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## Small Cap Strategy

### Key Takeaways

- ▶ The Strategy outperformed its benchmark, driven by strong stock selection in health care, energy and consumer discretionary sectors.
- ▶ Market leadership began to broaden as dispersion increased and speculative excess showed signs of fading, improving conditions for active managers.
- ▶ While macro uncertainty remains elevated, a shift toward quality and fundamentals may provide a more supportive environment for disciplined small cap investors.

### Market Overview

Small cap equities experienced a volatile start to 2026, as strong early gains gave way to shifting leadership and a more uncertain macro backdrop. The Russell 2000 Index returned 0.9% for the quarter, outperforming the larger cap Russell 1000 Index by over 500 bps. A partial rotation away from the dominant AI trade supported value stocks over growth during the quarter, with the Russell 2000 Value Index returning 5.0% compared to a 2.8% loss for the growth index.

Small caps rallied sharply out of the gate in January, significantly outperforming large caps, though the advance was driven largely by lower-quality, high-beta and heavily shorted companies — extending the speculative dynamics that have characterized much of the past year. While improving earnings expectations provided some fundamental support, the narrow and risk-seeking nature of leadership continued to present challenges for fundamentals-driven strategies. As the quarter progressed, however, rising dispersion and improving breadth indicated that investors were becoming more selective.

Leadership broadened beyond the most speculative areas of the market, with capital rotating toward more asset-intensive businesses supported by sound operational results, particularly within energy and materials. At the same time, escalating geopolitical tensions, including conflict in the Middle East, drove a sharp increase in oil prices and renewed concerns around inflation, growth and monetary policy. Equity markets responded with a broad-based pullback, with small caps experiencing a deeper decline given their greater economic sensitivity. Despite this volatility, the increase in dispersion and early rotation toward quality suggest the market environment may be becoming incrementally more supportive for active managers, particularly those focused on disciplined, bottom-up stock selection.

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### Portfolio Performance

The ClearBridge Small Cap Strategy outperformed its Russell 2000 Index benchmark during the first quarter, driven by strong stock selection in health care, energy and consumer discretionary.

In health care, several holdings delivered strong gains on company-specific developments and improving sentiment toward innovative biopharmaceutical companies. CG Oncology, a clinical-stage oncology company focused on bladder cancer therapies, Celcuity, a precision medicine company targeting cancer signaling pathways, and Palvella Therapeutics, a developer of treatments for rare genetic skin diseases, benefited from positive clinical progress and the advancement of differentiated pipelines. Performance in the sector reflects our focus on identifying companies with compelling science, clear catalysts and attractive long-term growth potential.

Energy was another notable area of strength, with five of the Strategy's top 10 contributors coming from the sector. Holdings such as Matador Resources, an independent oil and gas producer with operations in the Permian Basin, International Seaways, a global crude and product tanker company, and California Resources, a California-focused energy and carbon management company, benefited from improving industry fundamentals and a sharp increase in oil prices driven by geopolitical tensions in the Middle East. These companies continue to demonstrate strong free cash flow generation and capital discipline, positioning them well in a supportive commodity environment.

Stock selection in consumer discretionary also contributed, led by Murphy USA, a convenience store and gas station operator. The company's shares rose in March alongside a sharp increase in oil and gasoline prices, which lifted fuel margins and supported earnings expectations. Murphy's low-cost operating model and strategic store footprint continue to provide a competitive advantage, particularly during periods of fuel price volatility.

These gains were partially offset by weakness in industrials. Detractors included Upwork, an online freelance marketplace connecting businesses with independent workers, ICF International, a consulting and technology services provider focused on government and commercial clients, and AeroVironment, a manufacturer of unmanned aircraft systems and defense technologies, reflecting a combination of company-specific challenges and sensitivity to evolving demand expectations.

In information technology (IT), positions including nCino, a provider of cloud-based banking software, Q2 Holdings, a digital banking and payments platform, and Commvault, a data protection and management software company, came under pressure as investors increasingly weighed the potential for AI-driven disruption across software and online platform businesses, contributing to a reassessment of growth durability and valuation.

### **Portfolio Positioning**

Defense was a focus of activity in the quarter. We initiated a position in Parsons Corporation, an engineering and infrastructure services provider, as we see the company well positioned to benefit from increasing global investment in defense and critical infrastructure. Its growing exposure to higher-margin, technology-enabled solutions and strong backlog provide improved visibility into earnings and cash flow. We also added AeroVironment, for which rising demand for autonomous and defense technologies supports a durable growth outlook tied to evolving national security priorities.

We also initiated a position in PAR Technology, a provider of cloud-based software solutions for restaurants, where we believe the market is underappreciating the company's transition toward a higher-margin, recurring revenue model. As the business continues to scale its software platform and improve operating efficiency, we see potential for meaningful margin expansion and earnings growth. In addition, we added E&P and carbon management company California Resources, where strong free cash flow generation and improving capital discipline position the company to benefit from a more constructive commodity backdrop.

At the same time, we exited Stride, an online education platform, following a period of strong performance that left shares more fairly valued relative to our forward expectations. We also exited Corcept Therapeutics, a biopharmaceutical company, as we reassessed the risk-reward profile following strong prior gains and evolving considerations around its pipeline. Additionally, we exited Valaris, an offshore drilling contractor, following its agreement to merge with competitor Transocean in a primarily stock-based transaction that we believe would leave the combined company with an uncomfortably leveraged balance sheet.

### **Outlook**

The market environment appears to be at an inflection point. While speculative leadership and a preference for lower-quality, high-beta companies persisted into the start of the year, rising dispersion and improving breadth suggest conditions may be becoming more supportive for active managers. Early signs of rotation toward more asset-backed and higher-quality businesses are an encouraging shift after an extended period dominated by momentum and risk-seeking behavior.

At the same time, macroeconomic uncertainty has increased. Elevated oil prices, geopolitical tensions and shifting expectations around inflation and monetary policy have introduced new risks, particularly for small caps, given their greater economic sensitivity. These crosscurrents are likely to drive continued volatility and rapid rotations, with markets increasingly focused on distinguishing between winners and losers across sectors and business models.

Despite this backdrop, the underlying setup for small caps remains constructive. Valuations are attractive relative to large caps, and improving earnings breadth, combined with higher dispersion, should create a more favorable environment for stock selection. As fundamentals reassert themselves, we believe companies with durable business models, strong balance sheets and clear earnings power are well-positioned to drive long-term returns.

### Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed its Russell 2000 Index benchmark during the first 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 contributor was the energy sector, while the IT sector was the main detractor.

On a relative basis, overall stock selection detracted from performance but was more than offset by positive sector allocation effects. Stock selection in the health care, energy and consumer discretionary sectors, an overweight to the energy sector and underweights to the IT and health care sectors proved beneficial. Conversely, stock selection in the industrials, IT, materials, consumer staples and communication services sectors weighed on performance.

On an individual stock basis, the biggest contributors to relative returns in the quarter were Matador Resources, International Seaways, Murphy USA, California Resources and Solstice Advanced Materials. The largest detractors were Upwork, Ncino, Q2, Utz Brands and not owning Bloom Energy.

In addition to the transactions listed above, we initiated new positions in Descartes Systems in the IT sector, Prosperity Bank in the financials sector and the abrdn Physical Precious Metals Basket Shares ETF. We exited positions in Photronics and Commerce.com in the IT sector, Janus International in the industrials sector, Green Plains in the energy sector, Independent Bank in the financials sector and COPT Defense Properties in the real estate sector. During the period, holding PotlatchDeltic, in the real estate sector, entered a merger with competitor Rayonier, whose shares we received in exchange.

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