



Mid Cap Strategy



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Key Takeaways

- ▶ Mid cap 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 underperformed, as stock selection in industrials, energy and consumer staples and our overweight to industrials outweighed positive stock selection in health care.
- ▶ In a K-shaped economy facing higher rates and fuel costs, we remain focused on companies with strong competitive positions, healthy balance sheets, capable management teams and clear paths to value creation.

Market Overview

Mid cap equities gave up ground during the third quarter, with the benchmark Russell Midcap Index declining 3.0% but remaining in positive territory year to date. The market, and mid cap stocks specifically, grappled with the effects of rising interest rates and financing costs, sharply higher crude oil, gasoline and diesel prices and no credible timeline for an end to hostilities in the Middle East. Against this backdrop, mid caps trailed large caps, as the Russell 1000 Index rose 1.8%, but outpaced small caps, as the Russell 2000 Index fell 7.2%.

The rising cost of financing and higher gasoline and diesel prices are having a significant impact on consumers and businesses alike. Mortgage rates have risen to over 7.25%, and we believe that both existing and new home sales are likely to remain weak unless there is a sharp reversal in interest rates.

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 by the use of AI, including software as well as the industrial, health care and consumer discretionary sectors. Within the benchmark, energy and health care were the strongest sectors, while utilities and industrials were the weakest.

Performance Overview

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap benchmark during the third quarter, as broader market and economic headwinds to our industrials, energy and consumer holdings, along with

our overweight to industrials, more than offset positive stock selection in health care.

Industrials was the largest relative detractor as higher interest rates and fuel costs weighed on cyclical demand while data center and power infrastructure stocks pulled back over AI capex concerns. Modular space and storage provider WillScot fell despite raising guidance, as sentiment soured for nearly all stocks related to nonresidential construction. Solid waste company Casella Waste Systems faced a similar squeeze from elevated fuel costs. Public safety technology provider Axon Enterprise fell in sympathy with public backlash over a competitor's automatic license plate reader. We do not believe this will have a lasting impact on Axon's business. Finally, diversified industrial products maker Regal Rexnord declined after new management reduced full-year guidance on weaker organic earnings growth.

Energy detracted for two reasons in roughly equal measure: we did not own the refiners which were the best performers in the sector, and several of our own holdings came under company-specific pressure. The refining industry experienced a meteoric rise as Strait of Hormuz disruptions and tight global fuel inventories drove record refining margins and accounted for about half of the sector's drag on relative results. Meanwhile natural gas compression services provider Archrock fell after narrowing its full-year guidance citing short-term cost pressures, while natural gas producer EQT declined as weak Appalachian natural gas prices weighed on the shares.

In the consumer sectors, foodservice distributor Performance Food Group fell amid negative restaurant traffic and higher diesel costs, and convenience store operator Casey's General Stores beat on earnings, but grocery-led inside same-store sales fell short of high expectations, de-rating a premium multiple. In communication services, AppLovin, whose software platform helps advertisers market and monetize content, declined after a rare miss against its own guidance.

Stock selection in IT detracted overall, weighed down by holdings such as Microchip Technology, which gave up some ground after a very strong second quarter. Rubrik, a data security and cloud data management provider, 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.

Health care was the largest contributor to relative performance and the only sector to add to absolute returns. Hospital operator Tenet Healthcare was the top contributor after a significant beat and raise driven by cost efficiencies, higher-acuity volumes and supplemental payments. Drug development services provider Charles River Laboratories rebounded on bookings well ahead of expectations as biotech funding recovered, and Mettler-Toledo, a laboratory instruments maker and service provider, beat expectations and raised guidance on a broadening demand recovery in the biopharma industry.

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Portfolio Positioning

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

In materials, we 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 trimmed 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 sold Ferguson Enterprises to reduce our overweight to non-residential industrials.

In IT, we initiated a position in SiTime, the leading provider of silicon-based precision timing devices that keep processors, networks and other electronic components synchronized. SiTime holds a dominant share of silicon-based timing but only a single-digit share of the much larger overall timing market, giving it a long runway as the market shifts from quartz to silicon, supported by design wins across AI-related chips, servers and networking.

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 which companies will best use the technology to accelerate growth, become more productive and transform their businesses. For example, Axon Enterprise has been integrating AI into many of its product offerings, including 911 call center operations, the monitoring of officer body camera footage for possible backup needs and efficient report writing and evidence handling. We believe Axon is an excellent example of a company that was initially seen as an AI loser but is increasingly viewed as an AI winner.

The economy is also increasingly K-shaped, reflecting the growing bifurcation of consumer spending as lower income consumers disproportionately feel the pain of higher prices for gasoline, food, electricity and many other consumables while higher income cohorts are less affected. With this in mind, we are increasingly attracted to consumer stocks that offer products or services to higher-income and/or aging consumers. Viking Holdings, the largest river cruise company in the world and which serves mostly upper-income customers who are retired or nearing retirement, Service Corporation International, the largest owner and operator of funeral homes and cemeteries in the U.S. and Churchill Downs, a sports, gaming and entertainment company that owns the namesake racetrack and the Kentucky Derby, all fit this profile. We believe companies like these should have much greater earnings visibility in the years ahead, regardless of what shape the economy takes.

Portfolio Highlights

The ClearBridge Mid Cap Strategy underperformed its Russell Midcap Index benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from one of the 11 sectors in which it was invested – health care. The industrials sector detracted the most.

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

On an individual stock basis, the biggest contributors to relative returns were Tenet Healthcare, Rubrik, Charles River Laboratories, Mettler-Toledo International and Travelers. The largest detractors from relative returns were WillScot, Regal Rexnord, Performance Food Group, DTE Energy and Casey's General Stores.

In addition to the transactions discussed above, we initiated a new position in nCino in the IT sector. We also added to Mirion Technologies in the IT sector, Valvoline in the consumer discretionary sector and Robinhood Markets in the financials sector. We exited positions in Fabrinet in the IT sector, Karman Holdings in the industrials sector and Burlington Stores in the consumer discretionary sector.

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