



Garey Aitken CFA
Head of Canadian Equities,
Portfolio Manager



Michael Richmond CFA
Director,
Portfolio Manager

Canadian Small Cap Strategy

Key Takeaways

- ▶ The S&P/TSX Small Cap Index was modestly higher in the first quarter as strength in the gold-driven materials sector more than offset cyclical weakness in the rest of the index.
- ▶ While Canada seems to have been spared the most draconian of Trump's tariff plans, the size and unknown duration of the U.S. tariff agenda has brought into question the outlook for inflation, employment and GDP growth.
- ▶ An underweight position to gold was the main driver of Strategy underperformance versus the index.

Market Overview

We suspect market participants from a century ago would have felt right at home with the topics that dominated Canadian small cap equities in the first quarter of 2025 — tariffs and gold. Tariffs were by far the most impactful macro driver of equity performance. The “will-they, won't-they” gyrations out of Washington resulted in a sell first, ask questions later approach to a broad swath of the Canadian small cap market.

Equities with even the faintest ties to either U.S. trade or the broader North American economy sold off during the quarter. The cyclically exposed small cap information technology (IT), industrials, financials and energy sectors all trailed the S&P/TSX Small Cap Index and the S&P/TSX Composite Index, while defensive sectors such as consumer staples, utilities, real estate and gold producers within materials outperformed the benchmark.

For the most part, we have yet to see a material change in operating environments or forward outlooks for most cyclical equities. Nonetheless, market participants were clearly responding to the uncertainty around tariffs — both their intensity and duration — during the quarter and the corresponding uncertainty around the broader economy.

Offsetting the cyclical weakness in the small cap market during the first quarter was a sharp move higher in gold prices. Gold closed the quarter at an all-time high of U.S. \$3,123/oz — up 19% for the quarter and 39% year over year. Central bank buying and the perceived safety has pushed gold steadily higher. The heavily gold-weighted small cap materials sector followed suit, gaining 19% overall during the first quarter, with the gold sub-industry advancing a substantial 38%.

The net result was a flat, but volatile, quarter for the S&P/TSX Small Cap Total Return Index. The index was up 0.9% during the quarter versus the 1.5% return for the large cap S&P/TSX Composite Total Return Index and a 9.6% decline in CAD for the Russell 2000 — an index of U.S. small cap equities. The heavy weighting toward gold equities drove the relative outperformance of the Canadian small cap index. Ex-materials, the S&P/TSX Small Cap TRI was down 5% for the quarter.

Despite the volatile geopolitical backdrop, most macro variables were benign to start the year. The Canadian 10-year yield dropped by just 26 bps to 2.97%, and the spread to the U.S. 10-year yield tightened by 10 bps as the U.S. 10-year declined by 36 bps to 4.21%. The Canadian dollar was effectively unchanged around \$1.44 CDN/USD. The West Texas Intermediate crude price was also flat, ending the quarter at approximately U.S. \$71.50/bbl.

Exhibit 1: Sector Performance Varied Widely

S&P/TSX Small Cap Composite Index Sector	1Q 2025 Total Return
Energy	-4.4%
Materials	19.4%
Industrials	-14.8%
Consumer Discretionary	-7.3%
Consumer Staples	4.2%
Health Care	-17.6%
Financials	-7.5%
Information Technology	-17.3%
Communication Services	2.1%
Utilities	27.3%
Real Estate	2.3%
S&P/TSX Small Cap Composite	0.9%

As of March 31, 2025. Source: ClearBridge Investments, FactSet, S&P.

The ClearBridge Canadian Small Cap Strategy underperformed its benchmark by ~500 bps for the quarter, with our underweight allocation to materials, particularly gold, being the primary source of the underperformance. The portfolio was also negatively impacted by underperformance in financials, energy and an overweight allocation to industrials, while relative performance was supported by IT and utilities.

Portfolio Positioning

Volatility and M&A activity allowed us to be active during the quarter. We eliminated two equities following takeout offers, added two new names to the portfolio, and were vigorous in adding to positions where we believe the market is being overly punitive.

We eliminated Canadian Western Bank following its completed combination with National Bank Financial and Converge Technology Solutions following its announced take private transaction.

We added North American Construction Group (NOA) and Osisko Gold Royalties to the portfolio. NOA is a mining services and civil construction company that provides mine services to the Canadian oil sands (25% of revenue), Australian coal and copper mines (55%) and various civil projects, with a long history of steady, profitable growth. We believe the equity is trading at an attractive discount to intrinsic value based on unfounded concerns around contract structure in the oil sands and idle Canadian assets, which we believe can be profitably redeployed to their newly acquired Australian business.

In the case of Osisko Royalties, we have followed the name for a long time and now view the governance issues that had previously kept us on the sidelines to be behind the company. In addition, the valuation was attractive as it had materially lagged the small/mid cap gold royalties, creating a compelling entry point.

We were energetic in adding to industrials, materials, financials and energy names during the quarter at attractive discounts to intrinsic value as the market shifted away from more cyclical areas. We added to ATS Corp, Colliers International, Propel Holdings, Calian Group, Richelieu Hardware, Methanex and Adentra. We view these as a collection of high-quality businesses that have been negatively affected by the broader market selloff.

We reduced our position in Trican Well Service early in the quarter on strength and ATCO following a strong run in the equity.

Outlook

Our investment approach is a bottom-up strategy that prioritizes identifying and capitalizing on market inefficiencies, using our proprietary research, and the time arbitrage that comes with our long-term investment horizon. This approach is supported by our patient culture, enabling us to make well-informed decisions when there are discrepancies between expectations and underlying fundamentals.

We remain steadfast in our commitment to our investment style, diligently seeking out businesses that exhibit wise capital allocation practices, maintain structural competitive advantages and can generate high-quality growth — all under appropriate capital structures.

The Trump administration's "Liberation Day" tariffs shortly after the quarter end confirmed many of the worst fears of the market. While Canada seems to have been spared the most draconian of the U.S. tariff plans, the size and unknown duration of its tariff agenda has justifiably brought into question the outlook for inflation, employment and GDP growth globally.

Canadian market participants will have a lot to consider over the coming months: the implications of the tariffs as they stand today, a

broadly more protectionist southern neighbor and a new government in Ottawa. Regardless how events unfold we believe that high-quality growth companies — with appropriate capital allocation policies, capital structures and durable competitive advantages that produce above-average returns — should be well prepared to weather the uncertainty. Moreover, we believe that these companies should be well-positioned to be proactive in improving their competitive positions in volatile markets.

Portfolio Highlights

The ClearBridge Canadian Small Cap Strategy underperformed its benchmark in the quarter. On an absolute basis, the Strategy generated gains in three of the nine sectors in which it was invested (11 total). The primary detractors from absolute returns were the cyclical financials, industrials and energy sectors while the utilities and IT sectors were the main positive contributors to absolute performance.

Relative to the benchmark, sector allocation and security selection were both negative. The Strategy was negatively impacted by an underweight position to materials and an overweight to IT, industrials, and financials. Selection was most negative in materials, utilities and financials. On the positive side, selection in the IT and industrials sectors as well as our single health care holding, DRI Healthcare Trust, contributed to relative results.

Among individual securities, the leading absolute contributors were Converge Technology Solutions in IT, Sandstorm Gold in materials, AltaGas in utilities, Empire in consumer staples and Interrent REIT in real estate. The largest drags to absolute performance were Propel Holdings in financials, Enerflex in energy, Methanex in materials, Adentra in industrials and Jamieson Wellness in consumer staples.

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