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Mid Cap Strategy

Key Takeaways

- ▶ A strong rotation away from large caps beginning in July helped spur a rebound that helped the Russell Midcap Index outperform larger cap peers.
- ▶ The Strategy underperformed its benchmark as detractors in the industrials and communication services sectors overcame positive contributions from our holdings in IT and health care.
- ▶ Despite several difficult quarters, we believe more recent performance is confirmation that efforts to refine our positioning and conviction in high-quality companies is beginning to pay off.

Market Overview

A rotation away from large caps beginning in July helped spur a third-quarter rebound that helped propel the Russell Midcap Index 9.21% higher, outperforming the 6.08% gain of the large cap Russell 1000 Index and keeping pace with the 9.27% return of the small cap Russell 2000 Index. Value stocks outperformed during the period with the Russell Midcap Value Index returning 10.08%, over 350 basis points ahead of the Russell Midcap Growth Index.

From a sector standpoint, the Fed's decision to cut interest rates was a boon to interest rate sensitive sectors such as utilities (+19.04%) and real estate (+16.33%), which led performance in the Russell Midcap Index. The industrials (+11.69%), financials (+11.41%) and consumer discretionary sectors (+10.02%) also outperformed the broader index, while the communication services (+7.79%), health care (+6.95%), materials (+6.94%), information technology (IT, +4.53%) and consumer staples (3.78%) posted positive returns but lagged the index's overall result. Only the energy sector (-1.69%) saw negative returns for the period.

Despite causing surges in market volatility during the quarter, a series of weaker than anticipated labor reports and subdued inflation readings helped pave the way for the Fed to cut interest rate by 50 basis points in September, its first cut since the beginning of the COVID-19 pandemic. The likelihood of further cuts and access to cheaper and easier to obtain financing also acted as an additional tailwind to the rotation away from the generative AI beneficiaries that dominated the first half of the year and toward broader market leadership favoring small and mid cap stocks. This rotation was particularly beneficial to the Strategy, as the last eight weeks of the quarter saw meaningful gains relative to our benchmark, a positive development after several quarters of difficult performance.

The best course of action is to maintain conviction in our high-quality companies with strong balance sheets and compelling idiosyncratic drivers.

However, this enthusiasm has overshadowed the economic deceleration that continues to weigh on pockets of the market such as industrials and materials, with expected recoveries in these sectors pushed out further into 2025. Additionally, market uncertainty over a contentious U.S. presidential election, and its resulting policy and trade implications, appears to only be increasing as we approach November.

Several of our detractors came from the industrials and materials sectors, which have been impacted by customer destocking trends and, subsequently, declines in sales volumes. While we had hoped that the second half of 2024 would see the beginnings of a recovery, it appears that it will take longer than anticipated. Such was the case for two of our largest detractors: Atkore, in the industrials sector, and Ashland, in the materials sector. Atkore, which makes electrical, mechanical, safety and infrastructure products and solutions such as conduits, cables and mechanical pipes, continues to see weaker order volumes as well as increased costs of material inputs from Mexico. Ashland, which provides additives and specialty ingredients through business lines targeted to the life sciences, personal care and household as well as specialty and solvents industries, has also struggled with lower orders as demand levels have continued to slide below what we would expect for the middle of their business cycle. As a result, both companies faced tough year-over-year comparables and quarterly earnings that fell short of market expectations. Ultimately, while we believe that Ashland remains a compelling investment opportunity, the repeated pushback of an expected recovery has rendered Atkore's trajectory more opaque and we elected to sell the position in favor of other opportunities with greater transparency.

Selection in the communication services sector also weighed on performance, primarily driven by a decline in Pinterest, which operates a social media platform where users can express their interests and discover ideas through images they "pin" to their pages. Having been a strong contributor in the first half of the year, the company gave back some of its gains as investors captured gains and an uptick in economic uncertainty pushed out spending by leading advertisers. We capitalized on this weakness to add to the position, as we believe that several of its internal initiatives to increase the monetization of its users and become a better value-added advertiser to its customers are coming to fruition.

