



## SMID Cap Growth Strategy



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### Key Takeaways

- ▶ SMID growth equities declined in the first quarter, but they benefited on a relative basis from a meaningful broadening of market leadership beyond mega cap technology.
- ▶ The Strategy handily outperformed its benchmark, driven primarily by strong stock selection across several sectors, most notably industrials and information technology.
- ▶ Despite an uncertain backdrop, we see a widening opportunity set and remain focused on bottom-up stock selection to navigate volatility and generate long-term returns.

### Market Overview

Small and mid cap (SMID) growth equities as measured by the Russell 2500 Growth Index declined 3.5% during the first quarter as market leadership rotated away from a narrow set of mega cap growth leaders and toward a broader set of companies, including value-oriented and more cyclical areas of the market.

This shift in leadership has been somewhat counterintuitive given the macroeconomic backdrop. Rising rate expectations, as well as persistent and uneven inflation data, would historically be expected to weigh more heavily on smaller cap equities. However, the unwinding of crowded positioning in large cap technology — particularly within the Magnificent Seven — alongside early signs of stabilization in select cyclical end markets, has supported relative outperformance across SMID equities.

The macroeconomic and geopolitical backdrop remains highly fluid, with the first quarter marked by a rapid and often disorienting pace of headline-driven developments, including escalating geopolitical tensions in the Middle East, renewed policy uncertainty and a debatably shifting monetary policy framework following the appointment of a new Fed Chair. To that point, market expectations for rate cuts were revised lower over the quarter as inflation remained stubborn and energy prices rose rapidly. At the same time, the debate around the potential for accelerated disruption driven by artificial intelligence (AI) has reached a fever pitch, catalyzed by impressive new large language model (LLM) model releases and intensifying investor concerns around the AI disintermediation impact on existing business models, particularly in software and services.

These concerns have contributed to increased dispersion within sectors, as areas perceived to have greater obsolescence risk — such

as horizontal/front-office software, information services and contract research organizations (CROs) in health care — faced pressure, while more asset-heavy or capital-intensive businesses with limited disruption risk, including select industrial and energy companies, were viewed more defensively. As a result, certain value-oriented and cyclical segments of the market outperformed during the quarter.

Entering the year, investor expectations had begun to build around a potential recovery across several previously depressed end markets such as housing, consumer discretionary and industrials, supported by anticipated rate cuts, improved policy clarity and incremental fiscal support. However, continued policy volatility and geopolitical risks have reintroduced risks to these areas, reinforcing the importance of selectivity and idiosyncratic fundamentals in navigating the current environment.

### **Portfolio Performance**

The ClearBridge SMID Cap Growth Strategy generated positive absolute returns and handily outperformed its benchmark during the first quarter (on a gross basis), driven primarily by strong stock selection across several sectors, most notably industrials and information technology (IT).

Industrials were the largest contributor to relative performance and remain an area of meaningful overweight positioning within the portfolio. Our exposure spans a diverse set of end markets, including transportation, aerospace and defense, infrastructure tied to data center power and electrification and automation. Importantly, performance within the sector was driven by a broad set of holdings rather than concentrated exposure to any single theme, reflecting our emphasis on identifying differentiated businesses with both cyclical and secular growth drivers. For example, XPO, a less-than-truckload transportation provider, is benefiting from implementing an array of strategies to improve service quality, mix and pricing. This is helping profitability while positioning for a possible uptick in freight demand and activity. Additionally, several industrial holdings with exposure to defense, data center infrastructure and early-cycle recovery dynamics performed well, highlighting the increasing breadth of opportunity within the sector.

Our IT holdings were supported by consolidation activity and strength across select semiconductor companies. Silicon Laboratories, a provider of wireless semiconductor solutions, was boosted by its proposed acquisition by Texas Instruments. In addition, Coherent, Onto Innovation, Lattice Semiconductor and Allegro Microsystems benefited from continued demand tied to AI infrastructure investment, as well as early recovery in previously depressed cyclical end markets.

Our underweight positioning within software also proved beneficial. Over the past year, we have reduced exposure to certain areas of

software where we believe the long-term impact of AI remains highly uncertain. While the magnitude of the recent selloff across software has exceeded our expectations, our efforts to become more selective over the past few quarters helped to mitigate the downside while leaving the portfolio poised to capitalize on opportunities where the market may be overreacting.

