



## SMID Cap Growth Strategy



**Brian Angerame**  
Managing Director,  
Portfolio Manager



**Jeffrey Bailin CFA**  
Director,  
Portfolio Manager



**Aram Green**  
Managing Director,  
Portfolio Manager



**Matthew Lilling CFA**  
Managing Director,  
Portfolio Manager

### Key Takeaways

- ▶ The Strategy underperformed its benchmark as negative stock selection in the industrials sector overcame positive contributions from holdings in financials, consumer staples and IT.
- ▶ Bouts of volatility and contradictory signals around the health of the economy as well as broader market consolidation resulted in a retreat in SMID stocks.
- ▶ We are finding many opportunities of oversold companies with great business models, strong growth prospects and stellar balance sheets trading at attractive free cash flow yields.

### Market Overview

The second quarter proved a tale of two markets, as large cap market indexes saw rising concentration in mega cap tech companies and positive returns, while mid and small cap stocks faced a broad retreat. As a result, the Russell 1000 Index returned 3.57%, continuing its streak of outperforming the Russell 2500 Index, which returned -4.28%. Growth stocks held up only marginally better than their value counterparts, with the benchmark Russell 2500 Growth Index returning -4.22% compared to the -4.31% of the Russell 2500 Value Index.

At the macro level, after a variety of datapoints in the first quarter supportive of Federal Reserve rate cuts in the back half of the year, contradictory signals on various inflation prints have led to a pushout in the timing and magnitude of rate cuts expected in 2024. Rates ended the quarter up modestly, but it was a wild ride for the U.S. 10-year Treasury with yields going from 4.2% to 4.7% before ending the period at 4.4%.

Simultaneously, while broader stock market performance has been solid year to date, we have observed a variety of contradictory signals around the health of the economy. Outside of a small group of perceived winners from secular trends (i.e., AI, reshoring/electrification and GLP-1s), it is less clear regarding the magnitude of disruption to businesses in areas like software, consumer discretionary and food/beverages/alcohol, to name a few. Moreover, we can identify multiple areas of concern within broad swaths of the economy, with a non-exhaustive list including consumer goods spending, non-residential and housing related investment, aerospace production, transports, software budgets and large pharma R&D/sales and marketing spending.

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However, there were some bright spots in the quarter that leave us feeling optimistic. One was the rebalancing of the benchmark Russell 2500 Growth Index, and the removal of Super Micro Computer and MicroStrategy from the index. Despite having their market caps outgrow the category, these companies had an outside, negative impact on our year-to-date performance due to our eschewing them in favor of true SMID cap stocks. We [explained this impact last quarter](#) and believe their removal will result in a more accurate representation of the broader SMID growth universe.

Additionally, we are finding many opportunities of oversold companies with great business models, strong growth prospects and stellar balance sheets trading at attractive free cash flow yields. Many of these stocks exhibit still strong revenue growth rates, despite slight decelerations, and can compound through this period of weakness and become bigger and better companies on the other side of this economic malaise and top-heavy market. Finally, the IPO and capital markets have begun to rebound, albeit slowly, providing new investment opportunities and idea generation. In fact, this quarter saw our first IPO participation since the capital markets fervor of 2021 with data security provider Rubrik.

Against this backdrop, the ClearBridge SMID Cap Growth Strategy underperformed its benchmark. With strong contributions from a handful of companies across various sectors, the degree of relative underperformance was minimal during the second quarter, however we remain disappointed by recent Strategy results. We believe the Strategy has an appropriate and balanced spectrum of growth businesses and, with the unprecedented concentration at the top of the benchmark being addressed by index rebalancing, we anticipate that we should see less distortions in the underlying benchmark performance.

Stock selection in industrials was the leading detractor from relative performance, as the prospect of a higher-for-longer interest rates environment weighed on investors' outlooks for industrial and nonresidential construction. This proved a headwind for companies like Trex, which manufactures wood alternative decking products made from recycled wood fibers and plastic waste for residential and commercial customers. Also impacted was WillScot Mobile Mini, the North American leader in turnkey modular space and portable storage solutions. The company's stock price pulled back amid a decline in nonresidential construction starts and a less optimistic outlook for short-cycle industrials. However, WillScot continues to have high cash flow yields and a strong order backlog, which should help the company to weather near-term headwinds.

Stock selection in the financials sector provided a positive offset, led by Houlihan Lokey, an investment bank specializing in mergers and acquisitions. The company benefited from increased capital markets activity, seeing upticks in demand for M&A and restructuring. Shift4 Payments, a software and payment processing solutions company,

also saw positive returns during the period, with management increasing the top end of their full-year guidance for end-to-end payments volume.

