

ClearBridge

Investments

Small Cap Strategy



Albert Grosman
Managing Director, Portfolio Manager



Brian Lund CFA
Managing Director, Portfolio Manager

Key Takeaways

- ▶ The third quarter was a mirror image of the second, as last quarters' winners became losers due to growing uncertainty over the economy and interest rates.
- ▶ The Strategy outperformed its benchmark, as idiosyncratic drivers in our consumer discretionary stocks and an underweight to health care offset headwinds to our financials holdings.
- ▶ Market visibility is decreasing alongside the prospect of an economic soft landing, increasing the need for strong due diligence and active management.

Market Overview

The third quarter was a mirror image of the second quarter for small cap stocks. The Russell 2000 was down more than 5% after being up more than 5% in the second quarter; companies with the lowest returns on equity or no earnings were down the most after being last quarter's leaders; and value outperformed growth by about the same amount that growth had outperformed value previously. Where the outlook seemed to be for lower future interest rates in the second quarter, the third quarter crushed that optimism. The 10- and 30-year government bond rates both rose to the highest levels since before the Global Financial Crisis of 2008. Russell 2000 energy stocks substantially outperformed on rising crude prices, and financials bounced back from their weak first-half performance by rising slightly, while health care, information technology (IT), and rate-sensitive utilities and real estate sectors underperformed.

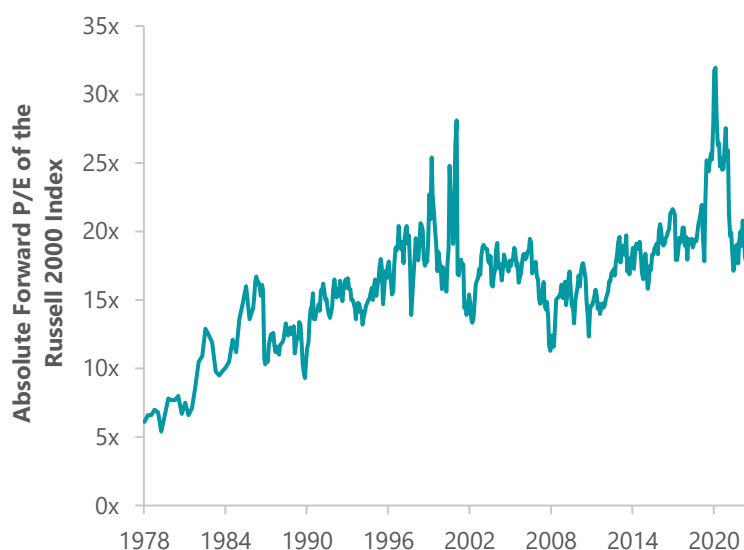
We don't expect these trends to continue. The market is exhibiting a great deal of uncertainty, not just about the outlook for the economy and interest rates, but what that outlook would mean for stocks. We know that the cost of capital has risen, but is that good or bad for, say, IT stocks that have long-duration cash flows but cash on the balance sheet? Is it good or bad for financials that need the yield curve to uninvert so that long rates are higher than short rates and make lending more profitable, but have large holdings in Treasuries and mortgage-backed securities that are losing value as rates rise?

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The answer is it depends. This collision of highly unusual macro events—the yield curve deeply and persistently inverted; unemployment at historical lows and not responding to Fed tightening; the economy remaining strong while consumer sentiment declines—make sector-investing playbooks useless. Instead, we focus on the fundamental factors that will matter to individual businesses based on their unique circumstances rather than historical generalizations.

- **The cost of debt is higher now than it has been in 15 years.** Although corporate bond spreads are relatively narrow, even in high yield, the average cost of debt on balance sheets is well below the cost to refinance that debt. Companies with variable rate debt have already seen a big increase in cost, but there is a lot more debt to roll at higher prices and tight liquidity at banks means that the cost to renew their debt may also take another leg up. Companies, in any sector, that must roll debt (including mortgages and leases) will likely see higher costs.
- **Equity capital is increasingly expensive.** Although the equity risk premium seems to be relatively low and market valuations high despite rising debt yields, the IPO and secondary equity markets are historically weak. Companies that need access to equity capital should expect to pay a much higher price for it than they have in the past decade.
- **The cost to replace fixed assets is high.** Although material inflation has come down, the cost of land, labor, and financing is much higher than it was a few years ago. Companies that have underinvested in their physical plants and/or are going through a major upgrade are at a disadvantage against companies that own and operate established fixed assets.
- **Profitable small-cap stocks trade at a much lower valuation than large-cap peers.** Since the end of 2018, the Russell 2000 has underperformed the Russell 1000 by almost 7 percentage point per year on average, almost 50% cumulatively. The Russell 2000's relative P/E to the Russell 1000 is now lower than any time since the Internet Bubble burst in 2000 and in the bottom decile of the last 50 years. (Exhibit 1).
- **Almost half the companies in the Russell 2000 are not profitable.** About 47% of the companies in the Russell 2000 had negative trailing-twelve-month EBITDA at the end of the third quarter of 2023, a relic of the enormously speculative IPO market in 2020-2021. It has never been more important to pick stocks carefully from among index components as it is now, especially considering fragile macro-economic conditions.

Exhibit 1: Forward P/E Back to 2016 Levels



As of October 2, 2023. Source: FactSet, FTSE Russell, Jefferies Equity Research.

