



## Canadian Small Cap Strategy



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### Key Takeaways

- ▶ Canadian small caps rose modestly, with a strong July and August partly reversed in September as bond yields rose sharply. Commodities were again the dominant performance driver: crude oil rose roughly 30%, copper set record highs and gold rallied to a late-August high before reversing in September.
- ▶ The Strategy delivered a positive absolute return but slightly trailed the benchmark, as positive stock selection in information technology was offset by weakness in industrials.
- ▶ The market remains narrative- and momentum-driven, with “Build Canada” and resource themes pulling a small group of winners higher while businesses with solid fundamentals are discounted, which we see as an opportunity for our patient, bottom-up approach.

### Market Overview

Canadian small caps advanced in the third quarter, with the S&P/TSX Small Cap Index up 2.4%. Commodity price swings remained the key driver, and leadership was narrow. Energy (+7.6%), materials (+7.5%) and industrials (+4.3%) generated the bulk of the return, while information technology (IT, -14.0%), utilities (-8.9%), communication services (-8.6%), real estate (-7.4%), consumer discretionary (-5.3%) and financials (-3.1%) lagged.

Equities tied to resource and “Build Canada” narratives performed well, while those without narrative momentum trailed. AI-linked names were mixed: power infrastructure companies pulled back, while software companies seen as at risk from AI disruption earlier in the year rebounded on strong results. Dispersion within sectors was also wide, with oil-weighted exploration and production companies outperforming gas producers and producing miners generating cash flows rallying while critical mineral developers sold off.

Crude continued its volatile 2026. After falling 31% in the second quarter on progress toward reopening the Strait of Hormuz, WTI rallied 30% to US\$90.42/bbl, peaking near \$106 in mid-September, as the conflict dragged on and drew down global inventories. New York Harbor diesel futures reached \$5.26/gal, up over 100% since the conflict began. Gold climbed to \$4,657/oz in August but closed September at \$4,155 as higher rates raised the opportunity cost of holding it. Copper set records (LME \$14,858/ton; Comex roughly \$6.80/lb) on tight supply and tariff-driven inventory repositioning.

The Federal Reserve raised its policy rate 25 basis points to 3.75%–4.00% in September, its first hike since 2023, while the Bank of Canada held at 2.25% with a more hawkish tone. The Canadian 10-year yield rose 61 basis points to 3.99%, weighing on rate-sensitive sectors and driving the September pullback. Outside of resources, the domestic backdrop is mixed. Slowing population growth, affordability pressures, higher rates and renewed trade tensions with the U.S. are partly offset by increased federal and provincial capital spending.

### **Performance Overview**

The ClearBridge Canadian Small Cap Strategy slightly underperformed its benchmark for the quarter, with gains compiled in July and August offset by losses in September.

The largest relative detractor was industrials, where weakness in ATS Corporation, Element Fleet Management and Boyd Group, together with the lack of exposure to Russel Metals, more than offset strong performance from Bird Construction. We believe the softer outlook at ATS reflects project timing and an under-optimized cost structure. The company is well-positioned in life sciences, radiopharma and nuclear, and its cost program offers self-help upside. Slower originations and a commercial execution shortfall hurt Element shares, but its scale advantages are intact and walking away from the FleetPartners process signals capital discipline.

Energy also detracted despite a positive absolute return: strong results from Kelt Exploration, Headwater Exploration and PHX Energy were offset by weakness in Enerflex, North American Construction and Topaz Energy, and by the lack of exposure to more oil-levered producers as crude prices rose sharply. Our energy holdings are, on average, less sensitive to commodity prices, and we would expect them to trail the sector during a crude-led rally.

The largest relative contributor was IT, driven primarily by the absence of BlackBerry, which declined 38% during the quarter and exited the benchmark, along with strong results from Descartes Systems and Kinaxis.

Materials contributed modestly: strong performance from Hudbay Minerals, Capstone Copper, OR Royalties and Skeena Resources, together with the lack of exposure to critical minerals names such as Almonty Industries, 5N Plus and the lithium developers, was largely offset by the lack of exposure to the strongly rallying gold, silver and copper producers.

