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Small Cap Strategy

Key Takeaways

- ▶ The surging performance of AI- and bitcoin-related companies in the first quarter is overshadowing the risks of chasing long-term secular trends regardless of valuation.
- ▶ The Strategy underperformed its benchmark as a lack of exposure to a narrow subset of high-performing IT stocks overshadowed positive contributions from energy and materials.
- ▶ Rather than chasing market trends, we continue to seek companies with strong balance sheets and attractive cash flows, trading at compelling valuations.

Market Overview

The ClearBridge Small Cap Strategy underperformed the benchmark Russell 2000 Index in the first quarter by 177 bps, precisely the amount that the two largest-capitalization stocks in the index — Super Micro Computer and MicroStrategy — contributed to the index's performance. Our decision not to own Super Micro Computer and, to a lesser extent, bitcoin-related companies like MicroStrategy, overshadowed positive contributions from our companies in the energy and materials sectors.

The Russell 2000 Growth Index and the Russell 2000 Value Index returned +7.58% and +2.90%, respectively, and growth's outperformance is also partially attributable to Super Micro and MicroStrategy. Super Micro is now the largest position ever in the Russell 2000 Index, ending the first quarter at 1.93% of the index with a market cap approaching \$60 billion. MicroStrategy also ended the quarter with a market weighting of 0.95% of the index, one of the largest positions ever, and a market cap over \$27 billion.

Both stocks saw meteoric appreciation after being included in the index at last year's rebalance, but also started well above average because of the methodology that FTSE Russell uses in its rebalancing decisions. FTSE Russell only makes changes to the index once a year, in June, deciding which stocks will be in the index in late April but without setting the weights until two months later, although it is now considering doing so semiannually in the future after this year's debacle. As a result, after the announcement of its inclusion in 2023, Super Micro rose a whopping 136% from April 30 to June 30, thus beginning the index year with a market cap over \$13 billion — well above many constituents of the larger Russell 1000 Index. We believe this to be an antiquated, and easy to manipulate, problem.

But let's focus on another aspect of Super Micro's 10-fold rise over the past year. Long considered a commodity technology hardware

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company and valued as such, the company traded at a 5x–10x EV/EBITDA for the 20 years preceding the first quarter of 2023. However, by the end of the first quarter of 2024, it traded around 25x after the market became convinced that it has a crucial role in artificial intelligence (AI) hardware. Super Micro's move is similar to Nvidia's, which has also risen dramatically in the past two years and trades around 29x forward EV/EBITDA. There's no denying that AI and other computing-intensive activities, such as bitcoin mining, are driving a renaissance in hardware.

Spotting a secular trend and identifying the winners is a time-honored investment strategy that has made investors a lot of money but has also failed spectacularly depending on the valuation. People mostly remember the 2000 dot-com bubble as being marked by silly business models like Pets.com and Webvan, but there were also major secular themes in play around rising internet traffic increasing demand for fiber optics, networking equipment, web hosting, etc., supporting companies like JDS Uniphase, Level 3 Communications, Global Crossing, Lucent, Nortel, Cisco and EMC. This thesis was entirely correct, but the stocks drastically failed if you bought them near the top. Only one of those companies still remains, Cisco, and it still hasn't gotten back to its 2000 highs. For many of the others, the problem wasn't the theme but the lack of competitive advantage necessary to produce long-term excess returns.

Another theme of that era was mobile telephony. Qualcomm soared over 2,600% in 1999 on a very similar premise as Nvidia is seeing now — it was the brains behind the secular trend, so whoever won, Qualcomm would participate. The theme was spot on, the company was perfectly positioned, and it went on to perform massively well. From 1999 to 2023, Qualcomm's sales rose more than 9x and EBITDA 12x, very impressive long-term growth rates. Investors who held the stock during that period, however, received a total return of only 154%, underperforming the 410% return of the S&P 500 Index.

This reminds us of a quote from famous horserace handicapper Steven Crist:

"This is the way we all have been conditioned to think: Find the winner, then bet. Know your horses and the money will take care of itself.... The problem is that we're asking the wrong question. The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory. This may sound elementary, and many players may think they are following this principle, but few actually do. Under this mindset, everything but the odds fades from view. There is no such thing as 'liking' a horse to win a race, only an attractive discrepancy between his chances and his price."¹

¹ "Bet With the Best: Expert Strategies from America's Leading Handicappers," Daily Racing Form, October 8, 2001.

Rather than chase short-term outperformers, we continue to pursue investments where the potential future free cash flow valuation suggests fair value in excess of the current market price.

For example, despite being a detractor in the first quarter, we maintain high conviction in wired and wireless cloud network solutions company Extreme Networks. While the company has faced a recent boom and bust from an uneven supply and demand during and after the COVID-19 pandemic, we believe the company has fundamentally improved its competitive position and return profile. Regarding recent performance, we believe the business is merely experiencing a classical cyclical downturn that should bottom out over the next few quarters. We believe the market isn't giving sufficient credit to Extreme Network's growth and margin potential once excess inventories have cleared.