Stock selection in the consumer staples sector also proved beneficial, primarily driven by our holdings in Casey's General Stores and BJ's Wholesale Club. An operator of gas stations and convenience stores, Casey's is now reaping the rewards of its aggressive reinvestment in its stores over the past decade, building its private label brand and broadening its product offerings. This has not only helped boost same-store sales but also encouraged repeat traffic, allowing the company to buck broader industry trends toward contraction in gas volumes and margins. Finally, the company's strategy of choosing locations in smaller and more remote markets has afforded it stronger pricing power. Likewise, BJ's, which operates warehouse clubs providing perishable, general merchandise, gasoline and other ancillary services, continues to exceed expectations. With inflation continuing to weigh on consumer spending, the company's membership channel continues to grow due to its perceived value to customers.

Another top individual contributor was Monolithic Power Systems, in the IT sector, which makes semiconductor-based power electronics for the computing and storage, automotive, industrial, communications and consumer markets. Continued demand for AI-related companies and beneficiaries and anticipation of greater demand for data center components such as power management hardware for CPUs helped drive strong performance in the quarter. We believe Monolithic is one of the most attractive semiconductor plays within the SMID universe and that the company will continue to gain share in analog semiconductors as it wins design contracts.

### **Portfolio Positioning**

We initiated a new position in online pet retailer Chewy in the consumer discretionary sector. We believe the company has exited a period of tough comparables achieved during COVID-19 and that the decline in pet products spending has begun to stabilize. The company's initiatives in warehouse automation, pharmaceutical services and private label products are strong catalysts, and Chewy, which has built a loyal base through peerless customer service, is set up to improve margins as customer growth inflects positively.

Rubrik, meanwhile, is a next-generation data storage, backup and recovery provider showing strong, double-digit subscription revenue growth. We believe its cloud-based offerings have resonated with its Fortune 500 customer base, positioning it well to continue to take share from legacy data backup providers. The introduction of new AI data security products could offer an additional revenue source to Rubrik's business.

We exited our position in health care company Stevanato, which designs, produces, and distributes products and processes to provide

integrated solutions for biopharma and health care customers. The company has struggled with broader industry headwinds including a delayed destocking and recovery from the COVID-19 pandemic, and our conviction in the company's management team was further weakened after it announced an additional equity offering and subsequent reduction of Stevanato's full-year guidance. Ultimately, we elected to exit the position in favor of other opportunities with greater risk/reward profiles.

### **Outlook**

Thus far in 2024 we have seen bouts of extreme volatility and contradictory signals around the health of the underlying economy. The market and investors are coming to terms with a world that is fundamentally different post COVID with difficulties assessing permanent changes versus typical normalization following an unprecedented shutdown and then an incentive-fueled restart of the global economy. With greater uncertainty on both the economic and political fronts, and mounting concerns over market concentration in such few stocks, we believe the benefits of our philosophy of active management and diversification and our focus on strong growth trajectories with solid fundamentals will continue to prove itself over the long term.

### **Portfolio Highlights**

The ClearBridge SMID Cap Growth Strategy underperformed its Russell 2500 Growth Index benchmark during the second quarter. On an absolute basis, the Strategy had positive contributions across two of the 10 sectors in which it was invested during the quarter (out of 11 sectors total). The leading contributors were the consumer staples and financials sectors, while the industrials and consumer discretionary sectors were the chief detractors.

On a relative basis, overall stock selection detracted from performance, but was partially offset by a positive contribution from sector allocation. Specifically, stock selection in the industrials, consumer discretionary, communication services and energy sectors weighed on performance. Conversely, stock selection in the financials, consumer staples and IT sectors and an overweight to the consumer staples sector benefited performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Insmid, Monolithic Power Systems, Casey's General Stores, Wingstop and BJ's Wholesale Club. The largest detractors from absolute returns were Five Below, Trex, Stevanato, WillScot Mobile Mini and IDEX.

In addition to the transactions mentioned above, we initiated new positions BCG in the financials sector, Coherent and Lattice Semiconductor in the IT sector, Colliers International in the real estate sector, Valvoline in the consumer discretionary sector and

Weatherford International in the energy sector. We exited positions in Shoals Technologies in the industrials sector, Americold Realty Trust in the real estate sector and Mettler-Toledo International and Shockwave Medical in the health care sector.

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