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Small Cap Growth Strategy

Key Takeaways

- ▶ Small cap stocks are enduring their largest period of underperformance versus large caps to start a year in the last 51 years, creating significant relative value for investors willing to look past market leaders.
- ▶ Strategy performance was negatively impacted by weakness among our software names as the industry has seen meaningful negative growth and earnings revisions due to an AI overhang diverting budgets and providing greater support to semiconductor and hardware stocks.
- ▶ We continue to deliver strong new idea generation with six new investments in the quarter across four sectors that build on the momentum of the last four quarters. We are encouraged by a positive hit rate and solid overall contributions from these newer names.

Market Overview

In many ways, the second quarter of 2024 has been a continuation of the narrow, thematic-driven market backdrop. While the benchmark Russell 2000 Growth Index was only down 2.9% in the quarter, underlying volatility was greater with a maximum drawdown of nearly 9% through late April. Meanwhile, small cap stocks continue to screen at significant relative value relative to their large cap brethren given one of the longest periods of relative underperformance. Research from Jefferies suggests that the year-to-date difference between the S&P 500 Index and the Russell 2000 Index represents the largest period of underperformance to start a year in the last 51 years, a divergence that would look even worse ex-Super Micro Computer (SMCI).

The year-to-date performance of the Russell 2000 Growth Index continues to be even narrower than the Russell 1000 Growth Index, with SMCI driving 44% of the gains in the index. SMCI and MicroStrategy combined have driven nearly 60% of the performance compared to Nvidia and Microsoft collectively driving 43% of the Russell 1000 Growth gain. A mere eight stocks have supported the entirety of the Russell 2000 Growth benchmark performance compared to 40 stocks driving the Russell 1000 Growth. Our internal analysis of the underlying benchmark highlights that through May, the trailing 12-month percentage of benchmark stocks underperforming is at the second-highest level in the last seven years (exceeded only by 2020).

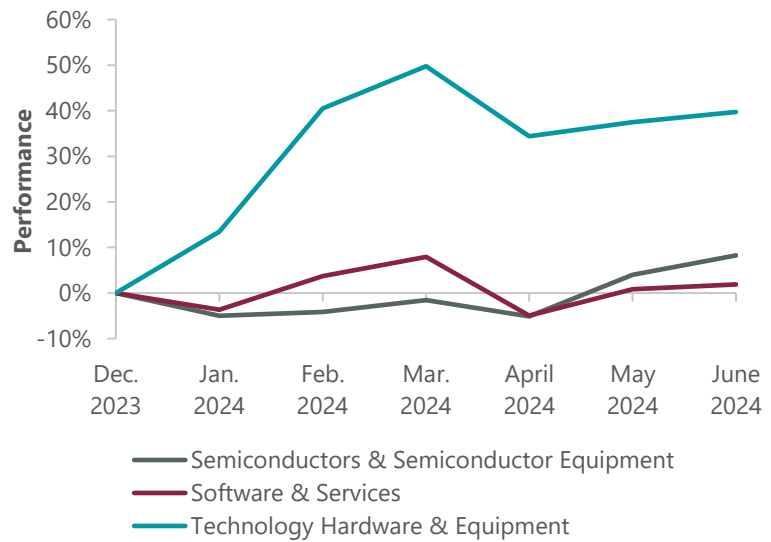
At the macro level, after a variety of datapoints in the first quarter supportive of Federal Reserve rate cuts in the back half of the year, contradictory signals on various inflation datapoints have led to a pushout in the timing and magnitude of rate cuts expected in 2024. Rates ended the quarter up modestly, but it was a wild ride for the U.S. 10-year Treasury with yields going from 4.2% to 4.7% before ending the quarter at 4.39%.

Simultaneously, while broader stock market performance has been solid year to date, we have observed a variety of contradictory signals around the health of the economy. Outside of a small group of perceived winners from secular trends (i.e., AI, reshoring/electrification and GLP-1s), it is less clear regarding the magnitude of disruption to businesses in areas like software, consumer discretionary and food/beverages/alcohol, to name a few. Moreover, we can identify multiple areas of concern within broad swaths of the economy, with a non-exhaustive list including consumer goods spending, non-residential and housing related investment, aerospace OEM production, transports, software budgets and large pharma R&D/S&M spending.

