FRANKLIN TEMPLETON | ClearBridge

Small Cap Growth Strategy

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Key Takeaways

- Small cap growth equities gave back a portion of their first-half gains as rising yields, renewed Fed tightening and higher oil prices drove one of the weakest third quarters for small caps relative to large caps on record.
- The Strategy underperformed its benchmark, as strong stock selection in health care and software was offset by weakness in consumer discretionary, industrials and semiconductor holdings.
- With small cap earnings growth intact and relative valuations still attractive relative to large caps, we believe the market's renewed focus on quality, growth visibility and idiosyncratic levers play to the strengths of our process.

Market Overview

The strong small cap rally of the second quarter reversed sharply in the third as rising rates, stubborn inflation (led by elevated oil prices), cracks in the AI cycle's enthusiasm and a challenged consumer coalesced to weigh on stocks. The Russell 2000 Growth Index declined 9.4%, trailing the Russell 2000 Value Index by roughly 450 basis points and giving back a meaningful portion of its 25.7% second-quarter gain, while the Russell 1000 Growth Index gained 0.9%. According to Jefferies Equity Research, the Russell 2000 Index's roughly 900 bps shortfall versus the Russell 1000 marked the third-worst third quarter in Russell data going back to 1979, exceeded only by 1990 and 1998.

While a July lull in momentum stocks, particularly semiconductors and other AI infrastructure beneficiaries, was to be expected after a torrid second quarter and an unprecedented Russell rebalance, the weakness accelerated across August against a backdrop of increasing oil prices, inflation expectations and Treasury yields all moving higher in tandem. Escalation of the U.S.-Iran conflict pushed Brent crude above $100 for much of September, just as the Federal Reserve shifted from an extended pause back to tightening with a 25 basis point rate increase. The 10-year Treasury yield rose more than 80 basis points to finish the quarter above 5%, a particularly damaging combination for longer-duration growth equities and smaller companies more reliant on external capital.

Importantly, the economy and corporate earnings did not break, but the discount rate did, at the same moment that forward visibility for the economy and key narratives deteriorated. AI remained the dominant market narrative, but investors became 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.

The crowded semiconductor and AI infrastructure trades that led the first half of the year reversed sharply, with semiconductors and tech hardware (within the Russell 2000 Growth Index) down 23% and 19%, respectively. Industrials and information technology (IT) were the weakest benchmark sectors, declining 18.2% and 12.9%, respectively, while health care proved relatively resilient with a decline of just 2.8%, supported by M&A activity and improving fundamentals, as well as perceived AI adoption benefits.

Performance Overview

The ClearBridge Small Cap Growth Strategy declined alongside its Russell 2000 Growth Index benchmark and underperformed in the third quarter. Strong stock selection in health care and software, along with contributions from energy holdings such as Cactus, was more than offset by weakness in consumer discretionary and industrials holdings, as well as in semiconductor investments caught up in the unwind of the AI trade.

Consumer discretionary was the largest relative detractor. Elevated gas prices and pressure on lower-income and younger consumers weighed on restaurant holdings Dutch Bros, a fast-growing drive-thru coffee chain, whose stock declined on guidance implying slower same-store sales growth and rising competition, and Wingstop, whose same-store sales remained negative. We believe much of the pressure on our restaurant holdings is cyclical rather than structural, but we continue to closely monitor the health of their core consumers and competitive dynamics. Universal Technical Institute, a national provider of trade schools, also detracted after lowering guidance on weaker high school enrollment starts.

Industrials also weighed on relative results, as our overweight to the benchmark's weakest sector was compounded by weakness in several large holdings. Despite continued strong execution, long-standing holdings RBC Bearings and BWX Technologies de-rated alongside a broad pullback in aerospace and defense and nuclear peers. Conversely, Xometry, an online marketplace for on-demand manufactured parts, gained as marketplace growth accelerated for a fourth straight quarter.

Within IT, results diverged sharply between semiconductors and software. Allegro MicroSystems and Lattice Semiconductor, both among our top contributors in the first half of the year, gave back gains. Software holdings, by contrast, were meaningful contributors. Zeta Global, a marketing technology platform, delivered another significant beat-and-raise quarter on rising adoption of its AI agent, while data security provider Varonis Systems benefited from reports of takeover interest and heightened focus on data protection amid concerns around AI-enabled cyberattacks.