However, there were also bright spots within the IT sector. Electronic memory and LED manufacturer SMART Global proved our second-best-performing holding for the quarter, rebounding from a disappointing fourth quarter. Contrary to the lowered expectations that management had previously guided to for its high-performance computing business, SMART Global saw accelerated demand beyond what both management and the market had previously anticipated, leading to improved margins and unexpectedly higher quarterly earnings. Likewise, network solutions company Itron was also rewarded for strong quarterly performance and issuing 2024 guidance above market estimates. The company appears to have largely shrugged off the supply chain issues that have weighed on past performance and looks to continue to improve its margins by closing two weaker-margin factories this year and announcing several new partnerships to support growth in both its software and network segments.

Rising energy prices helped to support the performance of exploration and production (E&P) companies Magnolia Oil and Gas and Matador Resources and increased demand for energy equipment services, lifting companies like Atlas Energy Solutions. We continue to have high conviction in Magnolia and Matador due to their strong and demonstrated ability to generate incremental returns on investment capital. Meanwhile Atlas continues to benefit from being the premier low-cost producer of materials needed by E&Ps in the Permian Basin. Building on its already strong distribution network and proprietary technology, Atlas's recent announcement of its intention to acquire competitor Hi-Crush will make it the largest producer in the country of proppant, a material mixed with fracturing fluid for shale production, and solidify its position as a premier industry logistics provider. Expanding its product volume while maintaining its current fixed cost structure should support long-term returns.

Our top individual performer for the quarter was Eagle Materials, which manufactures a range of construction materials including cement, gypsum wallboard and recycled paperboard. The stock

extended its gains on a more optimistic economic outlook and after it exceed quarterly expectations on both revenue and earnings. We believe the company's continued strong pricing power in its cement business and cost advantages versus its peers in its wallboard business should allow it to continue to maintain attractive returns on capital.

Portfolio Positioning

After a particularly active fourth quarter, we entered the first quarter of 2024 satisfied with our positioning and chose to be selective in taking advantage of some of the evolving opportunities in the market. Ultimately, we added three new positions and exited two.

Health care was a focus in the quarter, with our largest new position being Corcept Therapeutics, which is engaged in the discovery and development of drugs used to treat severe endocrinologic, oncologic, metabolic and neurologic disorders in the U.S. Since 2012, Corcept's Korlym treatment of Cushing's Syndrome has benefited from market exclusivity. Despite sales rising to \$482 million in 2023, Korlym has since encountered generic competition. However, management believes they will not see a decline in revenue, as the rare nature of the disease and specialty distribution channels make it difficult for a pharmacy to swap out the brand name for the generic. In addition, Corcept has a next-generation drug with fewer side effects than Korlym, which should increase its available market. We believe the new drug's Phase 3 trial results, due very soon, will show approvable efficacy and safety, as well as possible extension into other indications.

We also initiated a new position in Axsome Therapeutics, a biopharmaceutical company that develops drugs to treat central nervous system disorders. Axsome has two drugs on the market, five late-stage trials, a pipeline of 10 target indications, and a large addressable market of over 100 million potential patients. If multiple data readouts in 2024 are successful, it could have six marketing indications by 2025. Axsome has \$200 million net cash and is expected to become profitable next year. We believe the current valuation accounts for the value of the currently approved indications with relatively modest downside but considerable optionality if other trials are successful.

We exited our position in Sterling Check, in the industrials sector, which specializes in technology-enabled background and identity verification services. The company announced its intention to be acquired by rival First Advantage and, given the regulatory risks involved and limited likelihood of a competing offer for the company, we elected to sell the position.

Outlook

Despite investor enthusiasm over the IT hardware renaissance, we believe that the market's clamoring over such a narrow subset of stocks creates risks for those following the trend but opportunities elsewhere. Rather than chasing market trends, we continue to seek companies with strong balance sheets and attractive cash flows that are trading at compelling valuations. We believe serving the best interest of our investors over the long-term means avoid risking capital on things that could just as quickly fall out of favor in this tumultuous market environment.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the first quarter. On an absolute basis, the Strategy had gains across six of the 11 sectors in which it was invested during the quarter. The leading contributors were the industrials and energy sectors, while the greatest detractors were the communication services and real estate sectors.

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

On an individual stock basis, the biggest contributors to absolute returns in the quarter were Eagle Materials, SMART Global, SkyWest, HealthEquity and Primoris Services. The largest detractors were Forward Air, Integral Ad Science, Independent Bank, MP Materials and QuidelOrtho.

In addition to the transactions listed above, we initiated a new position in Warrior Met Coal in the materials sector. We also exited a position in NCR Atleos in the financials sector.

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