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Select Strategy

Key Takeaways

- ▶ Renewed leadership by the Magnificent Seven coupled with weakness among our technology, industrials and consumer staples names weighed on relative performance.
- ▶ The Strategy has exposure to mega caps and we allow that these companies are likely to be the most immediate winners in the AI race. Yet, we also see opportunities to deliver differentiated performance among smaller cap names that constitute the majority of our portfolio.
- ▶ We believe ongoing monitoring of existing holdings is just as important to long-term value creation as researching new ideas. Revisiting the investment thesis for several holdings during the quarter caused us to be disciplined sellers, eliminating 10 positions.

Market Overview

Equity leadership narrowed considerably in the second quarter, with a surge by mega cap growth stocks obscuring weakness across most of the market. The S&P 500 Index rose 4.3 for the period, while the benchmark Russell 3000 Index advanced 3.2%. By comparison, the small cap Russell 2000 Index was down 3.3% for the quarter while the small and mid cap focused Russell 2500 Index declined 4.3%.

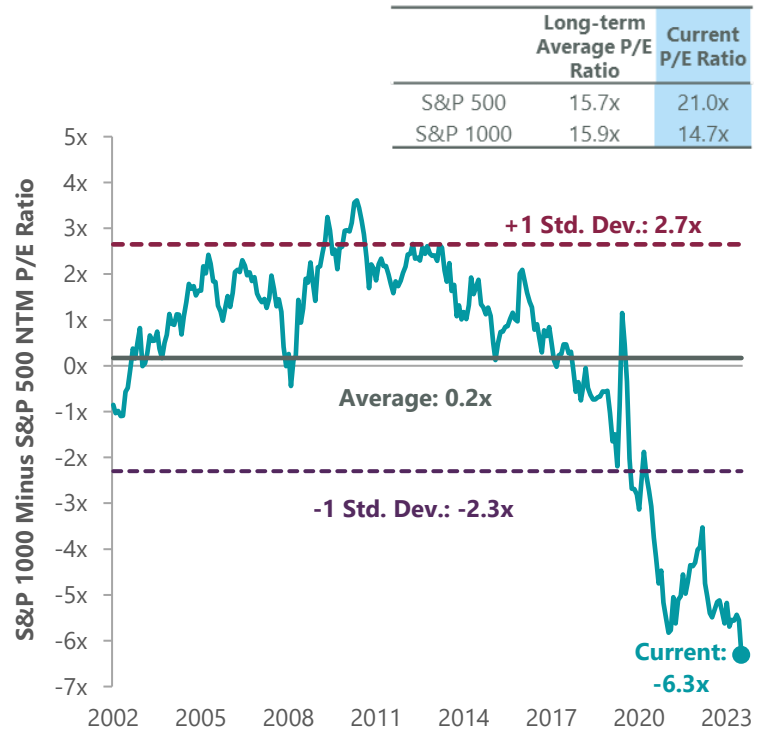
Boosted by Nvidia and a handful of other semiconductor stocks riding the momentum of generative AI demand, the Russell 3000 Growth Index surged 7.8%, outperforming the Russell 3000 Value Index by 1,005 basis points. This marked the fourth time since 2020 that quarterly style dispersion exceeded 1,000 bps in favor of growth. Even more telling was the size disconnect between large and small companies, with the Russell 2500 Growth Index underperforming the Russell 3000 Growth Index by 1,201 bps.

In another illustration of how market concentration is swallowing up investor assets and performance, the 20 largest stocks in the S&P 500 are up 27% year-to-date, the equal weight S&P 500 is up 5% and the Russell 2000 is higher by just 0.7%, according to J.P. Morgan.

The Select Strategy has exposure to mega caps — longtime holdings Nvidia and Apple, as well as newer addition Microsoft, being major contributors during the second quarter — and remains open minded that these companies are likely to be near- to medium-term winners in the AI race. Yet, we also see opportunities to deliver differentiated performance among smaller cap names that constitute the majority of our portfolio but have recently been treated as castaways in a ship

driven by the Magnificent Seven. Small and mid cap stocks have historically traded at similar multiples to large caps but since the pandemic, the valuation gap has continued to expand and now stands at its widest level in over two decades.

Exhibit 1: SMID Caps on Sale



As of June 30, 2024. Sources: FactSet, S&P.

The current dominance of mega caps has a lot to do with an uncertain economy as these cash-generating market leaders are viewed as defensive plays for nervous investors. While inflation is slowly coming under control, we do not see many other bright spots in the macro picture. Businesses are uncertain about the future with a higher-for-longer interest rate environment, causing company managements and consumers to second guess spending decisions. The housing market has been rocky, with a surge in 10-year U.S. Treasury yields to over 4.7% during the quarter creating challenges for homebuilders and affordability issues for potential home buyers.

Broadly, anything unrelated to AI and GLP-1s has struggled. Cyclical sectors in particular have suffered, with the materials, industrials and energy sectors the worst performers in the benchmark. Parts of information technology (IT) are also cyclical and what we have seen in the first half of 2024 is a prioritization for hardware and semiconductor spending due to the immediate need to invest in AI. Downsizing of contract renewals and difficult macro conditions weighed heavily on software holdings geared towards small and medium-size businesses, including portfolio holdings Sprout Social, Shopify and Fortinet. Workday, which serves larger enterprise

customers, has acknowledged that macroeconomic headwinds have led to longer sales cycles and increased scrutiny of deals.

