



Mid Cap Growth Strategy



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Key Takeaways

- ▶ Mid cap growth stocks fell in the third quarter as doubts about AI capital spending, a Fed rate increase and higher oil prices drove sharp declines in the benchmark's industrials and utilities sectors.
- ▶ The Strategy slightly underperformed, as positive stock selection in information technology (IT), health care and industrials was offset by our overweight to industrials and stock selection in energy as oil prices rallied.
- ▶ New positions in Snowflake, Teradyne, Keysight Technologies and DigitalOcean added exposure to AI beneficiaries in cloud data, semiconductor test and compute capacity.

Market Overview

Mid cap growth equities gave up ground during the third quarter, with the benchmark Russell Midcap Growth Index declining 5.8% for the period but remaining in positive territory year to date. The market, and mid cap growth stocks specifically, grappled with the effects of rising interest rates and financing costs, sharply higher crude, gasoline and diesel prices and no credible timeline for an end to hostilities in the Middle East. Against this backdrop both mid cap growth and mid cap value stocks retreated, but mid cap growth stocks trailed their value brethren by over 350 basis points.

Macro headlines remained influential during the quarter, pulling investor sentiment in different directions. The uncertainty of crude oil flows out of the Strait of Hormuz, stickiness of inflation data, wars in Iran and Ukraine, unpredictable trade policy and relentless increases in sovereign debt have pushed the 10-year Treasury yield above 5%. Meanwhile, the price of a barrel of West Texas Intermediate crude oil rose to over \$100 in September.

The rising cost of financing and higher gasoline and diesel prices are having a significant impact on consumers and businesses alike. The extra \$1.23 per gallon that the average American is paying for gasoline compared to one year ago is hurting discretionary income by over \$700 per year per driver. Mortgage rates have risen to over 7.25%, which is heavily disincentivizing homebuyers who can still remember 3% for a 30-year fixed mortgage. As such, we believe that both existing and new home sales will likely remain weak unless there is a sharp reversal in interest rates.

Thankfully the labor market is in decent shape; labor demand has been firming recently, while labor supply is being constrained by tighter immigration policies and the continued retirement of Baby Boomers.

It is more of a challenge to measure the impact of artificial intelligence (AI) on labor demand and productivity, but we suspect it is meaningful.

AI data center capex continues to dominate headlines and drive stock performance. The stocks of semiconductor equipment and chip makers, data center infrastructure companies, and the companies that generate the electricity needed to power them remained in focus during the quarter. Notably, however, attention has begun to ripple outward toward the other pockets of the economy that will be impacted use of AI, including the software, industrial, health care and consumer discretionary sectors. We are also keenly watching the societal and political pushback that has begun to bubble up to surface in the AI debate.

Performance Overview

The ClearBridge Mid Cap Growth Strategy slightly underperformed its Russell Midcap Growth benchmark during the third quarter, as broader market and economic headwinds to our energy, consumer discretionary and consumer staples holdings overcame positive stock selection in information technology (IT), health care and industrials.

Energy was the largest relative detractor from performance, as Diamondback Energy, EQT Corp and Baker Hughes lagged that of the two large refining companies in our benchmark — Marathon Petroleum and Phillips 66. These refiners experienced a meteoric rise as Strait of Hormuz disruptions and tight global fuel inventories drove record refining margins and made it difficult for our exploration and production and energy services holdings to keep pace.

In the consumer sectors, Wingstop cut guidance as elevated gas prices squeezed its lower-income, younger customers, and foodservice distributor Performance Food Group fell amid negative restaurant traffic and higher diesel costs. Meanwhile, in communication services, AppLovin, whose software platform helps advertisers market and monetize content, declined after a rare miss against its own guidance.

Our industrials exposure resulted in mixed performance, as our overweight to the sector weighed on performance while stock selection was positive — albeit partially due to what we didn't own. MasTec fell sharply after a surprise guidance cut in its communications segment, compounded by a broad pullback in data center and power infrastructure stocks — not owning the stock proved beneficial. Several of our holdings faced company-specific headwinds. WillScot, a provider of modular space and storage solutions, fell despite raising guidance. Vertiv, which supplies power and cooling infrastructure for data centers, sold off after missed lofty expectations for that management attributed to project timing and supply chain congestion.