Historically we have had an overweight to the software sector given the potential to disrupt large legacy markets, with visible recurring growth and strong unit economics. Simultaneously we have found a variety of successful long-term investments in the semiconductor and hardware space but have been mindful of potential cyclicality. Over the last handful of quarters there has been a growing dichotomy in performance between semiconductors/technology hardware and software, as software growth and valuations have seen meaningful negative revisions. Year to date, within the Russell 2000 Growth Index, software and services are up +2% versus semiconductors up 8% and technology hardware and equipment (including SMCI) up 40% (Exhibit 1).

Over the long term, we continue to see a lot of opportunity in software. However, we acknowledge that in the near term, the AI overhang is a challenge, both in terms of potential loss of seats per contract, as well as budgetary/mindshare diversion to AI hardware/development versus other software priorities. In the early enthusiasm around the potential of generative AI (Gen AI), the stock market beneficiaries have largely been those supporting the infrastructure to power the necessary advanced computing requirements. As the cycle matures, businesses with more durable recurring revenue models ultimately should outperform. This was seen in the early days of the dot-com buildout as data center and fiber investments took years to realize returns while the most profitable businesses proved to be the ones that built services and applications on that infrastructure, such as Salesforce, Oracle, Amazon and Google.

Exhibit 1: Wide Performance Divergence in Small Cap Technology



Data as of June 30, 2024. Performance of information technology subsectors of the Russell 2000 Growth Index. Source: FactSet.

Various software investments held in the Strategy, such as Varonis, Intapp or Wix, have intriguing AI drivers to their business that can become more meaningful as enterprise customers adopt Gen AI at the application level. Additionally, we have had a handful of hardware and semiconductor investments that have benefited like Monolithic Power or recent addition Fabrinet, but in these types of businesses we look for additional drivers such as underearning segments (i.e., Fabrinet's telecommunication business, which could cyclically improve) or long-term tailwinds (i.e., Monolithic Power's secular growth in industrial and automotive), underpinned by strong profitability and clean balance sheets.

Against this backdrop, the ClearBridge Small Cap Growth Strategy underperformed its benchmark in the second quarter. With strong performance from a handful of new additions, the pace of relative underperformance improved slightly versus the first quarter; however, we remain disappointed by recent results. We are encouraged by solid contribution to overall performance from the majority of the 25 new ideas added over the last four quarters, despite these representing only a modest portion of the Strategy's assets.

As has historically been the case in our Strategy, with the majority of risk allocated to stock selection coupled with very high active share, we have seen idiosyncratic issues impact stocks at a given time that can be a drag to performance. Uniquely over the last several quarters, we have observed increased volatility to the downside for businesses reporting even slight disappointments. Anecdotally, looking at our underperforming stocks in the quarter, we saw numerous instances of slight decelerations in growth or management changes leading to significant underperformance. We

Over the last handful of quarters there has been a growing performance dichotomy between semiconductors and technology hardware versus software.

believe this can be partially attributed to a decline in active management assets relative to passive, and within active management a shift to shorter-term-focused investment strategies. Consequently, stocks with the slightest hint of volatility, decelerating trends or controversy are punished severely while the narrow group of clean names, usually exposed to one of the market's preferred mega-theme narratives, see already elevated levels of relative strength go even higher.

Several of our worst-performing stocks in the quarter, such as Trex and H&E Equipment Services, were some of our best contributors in the first quarter and in 2023 but had significant moves in the last three months behind only modestly disappointing results. At an industry level, industrials and health care were the worst-performing sectors, although we continue to find an array of high-quality business models within each sector. Among most of our challenged holdings, we continue to see significant long-term potential with the magnitude of the stock reactions not matching the change in fundamentals in our opinion.

Portfolio Positioning

We continued to deliver strong new idea generation, building on the momentum over the last four quarters and in anticipation of the just completed annual Russell index rebalance. In the second quarter we initiated six new investments: Global-e Online, Construction Partners, Expro Group Holdings, Blueprint Medicines, Fabrinet, and Vaxcyte.

- Global-e Online, in the IT sector, is a provider of cross-border e-commerce solutions for DTC merchants that enable customers to navigate the complexities of selling in more than 200+ global markets. The company has partnerships with major players like Shopify and has a unique combination of robust organic growth and healthy expanding margins.
- Construction Partners, in the industrials sector, is a vertically integrated construction and maintenance company that focuses on public highways, bridges, airports and non-residential applications in the Southeast. Through a combination of organic and inorganic opportunities, as well as exposure to fast-growing public end markets, the company offers one of the highest EBITDA growth profiles within the construction industry.
- Expro Group Holdings, in the energy sector, is an oilfield services company that is differentiated by high exposure to international and offshore markets where upstream spending continues to grow. Competing in consolidated markets with attractive pricing dynamics, multiyear contracts and an outlook for accelerating topline growth, Expro Group should be able to realize margin expansion over the intermediate term with improving free cash flow generation and shareholder returns.