Industrials were another pocket of weakness with construction-related names Willscot Mobile Mini and Trex down sharply during the quarter on a slowdown in both non-residential construction and home improvement. Trex topped estimates in its latest quarterly report but was punished for failing to raise calendar year forecasts as had been expected earlier in the year. While optimism has waned, we see no fundamental issues at Trex, or Willscot, which is also dealing with the overhang of a pending acquisition.

Even more defensive areas of the economy like consumer staples have begun to see impacts of fatigued and spendthrift consumers, who have spent down COVID savings and are now second guessing regular purchases. That nervousness pressured energy drink maker Monster Beverage and restaurant supplier Performance Food Group during the quarter.

Offsetting the malaise, the Strategy saw solid contributions from AI-indexed names Monolithic Power and AppLovin. Monolithic is a provider of semiconductor-based power management systems for various technology and industrial end markets. We bought shares in the third quarter of 2023 when its base business was bottoming and the shares have since rerated as power-intensive AI workloads require advanced power management solutions. Electrical components and systems provider Vertiv has seen similar AI-driven demand for thermal management and cooling systems by data centers. AppLovin has climbed on uptake for its AI engine, which analyzes advertising inventory on behalf of video game publishers, driving app downloads and revenue. Strategy holdings nVent Electric and Marvell Technology saw more tepid performance during the quarter but are also well-positioned as AI beneficiaries.

Portfolio Positioning

We believe ongoing monitoring of existing holdings is just as important to long-term value creation as researching new ideas. Revisiting the investment thesis for several holdings during the quarter caused us to be disciplined sellers, eliminating 10 positions. After reducing exchange operator CME Group for the last several quarters, we fully exited the position in this steady compounder as we started to pick up more credible competitors that could challenge its interest rate offerings. Also in the steady compounder group, we closed out of UnitedHealth Group as managed care companies are facing higher health care utilization.

We sold two evolving opportunity positions in consumer sectors where our thesis for improvement had been delayed or invalidated. We initially purchased discount retailer Five Below at a depressed valuation as it was seeking to reduce shrink in its stores; however, recent theft protection initiatives have not been working and

spending among lower-income consumers has weakened. Fragrance maker Coty has shown decent growth and progress in its turnaround, but these improvements have not been reflected in its stock price. Given its more frugal mass merchandise market and lack of an identifiable catalyst for change, we decided to close the position.

We view Endeavor Group in communication services and Model N in IT as successful exits as both were taken out of the market by private equity investors.

On the buy side, we added two positions in the quarter. Clean Harbors, a waste management provider specializing in the disposal of hazardous waste, replenishes our steady compounder exposure where we have been trimming down other holdings. We added more traditional waste management name Waste Connections last year; that has been built into a sizable position. Clean Harbors shares similarities with a large moat due to its specialization in more toxic waste, high barriers to entry and strong pricing power. We believe new EPA guidelines on removal and remediation of PFAS, or “forever chemicals,” will be a significant driver of growth and returns for the company.

CyberArk, in the IT sector, adds to our disruptor group. Through a series of investments, the company has transformed itself from a single product provider of privileged access management to corporate IT systems to an access platform for a broad range of digital infrastructure. This is a growing area of importance as AI and the Internet of Things see accelerated growth within enterprises. CyberArk is unlocking these addressable markets in a profitable manner, combining high levels of revenue growth with margin expansion.

Outlook

Thus far in 2024 we have seen continued extreme volatility and contradictory signals around the health of the underlying economy. With wild swings in interest rates, inflationary pressures, inventory levels, consumer habits and crime, and amid multiple wars, geopolitical uncertainty and a partisan U.S. presidential election, it is increasingly important to lean into high-quality businesses with large, idiosyncratic growth opportunities. We believe our pyramid of growth approach is well-suited to identifying these companies at various stages of their maturity. We have leaned into steady compounders during an extended period of reduced liquidity brought on by Fed tightening, selectively participated in the catalysts evident among our evolving opportunity names and benefited from the above-market growth and creation of new markets offered by our cohort of disruptors.

We have been discussing the coiled spring of undervalued and under owned smaller cap companies for several quarters now. Small caps have borne the brunt of higher rates. In 2023, profits for Russell 2000 companies were down 12%. This year, they are up 13.6% and are projected to jump to 31% in 2025. If this plays out, we believe the

smaller cap part of the growth market that we target will be a leading beneficiary. The second quarter seemed to offer little relief from concentrated leadership, but we continue to believe that as financial conditions improve, with the initiation of Fed rate cuts being the main trigger, a rotation will ensue.

Portfolio Highlights

The ClearBridge Select Strategy underperformed its Russell 3000 Index benchmark during the second quarter. On an absolute basis, the Strategy posted gains across four of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributor was the IT sector while the industrials sector was the main detractor.

Relative to the benchmark, overall stock selection detracted from performance. In particular, stock selection in the IT, industrials, consumer staples and health care sectors, an overweight to industrials and an underweight to communication services had negative impacts on results. On the positive side, an overweight to IT, an underweight to financials and stock selection in the financials and energy sectors contributed to performance.

On an individual stock basis, the leading contributors were positions in Nvidia, Apple, Casey's General Stores, MercadoLibre and Microsoft. The primary detractors were Trex, Willscot Mobile Mini, Charles River Labs, Monster Beverage and Performance Food.

In addition to the transactions mentioned above, we exited positions in Paymentus in the financials sector, Oddity in the consumer staples sector as well as On Semiconductor and Everbridge in the IT sector. We also retained shares of Exxon Mobil after completing its acquisition of portfolio holding Pioneer Natural Resources.

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