IT was the largest contributor to relative performance led by Rubrik, a data security and cloud data management provider, which rallied on another clean beat-and-raise quarter and accelerating subscription growth as concern about AI-enabled cyberattacks sharpened focus on cyber resilience and data recovery. Data storage provider Everpure rose sharply on a second hyperscaler design win and strong AI-driven storage demand. Fortinet, a cybersecurity company outside the

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benchmark, saw its share price climb after announcing strong second-quarter revenue growth and a raised full-year outlook.

Stock selection in health care also positively contributed to performance, led by Mettler-Toledo, a laboratory instruments maker and service provider, who beat expectations and raised guidance on a broadening demand recovery in the biopharma sector.

Portfolio Positioning

Rather than chasing the quarter's swings in AI sentiment, we used the volatility to add AI beneficiaries where we believe durable economic value can accrue.

We initiated a position in Snowflake, a cloud data platform that enterprises increasingly use to build AI applications. Its own AI products are accelerating growth and pulling through use of its core platform. We also bought Teradyne, one of two global leaders in semiconductor test equipment. Rising chip complexity in AI computing is driving greater test intensity, and we see Teradyne regaining share with new products for leading AI chip customers. Keysight Technologies, whose electronic design and test tools are embedded in customers' R&D workflows, should benefit from AI data center buildouts and a recovering industrial cycle. Demand at DigitalOcean, a cloud provider that also rents GPUs and offers AI inferencing, far outstrips supply, giving it room to add capacity and move up the value chain. We also added meaningfully to Robinhood Markets and Astera Labs.

In materials, we exited Martin Marietta Materials on capital allocation concerns and initiated a position in Vulcan Materials, the largest U.S. aggregates producer, whose Sunbelt quarries and hard-to-replicate reserves support durable pricing power. In health care, we sold STERIS to fund higher-conviction ideas, including Protagonist Therapeutics, which develops oral drugs for immune and blood disorders. Its first-in-class psoriasis pill, co-developed with Johnson & Johnson, is off to a strong launch, and we see significant royalty growth ahead. We exited Bio-Techne after its acquisition by Merck KGaA, and we sold Ferguson Enterprises to reduce our overweight to non-residential industrials.

Outlook

The market's intense focus on all things AI-related is understandable. Much of the growth in the U.S. can be directly or indirectly linked to AI investment spending. But as the buildout of AI infrastructure comes more into view, we are spending more time understanding better which companies will best use the technology to accelerate growth, become more productive, and transform their businesses.

As for the broader economic landscape, there is no question our economy is "K-shaped." Higher interest rates and higher crude, gasoline and diesel prices are not helping. Additionally, in case you haven't already been bombarded by political ads on television, we have midterm elections coming up that could usher in entirely different political priorities. In unpredictable times like these, we find it refreshing and advantageous to tune out the noise and focus on

finding misunderstood or underappreciated growth compounders with disciplined capital management and balance sheets that can sustain the business, whatever the environment. We believe our approach to 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 Mid Cap Growth Strategy mildly underperformed its Russell Midcap Growth Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from three of the 11 sectors in which it was invested. The leading contributors were the IT and health care sectors, while 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 IT, health care, industrials and utilities sectors benefited performance. Conversely, an overweight to the industrials sector and stock selection in the energy, consumer discretionary, consumer staples, communication services and materials sectors weighed on relative results.

On an individual stock basis, the biggest contributors to relative returns were Rubrik and Mettler-Toledo, as well as an underweight to Teradyne and not owning MasTec and Fair Isaac. The largest detractors from relative returns were WillScot and AppLovin, as well as an underweight to Snowflake and not owning Marathon Petroleum and Atlassian.

In addition to the transactions discussed above, we initiated a new position in Affirm in the financials sector. We exited positions in Tradeweb Markets in the financials sector, DraftKings in the consumer discretionary sector and Roblox in the communication services sector.

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