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Select Strategy

Key Takeaways

- ▶ A rapid rotation out of AI-indexed and related growth equities, felt most acutely by the Strategy's larger cap and disruptor holdings, led to underperformance for the quarter.
- ▶ The balance we have established through active portfolio positioning mitigated some of the damage, highlighted by strength among leading e-commerce franchises as well as several consumer staples and industrials holdings.
- ▶ Indiscriminate selling in broad categories has provided opportunities to buy stocks on sale while reducing similar holdings with less compelling risk-reward profiles. This was a common theme among 10 new buys and eight sales.

Market Overview

Equities sold off sharply in the first quarter, with volatility accelerating into April, as a rotation out of mega caps followed by a raft of U.S. tariff actions raised fears of an economic slowdown and higher inflation. The S&P 500 Index declined 4.3%, the benchmark Russell 3000 Index fell 4.7% while the Russell 2000 Index dropped 9.5%. The selloff in the Magnificent Seven and technology-related areas of the market caused growth stocks to significantly underperform value, with the Russell 3000 Growth Index down 10% compared to a gain of 1.6% for the Russell 3000 Value Index.

The small and mid cap growth stocks that form the foundation of the ClearBridge Select Strategy and that drove outperformance in the fourth quarter of 2024 were similarly pressured with the Russell 2500 Growth Index retreating 10.8% in the first three months of 2025. Through this shift away from higher-multiple growth stocks, the Strategy's recent leadership among disruptors reversed course, leading to underperformance versus its core benchmark.

The unwind of the generative AI trade was sparked by the January introduction of China's DeepSeek, a large language model built more cheaply and efficiently than those of the Magnificent Seven. In the portfolio this led to weakness in Microsoft and Nvidia. An escalating trade war with China also weighed on Apple, which assembles most of its iPhones in Chinese factories. While sentiment has soured on their accelerating capex plans, the fundamentals of these companies remain sound. Shares of Nvidia, supplier of the most advanced GPU chips to power AI applications, fell sharply despite it continuing to deliver record financial results amid a strong rollout for its newest Blackwell GPU system.

Meanwhile the combination of DOGE-led government layoffs and Trump's unpredictable implementation of widespread tariffs weighed on the outlook for government, corporate and consumer spending. This most directly impacted companies with significant government contracts including software maker ServiceNow. Meanwhile, disruptors enabling digital advertising such as Trade Desk, Reddit and AppLovin derated on fears of a pullback in business ad spending as recession risks increase. We exited Trade Desk in favor of increasing our exposure to better-positioned Reddit.

Ballast was provided during the period among our consumer holdings. In the consumer discretionary sector, a pair of international e-commerce platforms, MercadoLibre in Latin America and Alibaba in China, delivered robust returns. MercadoLibre continues to leverage its dominant marketplaceshare to expand the services it offers customers to include logistics and financial services. Alibaba has recently benefited from the release and rising expectations for its newly unveiled AI offerings, which motivated our purchase late in the third quarter.

In consumer staples, convenience store and service stations operator Casey's General Stores continued to put up fantastic results while energy drink maker Monster flexed its pricing power and strong international sales. We took profits in Monster and put those proceeds to work in a new position in Colgate-Palmolive, a company offering consistent organic growth and margin expansion as well as a significant non-U.S. business.

The Strategy's industrials holdings were also significant contributors with H&E Equipment nearly doubling after accepting a higher offer to be acquired than an initial bid from new portfolio position United Rentals. Durable compounder Waste Connections also held up well in a market favoring stocks with defensive characteristics. That the portfolio would benefit from such disparate contributions speaks to the balance we have sought to achieve by combining higher-risk disruptors with more predictable durable compounders as well as evolving opportunities such as oilfield services provider Baker Hughes.

Portfolio Positioning

Many stocks were sold indiscriminately during the first quarter and into the second because of their association with certain "basket" trades such as AI beneficiaries, importers and semiconductors. This has provided opportunities to buy stocks on sale while reducing similar companies where the risk reward has worsened. This was a common theme among 10 new buys and eight sales.

In small and medium-sized business software, we sold Paycor HCM after it accepted an all-cash acquisition offer from Paychex, rolling some of the proceeds into Paylocity, a peer human resources and payroll services company. Paylocity is growing at a slightly slower, but more profitable pace. We also added merchant payments

disruptor Shift4 Payments, a name we are familiar with from holding in other SMID growth portfolios. In industrials, we sold out of nVent Electric in favor of Comfort Systems, a provider of HVAC and electrical installation services, a higher-quality franchise trading at a similar multiple.

We participated in the IPO of SailPoint, which offers identity security solutions to help companies manage and secure access to critical data and applications. We believe the incorporation of AI has swelled the company's attractive total addressable market — already growing at a high pace — as companies will need to begin addressing what data and functions their new AI agents can access across their enterprise. We used trims to data software provider DataDog and developer software holding Gitlab to make room for SailPoint and add to information security provider Varonis.

Also in the disruptor camp, Venture Global (VG) is upending the liquified natural gas (LNG) market with a first-mover advantage in faster, modular facility builds. Its inaugural earnings report disappointed, showing weaker margins, lighter volumes and higher operating costs, as global LNG prices declined. However, the company appears differentiated with more vertical integration featuring its own engineering, procurement and construction labor force that can lessen project delays and cost overruns, faster in-service time and higher production, all leading to more cost-effective production.

Outlook

The Trump 2.0 honeymoon ended abruptly in February as the president made good on campaign promises to disrupt the status quo in economic and foreign policy and the federal bureaucracy. While business and capital markets activity initially picked up to start the year, the uncertainty caused by tariffs and government layoffs could present headwinds in the near term. A rich pipeline of IPOs still exists but come-to-market plans have also been put on hold in the near term. We will continue to evaluate opportunities in anticipation of activity resuming quickly once we gain more certainty on global trade.

Fears around tariffs and growing recession risks could abate rapidly with a single executive order or social media post from the president. We are optimistic cooler heads in Washington, D.C. will prevail, lifting the shadow over the potential benefits of deregulation and tax cuts that are expected to come later in Trump's first-year agenda. The sharp selloff among SMID stocks, meanwhile, could create attractive entry points into growth businesses where fundamentals remain sound.

Portfolio Highlights

The ClearBridge Select Strategy underperformed its Russell 3000 Index benchmark during the first quarter. On an absolute basis, the Strategy saw losses across eight of the 10 sectors in which it was

invested. The lone contributors were energy and real estate while IT detracted the most.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the industrials, communication services, financials, health care, IT and consumer staples sectors, an overweight to IT and underweight to financials hurt results. On the positive side, stock selection in consumer discretionary and an overweight to consumer staples contributed to performance.

On an individual stock basis, the primary absolute detractors were ServiceNow, Nvidia, KKR, Apple and Trade Desk. The leading contributors were positions in H&E Equipment Services, MercadoLibre, Alibaba, Waste Connections and Casey's General Stores.

In addition to the transactions mentioned above, we added positions in Lam Research and Rubrik in IT and Vulcan Materials in materials. We also sold CrowdStrike and Shoals Technologies in IT and Ashland in materials. Summit Materials, in the materials sector, was acquired during the quarter.

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