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Mid Cap Strategy

Key Takeaways

- ▶ The fourth quarter proved tumultuous for mid caps, which rose on a post-election rally and interest rate cuts, and then held up amid a rotation back to large cap leadership.
- ▶ The Strategy outperformed its benchmark in the fourth quarter, lifted by strong stock selection among our IT and industrials holdings.
- ▶ While 2024 proved challenging, we believe that recent performance and periods of market broadening in the second half of the year may point toward a broader shift in the market beneficial to the mid cap companies we target.

Market Overview

The fourth quarter proved a tumultuous one for mid cap stocks, which rode a post-election rally before growing investor concern over the plans of the incoming Trump administration and fewer-than-anticipated interest rate cuts propelled large caps back to leadership. Overall, mid cap stocks generated positive returns, with the benchmark Russell Midcap Index returning 0.62% for the month, but failed to keep pace with large caps as the Russell 1000 Index and S&P 500 Index returned 2.75% and 2.41%, respectively. While value and cyclical names were the major participants of the post-election rally, a relative resurgence in growth in December helped the Russell Midcap Growth Index return 8.14% for the quarter, making it the best-performing area of the market, and outpacing the Russell Midcap Value Index by nearly 1,000 basis points.

From a sector standpoint, the rebound and rotation toward growth stocks helped propel the information technology sector (IT, +10.36%) to the best performance in the index in the fourth quarter, followed closely by energy (10.33%), as optimism of increased Chinese demand and forecasts for colder winter weather helped bolster oil and natural gas prices. The financials (+7.03%) and communication services (+6.86%) sectors also outpaced the broader index. An uncertain outlook and continued pushout of recovery expectations in materials (-10.50%) made it the worst-performing sector of the benchmark, followed by the health care (-7.59%), real estate (-6.78%), consumer staples (-3.39%), utilities (-1.96%), industrials (-1.04%) and consumer discretionary (-1.03%) sectors.

Inklings of a market broadening in the fourth quarter sparked by Donald Trump's election victory and investor optimism over greater deregulation and business-friendly policies were seen as a boon to

Several catalysts suggest 2025 may play out very differently than 2024, much to the advantage of mid cap stocks.

equities, particularly mid and small cap stocks. This was further bolstered by additional interest rate cuts from the Federal Reserve. However, rate cuts came amid strong economic data that began to support the case for a slower easing cycle in 2025 than had been expected, contributing to a market rotation back to growth and large cap leadership. This, along with potentially reflationary policy from the Trump administration, such as tariffs, as well as slight upticks in inflation, put some upward pressure on interest rates, causing some weakness in economically sensitive and rate-sensitive sectors.

The return to large cap and AI-beneficiary leadership was reminiscent of what we saw for a majority of 2024: a momentum-driven market where companies' competitive differentiation and fundamentals were largely overlooked in favor of those with AI-narrative tailwinds. Although this proved beneficial to portfolio holdings like AppLovin and Marvell Technology, which we view as the highest-quality AI beneficiaries in the mid cap market, it created an even more challenging environment for companies in more value-oriented and cyclical sectors like industrials and consumer discretionary. However, recent fundamental indicators point to the beginnings of a stabilization and potential recovery in these sectors that could lead to a greater broadening in market participation in the coming year.

Stock selection in IT was the greatest contributor to performance on strength in AppLovin and Marvell. AppLovin is the world's leading mobile game and app advertising platform, providing software for marketing and monetization, powered by its proprietary AI targeting engine Axon. We see opportunity for AppLovin to continue to expand and grow its share of the market for mobile app marketing at a time when mobile gaming ad spend is recovering from a higher-rate-driven trough. We also see the potential for the company to expand its addressable market to include e-commerce advertising, around which initial forays have been encouraging. With strong incremental margins and management keeping expenses controlled, the company should be able to drive significant free cash flow growth as revenue continues to scale. Likewise, Marvell, a networking and storage semiconductor designer, participated in the late-year rally share price rallied on the back of investors' enthusiasm for generative AI growth acceleration due to its position as a key supplier of custom silicon solutions for hyperscale data centers and AI infrastructure.

We also benefited from our strong stock selection in the industrials sector. CAE, which provides simulation training and critical operations support to both civil and defense aviation customers, reported solid quarterly earnings stemming from its defense business. In addition to the company's strong market share and customer demand in civil flight simulation, its strong growth in its defense business and active approach to improving its balance sheet should be long-term growth catalysts.

Stock selection in health care was the biggest detractor from returns, as the prospect of higher rates, continued push out of health care R&D spending and the potentially disruptive nomination of RFK Jr. as Secretary of Health and Human Services weighed heavily on the biotechnology, pharmaceutical industries and related supply chains. This included ICON, a contract research organization that provides outsourced development and clinical development organization serving biopharmaceutical and life science customers, and Avantor, which provides mission-critical products and services to customers in the biopharmaceutical, health care, education, government and other specialized industries. While recognizing these headwinds, we continue to believe that the health care sector is a fertile hunting ground for opportunities as end markets stabilize and begin to recover.

Portfolio Positioning

We initiated a new position in Archrock, an energy infrastructure company and the leading provider of natural gas compression equipment and services. The company has demonstrated strong capital discipline, maintaining high return thresholds for leasing, operating, and servicing its equipment. We believe that as more companies outsource their natural gas compression needs Archrock is well-positioned to capture this growing demand.

We also added International Paper, a leading paper and packaging company in the materials sector, as we believe it represents a strong turnaround story under the leadership of a new CEO we are familiar with from his time at IDEX. Historically, the company has struggled with manufacturing inefficiencies, but the new CEO has embarked on an ambitious plan to optimize its footprint, adjust pricing dynamics and improve margins within the next few years. Additionally, we believe that a favorable supply/demand balance within the industry for paper and packaging products should help support stronger pricing power moving forward.

We exited our position in Coterra Energy, an independent oil and gas exploration and production company, following the company's decision to acquire oil and gas assets in the Permian Basin in two transactions that we believe prioritize company size over operational efficiency.

Outlook

While 2024 proved a challenging year, we believe that recent performance and the market broadening in the second half of the year point toward a broader shift in the market. After two strong years driven by a narrow cohort of large caps, several emerging catalysts, including relative valuations, credit spreads and forward earnings growth, suggest that 2025 may play out differently than 2023 or 2024, much to the advantage of mid cap stocks. We have positioned the portfolio in the highest-quality AI companies, which we believe should outperform if this industry continues to grow, or if

investment dollars experience a digestion period and this broader theme dwindles. Going forward, competitive differentiation will be more important to stock performance as spending and investment evolve following the strong revenue accelerations that all companies exposed to this trend experienced at its beginning.

Portfolio Highlights

The ClearBridge Mid Cap Strategy outperformed its Russell Midcap Index during the fourth quarter. On an absolute basis, the Strategy had contributions from eight of the 11 sectors in which it was invested during the quarter. The largest contributors were the IT and financials sectors, while the health care and materials sectors were the greatest detractors.

On a relative basis, overall stock selection effects contributed to performance. Stock selection in the IT, industrials, consumer discretionary and consumer staples sectors and an overweight to the IT sector proved beneficial. Conversely, stock selection in the health care, real estate, materials and financials sectors weighed on performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were AppLovin, Marvell Technology, Rubrik, EQT and CAE. The largest detractors from absolute returns were ICON, Avantor, Eastman Chemical, Alexandria Real Estate Equities and Ashland.

In addition to the transactions listed above, we initiated a new position in Coinbase Global in the financials sector.

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