- Blueprint Medicines, in the health care sector, is a biopharmaceutical company focused on conditions related to allergy/immunology, as well as oncology/hematology. The company has an approved and marketed product early in its launch in a rare disease market with blockbuster potential, as well as opportunities to leverage its expertise in other indications related to allergies/respiratory/immunological conditions. We see a reasonable near-term path for Blueprint to inflect to profitability as its main product ramps, along with early optionality on its broader pipeline.
- Vaxcyte, in the health care sector, is a biopharmaceutical company focused on novel vaccine technology in major bacterial disease vaccine markets. The company has a differentiated vaccine platform with the potential to have the broadest spectrum coverage vaccine for adults and infants, which could support a dominant future position in a market worth over \$8 billion annually.
- Fabrinet, in the IT sector, is the leading contract manufacturer of optical components that go into data center networking and telecom equipment. Fabrinet has materially outgrown the industry as outsourcing has increased due to low manufacturing yields and volatile cycles in the optical market. New AI server architectures that involve connecting large amounts of servers together into “clusters” has driven further significant growth in Fabrinet’s data center networking, where the company is a leading contract manufacturer for Nvidia.

During the quarter, there were announcements of proposed acquisitions of two portfolio holdings. ChampionX, an oilfield services provider announced its sale to Schlumberger, accepting an all-stock offer. Model N, a vertical software company serving the health care industry, was acquired by a private equity buyer. In addition to exiting Model N upon the closure of its acquisition, we exited ICON due to its larger market capitalization, as well as Definitive Healthcare, Pacira Biosciences, Oddity Tech, and Arcadium Lithium due to fundamental considerations.

Outlook

The ClearBridge Small Cap Growth Strategy remains committed to identifying idiosyncratic companies with growth opportunities and attractive returns irrespective of the macro backdrop. The guiding principles that have also informed our investment process and philosophy remain at the core of our process to exercise “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.

Thus far in 2024 we have seen continued extreme volatility and contradictory signals around the health of the underlying economy. The market and investors are coming to terms with a world that is fundamentally different post-COVID with difficulties assessing in 2022 and 2023 what would be permanent changes versus typical normalization following an unprecedented shutdown and incentive-fueled restart of the global economy. With wild swings in interest rates, inflationary pressures, inventory levels, consumer habits and crime, and amid multiple wars, geopolitical uncertainty and a partisan U.S. presidential election, it is increasingly important to lean into high-quality businesses with large, idiosyncratic growth opportunities. Given greater levels of unknowns relative to prior investment regimes, coupled with a skinny market powered by the themes of AI, bitcoin and GLP-1s, we intend to carefully balance risk and opportunity within the Strategy's holdings. As always, with the annual Russell index rebalancing we have completed some repositioning work to appropriately manage sector, factor and market capitalization exposure.

We believe the Strategy has an appropriately balanced spectrum of growth businesses, and with the unprecedented concentration at the top of the benchmark index rebalancing out at the end of the second quarter, we anticipate fewer distortions in underlying benchmark performance.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy underperformed its benchmark in the second quarter. On an absolute basis, the Strategy posted gains across four of the nine sectors in which it was invested (out of 11 sectors total). We would note that of the nine sectors in which we were invested within the benchmark Russell 2000 Growth index, only two posted gains on an absolute basis in the quarter: consumer staples and communication services. The primary contributors to Strategy performance were in financials and consumer staples while the main detractors included industrials and health care.

Relative to the benchmark, overall stock selection detracted from performance while sector allocation was additive. In particular, stock selection in the industrials and health care sectors detracted from returns. On the positive side, an overweight to consumer staples and stock selection in the financials, consumer discretionary and materials sectors contributed to performance.

On an individual stock basis, the leading contributors were positions in Inmed, Casey's General Stores, Wingstop, Zeta Global Holdings and BJ's Wholesale Club. The primary detractors were portfolio holdings Trex, Sprout Social, H&E Equipment Services, Lattice Semiconductor and National Vision.

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