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Small Cap Growth Strategy

Key Takeaways

- ▶ A partial leadership rotation in the second half of 2024 could persevere into 2025 as a variety of macro factors stabilize and small cap earnings growth is poised to outperform up-market peers.
- ▶ The Strategy performed in line with the benchmark in the fourth quarter, as strength in industrials and health care was offset by weakness in IT and consumer discretionary sectors.
- ▶ 2024 proved an energetic year of new idea generation, as we added 23 new positions and sold 29, redeploying capital into new ideas with promise.

Market Overview

We entered 2024 with conditions setting up for a possible rebound in small cap stocks; however, the year wound up sharing many similarities with 2023, alongside a healthy share of volatility beneath the surface. The environment proved challenging for active managers, with an unprecedented set of narrow themes driving both benchmark and individual stock performance. Like many of our peers, the ClearBridge Small Cap Growth Strategy struggled with the acute concentration of the benchmark in the first half and a violent rotation into small caps in the third quarter. However, solid idiosyncratic contributions from a diverse range of holdings allowed us to keep pace with the benchmark in the fourth quarter, which we believe is attributable to a strong cohort of new investment ideas. This recent performance, coupled with what we believe is a more favorable backdrop for small cap growth securities in 2025, makes us optimistic entering the new year.

From a macro perspective, the U.S. economy avoided what had been a widely anticipated recession in 2024, powered by resilient consumption and productivity upside. As had been hoped, the pace of inflation cooled over the course of the year, while the labor market was reasonably steady both from a job creation and wage growth standpoint. This backdrop supported the Federal Reserve's ability to begin normalizing monetary policy with 100 basis points of rate cuts over the course of the last four meetings.

2024 was one of the strongest years for the momentum factor on record, with a business's actual or perceived exposure to a variety of interrelated mega themes and narratives mostly tied to the unprecedented infrastructure buildout to support generative AI ambitions — driving accelerating growth, expanding multiples or both. We have previously discussed how this led to unprecedented

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benchmark concentration in a few securities, some of which were highly speculative (with subsequent material declines in their stock prices after they left the Russell 2000 Growth Index in the annual rebalancing cycle). The animal spirits that first manifested in anything tied to generative AI/chips expanded to data center buildouts, HVAC equipment needed for these data centers, service providers to build/install these systems, and finally power solutions to support the electricity demands of this multiyear generational product cycle, which has been compressed into a period of 12 to 18 months. Within our small cap growth investing universe, this enthusiasm has also caused investors to seek out speculative but potentially high-growth exposure to themes like nuclear energy, space and bitcoin.

Taking a closer look, the market could best be characterized into three periods: the first half, the third quarter and the fourth quarter. The first half of the year was dominated by the Magnificent Seven and investor enthusiasm for AI, which peaked in early July as the soft June CPI data marked an inflection point in equities, paving the way for Fed cuts/policy normalization and a leadership rotation. This was reflected in a sharp rally in smaller cap and value stocks. More recently, investor attention shifted toward the election and an equity market leadership tug of war influenced by politics/policy speculation. Outside of generative AI and the second- and third-order derivatives, this was a year of pushouts for many sectors and still-present challenges for lower-income consumers and small businesses.

The year also saw continued extreme divergence in performance between large cap and small cap indexes, with a four-year losing streak now in the books. According to the Jefferies Equity Strategy team, this has been the longest losing streak ever for small caps, with relative valuation models similarly near historic lows. The Russell 2000 Growth Index returned 15.15% in 2024, underperforming the Russell 1000 Growth Index by 1,820 basis points, a streak that continued in the fourth quarter with the indexes returning 1.70% and 7.07%, respectively.

In summary, as we look back at 2024, the common denominator has been the dominance of the narrative at the expense of longer-term fundamental and quality derisking. The following quote from Peter Brooks' *Seduced by Story* feels apropos lately for the equity markets: "Narrative seems to have become accepted as the only form of knowledge and speech that regulates human affairs." While this can be true in the short term, we believe a patient and consistent fundamental derisking process in assessing small cap growth companies will be rewarded over time in economically driven capital markets.

Despite these challenges we see several reasons to be optimistic entering 2025. With a continued easing cycle, stable macro factors and a potential handoff to faster earnings growth for small caps, the asset class could be poised to end its recent losing streak.

Portfolio Performance

Despite underlying volatility and a challenging December, the ClearBridge Small Cap Growth Strategy performed in line with the Russell 2000 Growth Index in the fourth quarter.

The confluence of higher rates and the surprising and potentially disruptive nomination of RFK Jr. as Secretary of Health and Human Services weighed heavily on multiple health care subsectors such as biotech and providers and health care services. As a result, the Strategy's underweight to biotechnology as well as company-specific outperformance of some medical device holdings drove strong relative performance in the quarter. Additionally, outperformance across a diverse range of our industrial holdings was a positive contributor. One standout was Bloom Energy, a provider of alternative energy products, which announced a significant partnership with a major utility to provide fuel cells to power AI data centers, crystalizing its potential exposure to an fast-growing source of power demand.

