



Small Cap Strategy



Jeffrey Bailin, CFA
Managing Director,
Portfolio Manager



Erich Frey, CFA
Director,
Portfolio Manager

Key Takeaways

- ▶ Small cap stocks declined in the third quarter and lagged large caps, as a July momentum unwind, the Fed's first rate increase since 2023 and rising Treasury yields weighed on smaller AI-related companies.
- ▶ The Strategy underperformed the Russell 2000 Index, as negative stock selection in health care and financials outweighed strong stock selection in energy, consumer staples and IT.
- ▶ We expect earnings growth to decelerate from exceptional levels, and with dispersion within small cap sectors well above average, we believe bottom-up stock selection has room to work.

Market Overview

U.S. small caps declined in the third quarter and trailed large caps by a wide margin. The benchmark Russell 2000 Index fell 7.2%, and value held up better than growth within small caps, as the Russell 2000 Value Index declined 4.9% compared with a 9.4% drop for the Russell 2000 Growth Index. Small caps remained ahead of large caps year to date, though their lead narrowed.

The quarter unfolded in three phases. In July, a sharp momentum selloff unwound crowded AI-related positions and rewarded valuation and quality. Growth reclaimed leadership in August on strong second-quarter earnings, and within the Russell 2000 the smallest companies with no earnings and the lowest returns on equity led. In September, the Federal Reserve's first rate increase since 2023 and a sharp rise in Treasury yields raised borrowing costs for smaller companies and weighed on rate-sensitive and cyclical stocks.

Higher oil prices tied to the conflict with Iran made energy the only benchmark sector to gain in the quarter, and health care held up well, while industrials and information technology (IT) were the weakest sectors as AI infrastructure beneficiaries pulled back.

Leadership across the broader market narrowed sharply. Gains in the third quarter were concentrated in the largest companies as the median stock in the Russell 3000 Index fell well more than the index itself. Beneath the surface, quality was the strongest factor for the quarter, and value and low volatility also rebounded, while momentum fell sharply despite a strong September rally.

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Performance Overview

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the third quarter, as weak stock selection in health care and financials outweighed strong results from energy, consumer staples and select IT holdings. The Strategy held up well in July's rotation toward value and quality but gave back that advantage in August and September.

Health care was the largest detractor. Our underweight hurt as the sector held up far better than the overall benchmark, and stock selection added to the shortfall. Bicara Therapeutics, which is developing a treatment for head and neck cancer, declined amid an uneven backdrop for biotech stocks and its ongoing leadership transition. Physician enablement company Privia Health fell after announcing second-quarter results the market viewed as disappointing.

Financials and materials also weighed on results. PROG Holdings, the parent of lease-to-own provider Progressive Leasing, declined as higher write-offs and lower leasing revenue pointed to continued financial strain on its customers. Solstice Advanced Materials fell sharply after agreeing in July to acquire Element Solutions in a cash-and-stock deal, and the shares remained well below their pre-announcement level even after the companies terminated the agreement in late August.

Energy and consumer staples were among the strongest contributors. Tanker operator International Seaways reported record second-quarter earnings on higher spot rates and declared the largest quarterly dividend in its history, while Permian Basin producer Matador Resources delivered record oil production and raised its full-year production outlook as oil prices climbed. Snack maker Utz Brands rose after agreeing to be taken private at a substantial premium.

IT also contributed overall, led by marketing technology company Zeta Global, which raised its full-year outlook on rising adoption of its AI agent, cross-selling and growing confidence in its Palantir partnership. However, several AI infrastructure holdings gave back gains. TeraWulf, which is converting former bitcoin mining sites into data center capacity for AI customers, fell alongside peers even after signing a large data center lease with Anthropic, while Allegro MicroSystems, a maker of magnetic sensors and power semiconductors, gave back much of an exceptional first-half run as the crowded semiconductor trade unwound in July.

Portfolio Positioning

Biotechnology's weight in the benchmark rose meaningfully in the June Russell index rebalance, and several of our biotech positions had grown large. We trimmed Arrowhead Pharmaceuticals and Bicara Therapeutics and initiated positions in Protagonist Therapeutics, Rhythm Pharmaceuticals and TG Therapeutics, among others, which modestly increased our biotech exposure with greater diversification, though the Strategy remains underweight the industry. In energy, we added wellhead equipment maker Cactus, funded in part by trims to International Seaways and Weatherford International, and in financials

we initiated a position in FirstCash, the world's largest pawn store operator, where regulatory and zoning barriers limit new competition in a fragmented market the company continues to consolidate.

We sold trucking company Landstar System and airline Allegiant Travel to shift our industrials exposure toward more growth and AI buildout names, and we trimmed Terex as the rebalance left the portfolio overweight the sector. We also exited Portland General Electric as risks mounted that regulators would reject its holding company request, which would strain the economics of its proposed PacifiCorp acquisition, and sold Utz after its take-private agreement.

Outlook

Corporate earnings growth has been exceptionally strong this year and is broadening beyond AI and energy, including among small caps. We expect growth to decelerate as comparisons get harder as sharp rises in Treasury yields have historically weighed disproportionately on small cap earnings as these companies have more exposure to short-term funding. We see several paths from here: a continuation of current AI leadership, a migration of AI's economic value toward the companies that deploy it, or a slowdown in capital spending that could weigh on profits across the economy.

The width of those outcomes argues for balance. We have increased exposure to growth and the AI buildout while keeping a value bias and sector weights close to the benchmark, with the main exceptions an underweight to health care and an overweight to materials. Dispersion within small cap sectors is well above average, which should give bottom-up stock selection room to work. We remain focused on owning businesses with improving fundamentals, capable management teams and attractive risk/reward.

Portfolio Highlights

The ClearBridge Small Cap Strategy underperformed its Russell 2000 Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from two of the 11 sectors in which it was invested. The contributors were the consumer staples and energy sectors, while the industrials, financials and health care sectors detracted the most.

On a relative basis, overall stock selection detracted from performance, while overall sector allocation contributed. Stock selection in the consumer staples, energy and IT sectors, as well as an underweight to IT, benefited performance. Conversely, stock selection in the health care, financials and materials sectors and an underweight to health care weighed on relative results.

On an individual stock basis, the biggest contributors to relative returns were International Seaways, Utz Brands, Zeta Global, Matador Resources and Signet Jewelers. The largest detractors from relative returns were TeraWulf, Solstice Advanced Materials, Allegro MicroSystems, Penguin Solutions and PROG Holdings.

In addition to the transactions discussed above, we initiated new positions in GXO Logistics, Legence, Construction Partners, Modine

Manufacturing, Trex and Karman Holdings in the industrials sector, Vaxcyte, Spyre Therapeutics and Mirum Pharmaceuticals in the health care sector, Cipher Digital, Onto Innovation, JFrog and Clear Secure in the IT sector, Solaris Energy Infrastructure in the energy sector, Liffort Mobile in the communication services sector and Boot Barn in the consumer discretionary sector. We exited positions in Celcuity and Guardian Pharmacy Services in the health care sector, Jefferson Capital and Assured Guaranty in the financials sector, Criteo in the communication services sector, Camping World in the consumer discretionary sector and Descartes Systems Group in the IT sector.

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