### **Portfolio Positioning**

Trading activity was elevated as commodity volatility, higher yields and stock-specific dispersion created opportunities to recycle capital.

In materials, we exited Lundin Mining over August and September. Although the company has performed well, we see better metals and mining opportunities at market caps that match our objectives, such as new position Wesdome Gold Mines, an established underground producer with the Eagle River and Kiena mines in Ontario and Quebec. Wesdome is the kind of disciplined operator we look for in a sector

where capital allocation has often been poor. This year it has repurchased roughly C\$180 million of stock, expanded its buyback and initiated its first dividend. We also added to Skeena Resources, where Eskay Creek is more than 70% built with first production targeted for the second quarter of 2027, along with Lumina Metals, Hudbay Minerals and Major Drilling. We trimmed Methanex after methanol-driven strength and continued reducing Winpak, where we see a fair trade-off between valuation and trade-disruption risk.

In industrials, we added to ATS Corporation, Boyd Group and Element Fleet Management, where near-term concerns weighed on the shares without, in our view, impairing the franchise. Softer claims volumes and a systems conversion disruption weighed on sentiment for Boyd, but same-store sales are positive, synergy targets were raised and the company is buying back stock at a depressed valuation. We trimmed Calian and Bird Construction after strong performance.

In energy, we initiated CES Energy Solutions, a drilling fluids and production chemicals provider. The company fits our preference for capital-light service companies with recurring, consumable revenue less sensitive to commodity swings. We added to Paramount Resources, whose Montney assets offer growing gas exposure as LNG capacity expands as well as valuable condensate production. We trimmed Parex Resources after its strong move following the Frontera transaction.

At quarter end, the largest absolute exposures were materials, energy and industrials. The largest relative overweights were IT, utilities and financials, followed by industrials, energy and consumer staples. The largest relative underweights were materials, real estate and health care, with smaller underweights in communication services and consumer discretionary.

## Outlook

As we noted last quarter, the market remains highly narrative- and momentum-driven, and in our view it continues to turn cyclical and thematic trades into long-duration assumptions. This was evident in “Build Canada” equities. Governments have begun directly supporting large industrial and energy projects. LNG Canada Phase 2 reached a positive final investment decision in September, and shortly after quarter end the proposed Pacific Link Pipeline was deemed a project of “national interest,” opening a path to accelerated approval.

The resulting move in related cyclicals, including contractors, remote camp operators, metal distributors and drilling and oilfield services, has in some cases been justified, but not at the expense of other opportunities. Investors are driving a small group of winners higher while applying steep discounts to businesses lacking thematic tailwinds, regardless of fundamentals or valuation. We see that as an opportunity. Our approach is unchanged: bottom-up, research-driven, patient and long-term, focused on businesses that combine prudent capital allocation with durable competitive advantages, strong balance sheets and the ability to compound value.

Within materials, we remain biased toward copper and precious metal royalty and streaming companies, and we have expanded our

opportunity set to select gold producers and developers. Supply constraints and electrification and AI-related demand support a constructive long-term setup for copper and low-cost copper assets. Royalty and streaming businesses remain the core of our gold exposure, offering diversified participation while mitigating operational, geopolitical and geological risk. Alongside them, we have added Canadian-focused gold developers and producers with stronger capital allocation and risk management.

### Portfolio Highlights

The ClearBridge Canadian Small Cap Strategy underperformed its S&P/TSX SmallCap Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from five of the 10 sectors in which it was invested (out of 11 sectors total). The leading contributors were the materials and energy sectors, while the industrials and real estate sectors detracted the most.

On a relative basis, stock selection in IT, consumer staples and utilities contributed to performance. An underweight to real estate also contributed. Conversely, stock selection in industrials, real estate and energy detracted. An overweight to utilities also weighed on results.

On an individual stock basis, the largest contributors to relative returns were Hudbay Minerals and Kelt Exploration as well as not owning BlackBerry, Almonty Industries and 5N Plus. The largest detractors were ATS and Element Fleet Management and not owning Aya Gold & Silver, Russel Metals and Ero Copper.

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