Conversely, several previously strong 2024 performers in IT and consumer discretionary, such as Varonis, a security software company, and Wingstop, a high-growth franchised restaurant concept, saw profit taking amid high expectations during the fourth quarter earnings season. We had trimmed several of these holdings in recognition of elevated valuation levels but, considering attractive long-term revenue and profit compounding potential, we continue to maintain exposure to both.

Portfolio Positioning

2024 proved a particularly active year for new idea generation: we added 23 new investments while exiting 29 due to a variety of considerations, including acquisitions, market capitalization constraints, and our assessment of forward return potential. While many of the new investments we made during the year are of relatively modest size, we will continue to build these positions over time provided company execution and end market prospects remain intact.

In the fourth quarter we initiated five new investments: Oscar Health, TG Therapeutics, Clearwater Analytics, Fluor and Modine.

- Oscar Health is a managed care organization focused on the commercial Affordable Care Act exchange market. While there is modest regulatory uncertainty in its end markets, Oscar has the potential for market share gains, geographic footprint expansion and significant margin improvement as it scales.
- TG Therapeutics is a commercial stage biotechnology company focused on multiple sclerosis (MS), a significant chronic disease end market. Its lead product, Briumvi, has the potential to grow its market share significantly within the largest drug class in the \$8 billion MS market.

- Clearwater Analytics is a vertical cloud software provider of investment accounting and analytics solutions for corporate, insurance and asset management customers. The company has seen an attractive combination of robust revenue growth through client wins and product expansion, as well as significant margin expansion.
- Fluor is one of the largest engineering, procurement and construction firms, with global scale supporting megaprojects across various end markets. With an improved contract structure mix and balance sheet, the company is poised to benefit from an array of high-priority investment projects in markets such as data centers, GLP-1 manufacturing, mining and nuclear energy.
- Modine is a manufacturer of thermal management products serving a variety of climate solution (HVAC), air quality and vehicle/equipment end markets. The company has simultaneously been seeing inflecting demand and leveraging benefits from internal self-help margin projects.

We also exited 10 positions during the quarter: Aspen Technology and ChampionX ahead of proposed acquisitions, as well as Shoals Technologies, Viavi Solutions, Certara, Albany International, Hayward Holdings, Blackbaud, Progyny and Azenta.

Outlook

Our investment approach evaluates businesses without any macro tilt, focusing on companies that can compound high levels of growth in large markets without depending on macro tailwinds, provide durable returns and have ample access to capital to fund high-growth investment opportunities.

Based on our research and analysis, we believe there are several relevant trends heading into 2025:

- Political and economic forces are likely to further support onshoring/reshoring trends, as companies look to secure supply chains for geopolitical/tariff considerations as well as in recognition of inventory and supply chain vulnerability over the last few years. This should drive growth opportunities for select companies within the industrials, IT, energy and materials sectors.
- While there remains uncertainty around what policies the new Republican administration will pursue and successfully enact, we anticipate that deregulation will be a key priority. We recognize there can be unintended consequences, both positive and negative, from such efforts felt across sectors, with pockets of IT, financials and industrials as potential winners and greater complexity in assessing the impact in highly regulated sectors such as health care.
- M&A and capital markets activity appear poised for an upward inflection. While M&A activity improved in 2024, we anticipate that greater funding cost stability, deregulation and a less stringent antitrust posture could lead to further acceleration. By contrast, IPO

activity has been stagnant for multiple years, creating a backlog of high-quality candidates looking to test the market appetite in 2025. Historically, the ClearBridge Small Cap Growth Strategy has benefited from a more robust M&A environment while replenishing our pipeline of new investment candidates through the IPO markets.

Although small cap growth stocks have continued to be challenged relative to their larger peers, a variety of factors including the length of the underperformance, relative valuations, credit spreads and forward earnings growth suggest that the temporary leadership rotation of the third quarter could prove more enduring in 2025. Moreover, after a two-year period dominated by a narrow handful of narrative themes and idiosyncratic challenges for many end markets (consumer, SMB, non-AI technology to name a few), we could see a broadening out of performance. We continue to find an array of attractive investment opportunities across the spectrum of growth characteristics we seek.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy performed in line with its Russell 2000 Growth Index benchmark during the fourth quarter. On an absolute basis, the Strategy had gains in three of the nine sectors in which it was invested (out of 11 sectors total). The leading contributors were the industrials and financials sectors, while the health care and consumer discretionary sectors detracted the most.

On a relative basis, overall sector allocation effects contributed to returns, but were offset by negative overall stock selection. Stock selection in the IT and consumer discretionary sectors weighed on performance, while stock selection in the industrials and health care sectors and an underweight to health care proved beneficial.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Wix.com, Bloom Energy, Xometry, XPO and Shift4 Payments. The largest detractors were Wingstop, Surgery Partners, Varonis Systems, Zeta Global and Vaxcyte.

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