The economy and corporate earnings did not break — the discount rate did.

Health care was the Strategy's strongest relative contributor, reflecting solid stock selection across biotechnology, life science tools and diagnostics industries. Our biotech holdings were roughly flat in a quarter in which the benchmark's biotech constituents declined, Protagonist Therapeutics and TG Therapeutics both had strong commercial results. Additionally, Caris Life Sciences, a precision oncology diagnostics company, surged on strong quarterly earnings and favorable preliminary Medicare pricing for its blood-based cancer test. Charles River Laboratories and Medpace, both pressured earlier this year by concerns that AI could reduce drug development spending, rebounded on bookings well ahead of expectations as biotech funding and biopharma spending showed signs of recovery.

Performance Positioning

We continued to deliver strong new idea generation, adding 11 new positions during the quarter.

- FirstCash, in the financials sector, is the world's largest pawn store operator, with locations across the U.S., Latin America and the U.K. With regulatory and zoning barriers limiting new competition in a fragmented market that the company continues to consolidate, FirstCash offers solid growth potential alongside counter-cyclical demand that supports consistent earnings growth.
- Kiniksa Pharmaceuticals, in the health care sector, is a commercial-stage biotech 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.
- Lindblad Expeditions, in the consumer discretionary sector, is the leading expedition cruise operator, offering small-ship voyages to remote destinations in partnership with National Geographic. We believe its differentiated brand and loyal, affluent customer base support pricing power as demand for experiential travel grows, with revenue management and cost initiatives driving margin and earnings growth.

During the quarter we exited several holdings for company-specific and portfolio construction considerations. This included Bloom Energy, which we have owned since its 2018 IPO and which has been one of the Strategy's strongest long-term contributors, as its market capitalization grew well beyond the small cap universe. The other exited investments were Argan, Credo Technology, FTAI Aviation, Insulet, Sprout Social, Trupanion and York Space Systems.

Outlook

The third quarter was a reminder that the small cap recovery remains fragile and unfortunately at times susceptible to factors outside of our companies' control. We take solace that the third quarter is seasonally a more challenging one for the asset class, and such sharp quarters of relative underperformance versus large caps often presages a very strong fourth quarter performance in relative and absolute terms.

Median growth rates for small and mid cap stocks are forecast to exceed those of large caps, yet the Russell 2000 Index now trades below 20x earnings, a roughly 10% discount to large caps, and rolling 10-year returns for small caps relative to large caps are back in the first (worst) percentile. We believe the conditions remain in place for a longer-term recovery in relative performance.

The near-term path is admittedly dependent on several difficult to predict variables: the trajectory of energy prices, whether inflation continues to moderate, how far the Federal Reserve ultimately tightens and potential impacts from the upcoming midterm elections. 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 be increasingly advantaged, while businesses reliant on falling rates, repeated financing or distant profitability may face continued pressure. This is the type of market in which our guiding principles — exercising "judgment and patience" to maintain the right balance of opportunity and risk while owning appropriately capitalized companies with substantial long-term growth opportunities — should matter most.

Portfolio Highlights

The ClearBridge Small Cap Growth Strategy underperformed its Russell 2000 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 (out of 11 sectors total). The health care and energy sectors were the contributors, while the industrials sector detracted the most.

Relative to the benchmark, overall stock selection and sector allocation effects detracted. Stock selection in the consumer discretionary and industrials sectors, as well as an overweight to the industrials sector, weighed on performance. Conversely, stock selection in the health care, IT and energy sectors contributed positively.

On an individual stock basis, the leading contributors to relative returns were Zeta Global, Caris Life Sciences, Cactus, Charles River Laboratories and Varonis Systems. The primary detractors were Allegro MicroSystems, Dutch Bros, Universal Technical Institute and BWX Technologies, as well as not owning 10x Genomics.

In addition to the transactions discussed above, we initiated new positions in Definium Therapeutics, Krystal Biotech, Spyre Therapeutics and Twist Bioscience in the health care sector, JFrog and Onto Innovation in the IT sector, Materion in the materials sector and Timken in the industrials sector.

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