Amid this background, the ClearBridge Small Cap Strategy outperformed its Russell 2000 Index benchmark for the third quarter, as strong performance from our consumer discretionary holdings and an underweight allocation to the health care sector helped to overcome headwinds to our financials holdings. For example Vista Outdoor, which manufactures and sells a wide range of products serving the outdoor sports and recreation markets, topped analysts' expectations for second quarter earnings and was further lifted on optimism about the spinoff of its outdoor products business in the fourth quarter. Retail gas station and convenience store operator Murphy USA benefited from rising fuel margins thanks to the combination of rising oil and gas prices while still maintaining its low-cost operating discipline. As investors grew more uncertain about the future, the company saw increased demand for its lower-cost convenience store merchandise. We believe the company's more defensive nature will remain a tailwind in an increasingly uncertain economy.

The Strategy also benefited from its underweight allocation to the health care sector, the worst performer in the benchmark, which had limited exposure to biopharmaceuticals. These companies tend to be very reliant on capital markets throughout the development and trial stages for their products, resulting in longer-duration cash flows and valuations more susceptible to discount rates. We have purposely tilted our health care exposure towards medical service companies, which have stronger balance sheets, positive cash flows and are less reliant on capital markets. HealthEquity actually benefited from the prospect of maintaining higher interest rates. As the largest independent provider of Health Savings Accounts in the U.S., delays to future rate cuts provide more opportunities for HealthEquity to reinvest assets at higher rates.

Stock selection in the financials sector weighed the most on relative results, particularly the performance of Euronet Worldwide. The company is a global leader in providing payment and transaction processing to financial institutions, retailers, merchants and individual consumers through ATM networks, point-of-sale management and fraud management. Management revised its earnings outlook lower due to the impact that potential economic weakness could have on its business lines. Additionally, data showing electronic transactions extending its lead over cash transactions spurred concerns the company's highly profitable ATM business could be vulnerable to a continued shift towards a cashless society. However, we believe investors' concerns over the growth of e-payments over cash are superfluous. While the company's myriad of transaction processing and services stand to benefit from further e-payment growth, the number of absolute cash transactions globally continues to rise and makes us confident that the company will continue to generate attractive returns over a full market cycle.

Portfolio Positioning

We were quite active in the third quarter adding 10 new positions and exiting 11, as we continued to target companies with strong balance sheets and long-term earnings drivers at attractive valuations.

We made a number of moves within financials to favor banks with rising net interest margins, higher capitalization ratios and lower risk securities portfolios. As a result, we exited our existing positions in WesBanco, Cadence Bank and Prosperity Bancshares in favor of several new additions including Texas Capital Bancshares. A full-service financial firm offering commercial and retail banking, investment banking and wealth management services, Texas Capital Bancshares has started to see results from a turnaround by its new management team. By focusing on deposit rather than loan creation and shifting its focus from commercial real estate loans to commercial lines of credit, the company is beginning to realize higher loan yields and improve its net interest margin while limiting the size and exposure of its securities portfolio.

We also added QuidelOrtho, in the health care sector, a leading provider of in vitro diagnostic solutions for measuring and detecting a wide range of diseases and health conditions. The company, formed from the merger of Quidel and Ortho Clinical Diagnostics in 2022, is starting to show signs of synergies largely overlooked by the market. In addition to lower revenue volatility stemming from more product offerings and cross-selling opportunities, we believe the company is poised to capture additional market share as it expands its testing products across disease types and its testing facilities geographically. We believe greater consumer awareness and demand for disease and health

condition testing in the wake of the COVID-19 pandemic, will be a long-term revenue and margin driver.

We exited our position in packaged food company Sovos Brands after it agreed to be acquired by Campbell Soup at a premium to its market price. As we did not anticipate the company receiving a better offer, we elected to exit the position to capture gains.

Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed its Russell 2000 Index benchmark during the third quarter. On an absolute basis, the Strategy had gains across two of the 11 sectors in which it was invested during the quarter. The leading contributor was the energy sector, while the IT and health care sectors were the largest detractors.

On a relative basis, sector allocation effects positively contributed to performance while stock selection detracted. Specifically, stock selection in the consumer discretionary sector, an underweight to the health care sector, an overweight to the energy sector and the Strategy's cash position positively contributed to relative returns. Conversely, stock selection in the financials, utilities, communication services, IT and industrials sectors weighed on relative performance.

On an individual stock basis, the biggest contributors to absolute returns in the quarter were HF Sinclair, Vista Outdoor, HealthEquity, Atlas Energy Solutions and Murphy USA. The largest detractors were Euronet Worldwide, Integral Ad Science, Sunnova Energy, Tecnoglass and Omnicell.

In addition to the transactions listed above, we initiated new positions in Home BancShares, Independent Bank and Essent Group in the financials sector, Oxford Industries in the consumer discretionary sector, Janus International and Tecnoglass in the industrials sector, ONE Gas in the utilities sector and Rhythm Pharmaceuticals in the health care sector. We exited positions in NovoCure in the health care sector, Petco Health & Wellness and Urban Outfitters in the consumer discretionary sector, Thoughtworks in the IT sector, Black Hills and Sunnova Energy in the utilities sector and NMI in the financials sector.

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