies were caught up in this area of

concern despite fairly strong results and outlooks, including IT holdings Klaviyo and Wix.com and financials holding Shift4 Payments.

Portfolio Positioning

We continued to generate a number of compelling new ideas, adding five new investments that we still held at quarter end: Glaukos, Rocket Lab USA, Karman Holdings (through its IPO), Archrock, Hims & Hers and Geron.

- Glaukos is a medical device company focused primarily on treating ophthalmological conditions such as glaucoma and corneal health. With several commercialized products and an innovative track record, the company is in the process of launching a potential blockbuster product, iDose, which is a drug-device combination with a variety of administration/efficacy advantages in treating glaucoma.
- Rocket Lab USA is a manufacturer of spacecraft and satellite components as well as a service provider for satellite launch services, primarily focused today on smaller payloads. With an innovative founder-led management team competing in an enormous market with significant growth in commercial, government and classified applications, we see significant growth potential.
- Karman Holdings is a defense company providing key systems to customers in the areas of hypersonics, missile defense and space. Given its small initial allocation and its over 55% appreciation following the IPO, we took profits and exited the position.
- Archrock is a production-driven compression service provider supporting natural gas production. There are multiple catalysts driving a secularly positive trajectory for natural gas demand and Archrock operates in a consolidated, capacity-constrained market providing critical services supporting production.
- Hims & Hers is a health care IT services company providing a consumer telehealth platform across a variety of men's and women's health categories, including weight loss, dermatology and mental health. With an integrated experience, strong brand recognition and a convenient stigma-free value proposition to consumers, the company is seeing robust revenue growth while improving profitability.
- Geron is a biotechnology company with a commercialized drug launching to treat blood cancer. Its product is newly entering a sizable market with broad applicability for patients who cycle through a variety of treatments throughout the course of the disease, allowing for a potentially larger revenue opportunity than currently appreciated by the market.

On top of this, early in the first quarter, several portfolio holdings announced acquisitions at healthy premiums to strategic buyers: Paycor in the industrials sector (acquired by Paychex), Intra-Cellular

Therapies in the health care sector (acquired by Johnson & Johnson) and H&E Equipment Services in the industrial sector (acquired by Herc Holdings). We exited these positions ahead of their pending acquisitions. Also, during the quarter we exited Conmed and Tennant due to idiosyncratic fundamental considerations.

Outlook

The Small Cap Growth Strategy remains committed to identifying idiosyncratic companies with growth opportunities and attractive returns irrespective of the macro backdrop. Exercising “judgment and patience” to ensure that we have 1) the right balance of opportunity and risk in the Strategy and 2) appropriately capitalized investments with substantial intermediate- to long-term growth opportunities remains at the core of our investment philosophy and process.

With ever-changing policy priorities out of the new leadership in Washington, D.C., particularly around tariffs, taxes, funding priorities and geopolitical conflicts, we have endeavored to have frequent touchpoints with the management teams of our investments. It is premature to declare definitive winners and losers or to precisely quantify impacts given the fluidity of the potential outcomes and many remaining related, but unknown, variables. What is clear, however, is that the pace of proposed change and lack of clarity around the duration of proposals (particularly tariffs/reciprocal tariffs) has had a chilling impact on general investment and consumer activity.

We anticipate softer near-term results across most every major sectors until macroeconomic and governmental drivers solidify (in either direction), which can allow companies and investors to reposition as necessary. However, the speed and magnitude of the recent momentum reversal in various corners of the stock market have likely created attractive long-term opportunities. With the rolling underperformance and valuation gaps between small caps and large caps persisting, coupled with some comforting dynamics (healthy balance sheets, functioning capital markets, still-healthy innovation, low unemployment), we continue to believe that the asset class is poised for better performance. We are encouraged by a second-straight quarter of improved relative performance in the Strategy, with broad-based contribution from last year’s elevated new idea generation, as well as legacy holdings that continue to compound nicely.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy outperformed its benchmark in the first quarter. On an absolute basis, the Strategy posted gains in one of the nine sectors in which it was invested (out of 11 sectors total): consumer staples. The main detractors were the IT and consumer discretionary sectors.

Relative to the benchmark, both overall stock selection and sector allocation effects contributed to performance. Stock selection in the IT, industrials and health care sectors, as well as an overweight to the consumer staples sector proved beneficial. Conversely, stock selection in the consumer discretionary and financials sectors weighed on performance.

On an individual stock basis, the leading contributors were positions in H&E Equipment Services, Intra-Cellular Therapies, BJ's Wholesale Club, TG Therapeutics and Paycor HCM. The primary detractors were Vaxcyte, Wix.com, Global-E Online, Xometry and Klaviyo.

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