



SMID Cap Growth Strategy



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Key Takeaways

- ▶ Small and mid cap growth equities declined sharply in the third quarter, as rising interest rates, renewed Fed tightening and higher oil prices weighed on longer-duration and more cyclical growth stocks.
- ▶ The Strategy outperformed its benchmark, as strong stock selection in health care and information technology (IT) more than offset weakness in industrials and consumer-oriented holdings.
- ▶ A renewed focus on quality, execution and free cash flow is beginning to reward fundamentals, a backdrop we believe favors diversified, bottom-up stock selection.

Market Overview

Small and mid cap (SMID) growth equities reversed course in the third quarter, with the Russell 2500 Growth Index declining 10.4% and giving back a substantial portion of its exceptional second-quarter rally. The growth style within the Russell 2500 trailed the Russell 2500 Value Index by roughly 600 basis points.

The central macro development was a substantial upward reset in interest rates across the Treasury curve. Escalation of the U.S.-Iran conflict pushed Brent crude above \$100 for much of September, reigniting inflation concerns and prompting the Federal Reserve to move from an extended pause back to tightening with a 25 basis point increase. The 10-year Treasury yield rose more than 80 basis points to over 5%, raising both discount rates and financing costs — a particularly difficult combination for longer-duration growth companies and businesses reliant on external capital.

The economy and corporate earnings generally remained robust, although visibility became less clear amid evolving macro conditions. AI remained the dominant market narrative, but investors are becoming far more discriminating about where returns will accrue. Our hypothesis that the trade could begin to shift toward those businesses that benefit from the adoption of AI, both in terms of cost and revenue opportunities, has begun to play out with enthusiasm spreading into areas of health care, industrials, payments and consumer companies that can capitalize on the enormous potential of the technology.

Beneath the surface, leadership was unusually dispersed. Industrials were the weakest benchmark sector, falling 21.8% as aerospace names were pressured by elevated jet fuel costs, AI-related power and infrastructure companies derated and short-cycle recovery enthusiasm diminished. Meanwhile, IT declined 10.4% as the crowded semiconductor trade unwound. Health care held up relatively well,

declining just 2.1%, supported in part by M&A alongside improving fundamentals. At the factor level, the cheapest quintile of benchmark stocks (as measured by P/E multiple) gained 7.6% while the most expensive fell 19.1% and the quintile with the lowest returns on equity (ROE) declined 11.5%, signaling a market that is beginning to reward valuation discipline and profitability.

Performance Overview

The ClearBridge SMID Cap Growth Strategy declined during the quarter but outperformed its Russell 2500 Growth Index benchmark, as strong stock selection in health care, IT and energy more than offset weakness in select AI-related, industrials and consumer-oriented holdings.

“Generalized AI or cyclical exposure is no longer enough; execution, free cash flow generation and idiosyncratic visibility matter.”

Health care was the largest contributor to relative performance, with strength spanning across industry sectors. Natera, a leader in cell-free DNA testing, surged on a substantial beat-and-raise quarter led by record volumes for its cancer recurrence monitoring test, along with new regulatory directives that expand the test’s use. Charles River Laboratories, which was pressured earlier in the year on concerns that AI could reduce drug development spending, rebounded sharply as the company returned to organic growth for the first time in nearly three years, with bookings well ahead of expectations as biotech funding and biopharma spending show signs of recovery. Hospital operator Tenet Healthcare rallied on strong earnings driven by cost efficiencies and higher-acuity volumes, alongside a sizable increase to its share buyback program.

IT also contributed meaningfully, as strength in software and data storage holdings more than offset weakness in semiconductors. Everpure, a provider of enterprise data storage solutions, was our top individual contributor after securing a second top-five hyperscaler design win, as well as delivering a large beat-and-raise quarter on AI-driven storage demand. Rubrik and Dynatrace benefited from accelerating growth and heightened focus on cyber resilience and AI observability, respectively. These gains were partially offset by semiconductor holdings Allegro MicroSystems and Onto Innovation, which gave back some first-half gains as the AI semiconductor trade unwound despite generally solid fundamentals.

Energy holdings Cactus and Permian Resources benefited from higher oil prices tied to the Middle East conflict, along with strong international orders at Cactus and raised production guidance and accretive acquisitions at Permian.