Stock selection in the IT sector was the greatest contributor to relative performance, driven by AppLovin, which operates a software-based platform for advertisers to enhance the marketing and monetization of their content, particularly in mobile apps. We believe the company is one of the best examples of an AI beneficiary in the mid cap market, as it has already incorporated AI capabilities into its platform, translating into more effective take rates on clients' mobile games and transactions. We believe mobile games represent only the tip of the iceberg of AppLovin's potential for its AI-enabled platform and that it has a strong growth trajectory over the next few years.

Health care was also a positive contributor in the third quarter. Our top holding in the sector was Avantor, a leading global provider of services to customers in the biopharmaceutical, health care, education and government, and advanced technologies and applied materials industries. The company has demonstrated solid execution through a weaker life sciences spending environment and continues to make progress on expanding its margins. With signs of research and development spending stabilizing, we see a number of green shoots appearing both for the biopharma industry and Avantor.

Portfolio Positioning

We initiated a new position in SBA Communications, in the real estate sector. SBA is a leading owner and operator of wireless communications infrastructure, including cellular towers. We believe consistent growth in demand for cellular data and devices allows the company greater pricing power and high levels of customer retention. Additionally, while investment in telecommunication infrastructure has been subdued recently, we believe continued rollout of 5G devices will result in a rebound in customer spending over the long term.

We also added Tenet Healthcare, the third-largest for-profit hospital operator in the U.S.. The company's new management team is capitalizing on the growing opportunity in offsite surgical centers as insurance companies are increasingly preferring them for outpatient procedures as opposed to hospitals. Additionally, we have high confidence in the management team, which has shown itself to be an astute operator, focusing on more profitable procedures and selling off non-core hospitals at attractive multiples.

We exited our position in Five Below, which operates as a specialty value retailer for products including apparel, accessories, novelty items, décor, cosmetics and accent furniture. The company's share price has been impacted by elevated shrink, as well as persistent inflationary pressures weighing on lower-end consumers. While the issues involving shrink are endemic across the entire sector, we believed that the company's low price point would make it a beneficiary of persistent inflation and weakening consumer spending. However, as consumers tightened their spending, we underestimated how discretionary the company was seen by consumers who instead turned to other off-price discount retailers they perceived as having greater value. These factors, along with the departure of the company's CEO, ultimately contributed to our sell decision.

Outlook

Despite several difficult quarters, we see our improved relative performance in the third quarter as a sign that our efforts to refine our positioning and conviction in high-quality companies is beginning to pay off. While a slowing economy and the U.S. presidential election will undoubtedly contribute to further uncertainty, we adhere to our

rigorous due diligence process and philosophy that companies with good business models, strong balance sheets and positive long-term drivers will ultimately persevere through any kind of turbulence ahead. While we continue will continue to be vigilant as we round out 2024, we believe the pieces are in place for the Strategy to generate attractive risk-adjusted returns over the long term.

Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index during the third quarter. On an absolute basis, the Strategy had gains in nine of the 11 sectors in which it was invested during the quarter. The largest contributors were the IT and financials sectors, while the communication services and energy sectors detracted.

On a relative basis, overall stock selection and sector allocation effects detracted from performance. Specifically, stock selection in the industrials, communication services, real estate and energy sectors weighed on performance. Conversely, stock selection in the IT, health care, financials, utilities and materials sectors proved beneficial.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were AppLovin, Crown, Regal Rexnord, Avantor and Performance Food Group. The largest detractors from absolute returns were Atkore, Pinterest, Ashland, Icon and API.

In addition to the transactions listed above, we initiated new positions in DraftKings in the consumer discretionary sector, Vistra in the utilities sector, Ultragenyx Pharmaceutical in the health care sector and Corpay in the financials sector. We exited positions in Workiva, Freshworks and NCR Voyix in the IT sector, Etsy and Aptiv in the consumer discretionary sector, ATS in the industrials sector and Sun Communities in the real estate sector.

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