Canadian Small Cap Strategy

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Key Takeaways

- Canadian small caps delivered solid gains, with sector leadership shifting meaningfully away from the resource-driven gains that dominated much of 2025 and early 2026 to AI infrastructure as well as companies tied to power, space and satellites, defense and robotics themes.
- The Strategy underperformed its benchmark as weak stock selection in IT and industrials sectors, as well as not owning strong performer BlackBerry, overcame positive contributors in financials and energy.
- We continued to find attractive opportunities, participating in two IPOs and recycling capital into high-conviction opportunities across industrials, real estate, health care and consumer staples.

Market Overview

Canadian small cap equities posted another strong quarter, with the S&P/TSX Small Cap Index returning 5.9%. Geopolitical uncertainty surrounding the Iran conflict and the Strait of Hormuz continued to influence investor sentiment and energy markets, while AI-related capital spending, power infrastructure investment and broader "build Canada" initiatives supported strength across select cyclical, industrial, financial and infrastructure-related businesses.

Market performance broadened during the second quarter, with only the energy and consumer discretionary sectors posting negative returns. Information technology (IT), industrials, health care and real estate, meanwhile, delivered double-digit gains. While this represented an expansion in market leadership compared to recent quarters, performance remained concentrated within certain themes and companies. For example, IT returns were largely driven by information security and embedded software provider BlackBerry, whose shares rose nearly 300%, highlighting that broader participation did not necessarily translate into broad-based leadership.

The quarter also marked a notable shift in market drivers. During late 2025 and early 2026, rising crude oil prices resulting from the conflict in the Middle East made energy the dominant contributor to Canadian small cap performance. By contrast, in the second quarter, both energy and materials were modest detractors as expectations shifted toward a global crude oil surplus despite historically low inventory levels, evident by the U.S. crude benchmark declining 31% during the quarter to US$69.50 per barrel.

Several themes continued to shape investor sentiment, including tariff risk, the upcoming Canada-United States-Mexico Agreement (CUSMA) renegotiation, AI-related investment and disruption and ongoing geopolitical instability. Capital spending tied to AI infrastructure remained robust, while investor enthusiasm extended to power infrastructure, defense, satellites, robotics and other businesses viewed as beneficiaries of long-duration structural growth themes.

Portfolio Positioning

Trading activity remained elevated as strong market performance, sector rotation and stock-specific volatility created opportunities to recycle capital. New additions were concentrated in industrials, real estate, health care and consumer staples, reflecting a combination of adding to out-of-favor cyclical businesses, selectively increasing exposure to companies impacted by AI-related concerns and initiating new positions in Lumina Metals and Apotex Health. Funding for these new positions came primarily through the sale of Killam Apartment REIT and Corby Spirit and Wine, together with trims across real estate, energy, industrials and materials following strong share-price performance or where valuation support had become less compelling.

Within materials, we participated in the IPO of Lumina Metals. Lumina's flagship copper-silver project offers exposure to one of Europe's largest undeveloped copper districts, supported by world-class resource scale, proximity to established mining infrastructure and favorable long-term demand for copper. We believe management has demonstrated an ability to create shareholder value through advancing large-scale mining assets toward strategic transactions. We also trimmed our holdings in Hudbay Minerals, Lundin Mining, Methanex and Winpak.

In health care, we participated in the IPO of Apotex Health, establishing a modest position in a business with leading generic pharmaceutical operations, a growing specialty generics platform and expanding biosimilar capabilities. We also added to DRI Healthcare at valuations we viewed as offering an attractive balance of risk and reward.

Within real estate, we increased our investment in Colliers International as investor sentiment weakened on concerns surrounding commercial real estate services, engineering demand and fundraising within its asset management platform. We also added to FirstService as concerns regarding a quieter storm season created an opportunity to increase exposure. On the sell side, activity was concentrated among REITs where we view prospective returns as less attractive, leading to the sale of Killam Apartment REIT and a reduction in Granite REIT.

Activity within the consumer sectors focused primarily on improving the portfolio's overall valuation profile. In consumer staples we added to North West Company, where we continue to see an attractive combination of defensive earnings and durable competitive positioning at a reasonable valuation. Within consumer discretionary, we increased our position in Pet Valu on valuation weakness, reflecting our confidence in the company's longer-term growth prospects. These purchases were partially funded through the sale of Corby Spirit and

Wine, where we believed expected returns had become less compelling relative to other opportunities.

We trimmed our positions in energy companies Enerflex and Kelt Exploration after meaningful appreciation reduced valuation upside, while adding to Headwater Exploration at levels we believed better reflected the company's asset quality and long-term cash flow potential.

Within industrials, we reduced positions in Calian and Bird Construction following strong performance driven by thematic investor interest. We subsequently redeployed capital into Boyd Group Services and Element Fleet Management, both of which experienced share-price weakness related to AI disruption concerns despite business fundamentals that we believe remain attractive over the long term.

Outlook

The Canadian small cap market remains highly narrative- and momentum-driven. Although leadership broadened beyond energy and materials during the quarter, investor interest continues to be concentrated in companies exposed to a relatively narrow set of structural themes.

This is particularly evident in the market's treatment of AI. Investors increasingly appear willing to value perceived AI beneficiaries using long-term growth assumptions, while assigning materially lower values to businesses viewed as vulnerable to AI disruption. We believe this has created a more binary valuation environment than fundamentals warrant.

Similar debates have occurred before; for much of the past decade, Canadian energy companies faced persistent concerns regarding the long-term role of hydrocarbons and the durability of their cash flows. While those concerns have moderated as affordability, reliability and energy security have regained importance, they illustrate how markets can overextend long-term assumptions during periods of structural change.

We agree that AI will reshape many industries, but we also believe the market is increasingly discounting widespread disintermediation without adequately considering business adaptability, competitive positioning and valuation. While some companies will undoubtably experience meaningful structural disruption, others are likely to integrate AI without fundamentally impairing long-term economics.

Beyond AI-related opportunities, we continue to see attractive long-term prospects tied to Canada's renewed focus on domestic investment. Federal and provincial governments have taken steps toward a more supportive policy environment through large industrial projects and infrastructure investment. We believe multiple companies across industrials, energy, utilities and consumer staples are well-positioned to benefit from increased capital spending and more business-friendly policy initiatives over the coming years.

Within materials, we remain constructive on copper producers as well as precious metals royalty and streaming companies. Copper continues to benefit from favorable long-term supply-demand dynamics driven by electrification, power infrastructure and AI-related investment. Our gold exposure remains concentrated in royalty and streaming businesses, which provide diversified participation across multiple projects while reducing operational, geopolitical and development risk relative to traditional mining companies.

Portfolio Highlights

During the second quarter, the ClearBridge Canadian Small Cap Strategy underperformed its S&P/TSX Small Cap TRI benchmark. The Strategy generated gains in seven of the 10 sectors in which it was invested (out of 11 total). The largest positive absolute contributors were financials and industrials while energy was the largest detractor.

Relative to the benchmark, sector allocation contributed to performance but was offset by negative stock selection effects. In particular, stock selection in IT, industrials, materials, real estate and consumer discretionary and an underweight to health care detracted from results. On the positive side, stock selection in financials, energy and consumer staples and overweights to industrials and IT supported performance.

At the individual security level, the main relative detractors were OR Royalties and Triple Flag Precious Metals in materials, PHX Energy, Boyd Group in industrials and not holding BlackBerry in IT. The primary relative contributors were Propel Holdings and EQB in financials, Bird Construction in industrials as well as Capstone Copper and Hudbay Materials in materials.

Performance source: Internal. Benchmark source: Standard & Poor's.