Industrials proved a detractor, as our overweight to the benchmark’s weakest sector and stock-specific headwinds weighed on several holdings. WillScot, a provider of modular space and portable storage solutions, declined as margins compressed, capital spending rose and local construction demand stayed soft. BWX Technologies and RBC Bearings declined alongside aerospace/defense and nuclear peers despite continued strong results, while Legence fell on disappointing margins and growing skepticism toward businesses with meaningful data center exposure.

Consumer-oriented holdings also detracted as rising prices weighed on Wingstop's core younger, lower-income customers, keeping domestic same-store sales negative. Wingstop was not alone as broader concerns about the health of the consumer and overall restaurant traffic contributed to pressure for foodservice distributor Performance Food Group.

Portfolio Positioning

The third quarter was another active one from a new idea generation standpoint with nine new positions added. Highlights include:

- Affirm, in the financials sector, is a leading “buy now, pay later” platform offering consumers installment financing at checkout and through its own Affirm Card. We believe its underwriting capabilities, high-profile merchant partnerships and fast-growing card business position it to keep gaining share of consumer payments while expanding profitability.
- Kiniksa Pharmaceuticals, in the health care sector, is a commercial-stage biotechnology company focused on pericarditis, an inflammatory heart disease. We believe that its ARCALYST drug, the only approved treatment for recurring and painful inflammation of the lining around the heart, still has a long growth runway, while a follow-on drug in late-stage trials could extend the drug franchise with better economics.
- Timken, in the industrials sector, is a global leader in engineered bearings and industrial motion products. We believe the company is well positioned for a recovery in short-cycle industrial demand, while new management's portfolio reshaping and streamlining efforts should drive meaningful margin expansion and earnings growth.
- During the quarter we exited life sciences tools provider Bio-Techne following its announced acquisition by Merck KGaA. Bloom Energy and Credo Technology saw their market caps eclipse what we believed to be an appropriate level for a SMID strategy, and we subsequently exited the positions. We also exited BJ's Wholesale Club, Shift4 Payments, SentinelOne and Viking Therapeutics as part of our ongoing effort to reallocate capital toward higher-conviction opportunities or to manage portfolio construction considerations.

Outlook

We believe the third quarter was primarily a repricing of duration and valuation risk, alongside less certainty around the growth outlook, rather than a material deterioration in fundamentals for SMID growth companies. Economic growth, capital investment and earnings expectations remain largely resilient, while SMID growth valuations have reset meaningfully. That being said, the near-term path forward will likely hinge on factors outside of any company's control, including the trajectory of energy prices, whether inflation continues to moderate and how far the Federal Reserve ultimately tightens. In this environment, we believe generalized exposure to AI or to cyclical recovery is no longer sufficient. Companies with visible organic growth,

positive and improving free cash flow, limited refinancing needs and pricing power should see significant advantages, while businesses reliant on falling rates, repeated financing or distant profitability may face continued pressure.

While the near-term path relies on several difficult-to-predict macro outcomes, we are finding ample opportunities to identify businesses with idiosyncratic and durable growth potential, particularly as the usage of AI proliferates, creating new monetization or profit drivers. By potentially driving more discerning evaluation of businesses and the possibly of greater individual stock dispersion, this backdrop creates opportunities for active managers. We believe disciplined stock selection and thoughtful portfolio construction across a broad spectrum of growth businesses position the Strategy well for the period ahead.

Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from two of the nine sectors in which it was invested: health care and energy. Meanwhile, the industrials sector detracted the most.

On a relative basis, overall stock selection contributed to performance, while overall sector allocation detracted. Stock selection in the health care, IT and energy sectors benefited performance. Conversely, an overweight to the industrials sector and stock selection in the consumer discretionary, consumer staples and industrials sectors weighed on relative results.

On an individual stock basis, the biggest contributors to relative returns were Everpure, Natera, Charles River Laboratories, Rubrik and Dynatrace. The largest detractors from relative returns were Allegro MicroSystems, WillScot, Casey's General Stores, RBC Bearings and BWX Technologies.

In addition to the transactions discussed above, we added positions in, FirstCash in financials, JFrog in IT, Lindblad Expeditions in consumer discretionary, Materion in materials and Spyre Therapeutics and Twist Biosciences in health care. We exited positions in Argan, Kratos Defense & Security Solutions and York Space Systems in the industrials sector.

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