Stock selection in consumer discretionary detracted, meanwhile, as several holdings faced both macro and company-specific challenges. Chewy, a leading online retailer of pet products, Wingstop, a fast-growing restaurant chain, and Churchill Downs, an operator of gaming and entertainment locations, were among the weaker performers during the quarter. In the case of Churchill Downs, regulatory developments related to potential competitive casino approvals, as well as the uncertainty surrounding emerging online prediction markets, contributed to volatility.

Additionally, several holdings across health care and financials experienced pressure tied to AI-related disruption concerns. CROs Charles River Laboratories and ICON saw meaningful declines as investors reassessed long-term demand in light of potential AI-driven efficiencies in drug development. Similarly, Houlihan Lokey, an investment bank with exposure to M&A activity, gave back some of its prior gains as expectations for a recovery in deal activity moderated.

### **Portfolio Positioning**

It was an active quarter for new idea generation with 13 new purchases. We added Mirum Pharmaceuticals, a commercial-stage biotechnology company focused on rare liver and genetic diseases. Mirum is in the early stages of launching multiple therapies addressing a high number of unmet medical needs, with pipeline opportunities that could expand its addressable market into larger patient populations.

Another addition was Rambus, a semiconductor and intellectual property company specializing in high-performance memory interface solutions. As memory architecture becomes increasingly complex, particularly in data center and AI-related applications, we expect the memory content per system to increase. Combined with Rambus's high-margin licensing business and expanding product portfolio, we see a compelling opportunity for durable revenue and earnings growth.

We exited seven positions, including Matador Resources, an oil and gas producer, as part of a reallocation of capital toward higher-conviction opportunities. We also exited Duolingo, an online education platform, against a growing backdrop of potential AI disruption.

## Outlook

The investment landscape remains characterized by a high degree of uncertainty across macroeconomic, geopolitical and technological dimensions. The path of inflation and interest rates, the durability of a recovery in cyclical end markets and the ultimate impact of AI on a wide range of business models all remain difficult to predict, while the potential range of outcomes has widened.

In this environment, we believe it is critical to emphasize our rigorous, bottom-up approach to identifying companies with durable competitive advantages in large and growing markets, strong balance sheets and clear idiosyncratic paths to value creation. We continue to see opportunities across a diverse set of sectors, particularly industrials, energy and select areas of IT and health care, where both secular and company-specific drivers can support growth independent of the broader macro backdrop.

While volatility is likely to persist, we believe the increasing dispersion across equities is creating a more favorable environment for active management. By remaining disciplined and selective, we believe the Strategy is well-positioned to navigate uncertainty and deliver attractive long-term returns.

## Portfolio Highlights

The ClearBridge SMID Cap Growth Strategy outperformed its Russell 2500 Growth Index benchmark during the first quarter. On an absolute basis, the Strategy had positive contributions from four of the 10 sectors in which it was invested (out of 11 total). The largest contributor was the industrials sector, while the health care sector was the chief detractor.

On a relative basis, overall stock selection and sector allocation effects contributed to performance. Stock selection in the industrials, IT and consumer staples sectors as well as an overweight to industrials proved beneficial. Conversely, stock selection in the health care, consumer discretionary and financials sectors, as well as an underweight to the materials sector, weighed on performance.

On an individual stock basis, the biggest contributors to relative returns were XPO, Comfort Systems, Casey's General Stores, Bloom Energy and Permian Resources. The biggest detractors were Doximity, ICON, Wingstop, Rubrik and Insulet.

In addition to the transactions mentioned above, we initiated positions in Permian Resources, Solaris Energy Infrastructure and Cactus in the energy sector, BridgeBio Pharma, Scholar Rock and Tenet Healthcare in the health care sector, EquipmentShare.com, Modine Manufacturing and York Space Systems in the industrials sector, Solstice Advanced Materials in the materials sector and Boot Barn in the consumer discretionary sector. We exited positions in Weatherford International in the energy sector, CyberArk Software

and Monday.com in the IT sector, ICON in the health care sector and Live Nation Entertainment in the communication services sector.

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