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Small Cap Strategy

Key Takeaways

- ▶ The Strategy underperformed its benchmark in the fourth quarter, as strength in financials, energy and select health care holdings was offset by weakness in materials and consumer discretionary.
- ▶ Extreme factor dispersion and speculative leadership made 2025 one of the most challenging environments in decades for fundamentally driven small cap strategies.
- ▶ Despite near-term headwinds, attractive relative valuations and early signs of earnings broadening point to a more constructive setup for patient investors.

Market Overview

The fourth quarter capped a volatile and demanding year for small cap investors. The Russell 2000 Index returned 2.2% for the quarter and finished the year up 12.8%, trailing the Russell 1000 Index by approximately 450 basis points. A partial rotation away from the dominant AI trade supported value stocks over growth during the quarter, with the Russell 2000 Value Index returning 3.3% compared to a 1.2% gain for the growth index.

Beneath the surface, however, market leadership remained uneven. The quarter began with a continuation of one of the most extreme low-quality rallies on record, as non-earners, low-return on equity companies and high-beta stocks dramatically outperformed, leaving active managers broadly behind. This dynamic briefly gave way to a more constructive environment, as leadership rotated toward value, quality and lower-beta stocks, allowing small caps and active strategies to outperform for a short period. That improvement ultimately proved fleeting, as momentum leadership reasserted itself into year-end, closing the quarter with narrow breadth and elevated speculative activity.

Throughout the period, retail participation, leverage through ETFs and options and a persistent appetite for high-risk assets continued to dominate market structure. While small caps remain relatively inexpensive versus large caps on a valuation basis, that discount offered limited protection in an environment where factor leadership overwhelmingly favored momentum over valuation.

Portfolio Performance

The ClearBridge Small Cap Strategy generated positive absolute performance but trailed its benchmark in the fourth quarter, as notable strength in financials and energy, along with contributions from select health care holdings, were offset by weakness in materials and consumer discretionary.

Financials strength reflected strong stock selection within consumer finance and specialty credit. OneMain Holdings, a provider of personal loans and related financial services, benefited from resilient credit trends and improving visibility into earnings as macro conditions stabilized. Encore Capital, which focuses on debt recovery and receivables management, also contributed positively as investor sentiment improved toward companies with demonstrated cash flow generation and disciplined balance sheet management in a benign credit environment.

Energy was another area of relative strength, driven by company-specific execution and favorable industry fundamentals. Weatherford International, an oilfield services provider and a new position, advanced as improved operational performance and sustained upstream activity supported earnings momentum. International Seaways, a global tanker operator, benefited from constructive tanker market conditions, including favorable freight rates and tighter vessel supply. Green Plains, a biofuels and agricultural processing company, contributed as margins improved and investor focus increased on the company's strategic repositioning and longer-term earnings potential.

Health care delivered mixed results as a sector but accounted for a large collection of the Strategy's top individual contributors. Arrowhead Pharmaceuticals and Celcuity led performance on continued progress across their respective pipelines, while Axsome Therapeutics, Tarsus Pharmaceuticals and Avidity Biosciences added further positive contributions tied to clinical and regulatory developments.

However, these gains were offset by weakness in Corcept Therapeutics and Acadia Healthcare. Corcept declined following the issuance of a Food and Drug Administration Complete Response Letter for its relacorilant program, which introduced uncertainty around the timing and commercial potential of a key pipeline asset. Acadia Healthcare, meanwhile, detracted after lowering its outlook to reflect higher anticipated costs and increased legal-related reserves, which pressured near-term earnings expectations. We ultimately elected to exit Acadia and reinvest some of the proceeds into new holding Palvella Therapeutics, which is developing novel topical therapies for rare genetic skin diseases with significant unmet medical needs.

On the detractor side, materials weighed on relative results due to stock selection. MP Materials, a producer of rare earth materials,

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declined as sentiment toward certain commodity-exposed names softened following strong prior performance and shifting expectations around demand. Eagle Materials, a supplier of construction materials, also detracted amid increased sensitivity to cyclical construction trends and input cost dynamics.

Consumer discretionary was another area of relative weakness. Stride, an education services provider, declined as concerns emerged around enrollment trends and near-term growth visibility, while Visteon, an automotive electronics supplier, detracted amid volatility tied to global auto production and demand expectations.

Portfolio Positioning

We initiated a new position in Landstar System, an asset-light transportation and logistics company providing truckload freight brokerage services, as a pullback in the share price created an attractive entry point into a higher-quality business within our transportation exposure.

We also adjusted our exposure to consumer sectors with the addition of staples company Interparfums and Signet Jewelers in discretionary. Interparfums develops and markets prestige fragrances under long-term licensing agreements with global fashion and luxury brands, and we believe the market is undervaluing the company's long-term growth potential as it broadens its portfolio across brands and fragrances. Meanwhile, Signet Jewelers, the largest specialty jewelry retailer in North America, has shown signs of stabilization following a multiyear post-COVID demand contraction. We see improving execution, strong cash generation and ongoing capital returns supporting the company's recovery as demand normalizes.

We also exited Alexander & Baldwin, a Hawaii-focused real estate company, following the announcement of its agreement to be taken private, and Beta Bionics, a medical device company focused on automated insulin delivery systems, as the investment case became increasingly dependent on longer-dated outcomes, leading us to reallocate capital toward opportunities with clearer near-term visibility.

Outlook

We remain realistic about the challenges facing active small cap investors in the near term. The market's preference for speculative growth, leverage and momentum has persisted longer than historical precedent would suggest, and periods of narrow leadership can continue to test patience. In such environments, outcomes tend to be unforgiving, and dispersion can remain elevated.

That said, starting conditions matter, and we believe the current setup is increasingly constructive. Small cap valuations remain compelling relative to large caps, earnings leadership has the

potential to broaden, and early, albeit intermittent, rotations toward quality and value suggest the market may be becoming incrementally more responsive to fundamentals. While we do not attempt to time inflection points, history suggests that periods of extreme factor dominance are often followed by more balanced leadership.

As enthusiasm for low-quality extremes fades and fundamentals reassert themselves, we believe disciplined, bottom-up portfolios focused on durable business models, strong balance sheets and long-term value creation are well-positioned to benefit. While the path forward may not be linear, we are confident that patience, selectivity and adherence to our investment discipline will be rewarded as market conditions normalize.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in four of the 11 sectors in which it was invested during the quarter. The leading contributors were the health care and financials sectors, while the consumer discretionary and information technology (IT) sectors were the main detractors.

On a relative basis, overall stock selection detracted from performance but was slightly offset by a positive contribution from sector allocation effects. Stock selection in the materials, consumer discretionary, IT and communication services, as well as stock selection in and an underweight to the health care sector, weighed on performance. Conversely, stock selection in the financials and energy sectors and an underweight to the IT sector proved beneficial.

On an individual stock basis, the biggest contributors to relative returns in the quarter were Arrowhead Pharmaceuticals, Celcuity, Photronics, Allegiant Travel and Yeti. The largest detractors were Corcept Therapeutics, MP Materials, Penguin Solutions, Stride and Janus International.

In addition to the transactions listed above, we initiated new positions in Solstice Advanced Materials in the materials sector, Upwork and Openlane in the industrials sector and Arlo Technologies in the IT sector. We exited positions in Avidity Biosciences and Verona Pharma in the health care sector, Crane NXT and JAMF in the IT sector, Redwood Trust in the financials sector, Marten Transport in the industrials sector and Atlas Energy Solutions in the energy sector.

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