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Select Strategy

Key Takeaways

- ▶ Weakness in software holdings and a continued bid to mega cap names with limited exposure in the Strategy weighed on relative performance.
- ▶ We were encouraged by contributions outside of technology and communications, with standout results from names in retail, financials and industrials serving as evidence of the balance we have built into the portfolio over the last several years.
- ▶ With the Fed at the end of its tightening campaign, financial conditions should continue to loosen, removing a major headwind to both growthier and smaller cap stocks and jumpstarting IPO and M&A activity.

Market Overview

The positive momentum of 2023 extended into the first quarter as a likely economic soft landing and being past the peak of monetary tightening sent stocks broadly higher. The S&P 500 Index advanced 10.56%, its best start since 2019, while the Russell 3000 Index gained 10.02%, boosted by solid corporate earnings and continued enthusiasm for generative artificial intelligence (AI).

After the market showed signs of broadening in the fourth quarter, mega cap growth stocks flexed their leadership again to start the year. Boosted by strong performance from several of the Magnificent Seven stocks, growth equities maintained their advantage over value in a still-concentrated market with the Russell 3000 Growth Index rising 11.23% and outperforming the Russell 3000 Value Index by 261 basis points.

Growth stocks topped value across most market caps, with the Russell Midcap Growth Index advancing 9.50% to best its value counterpart by 127 bps while the Russell 2500 Growth Index rose 8.51% to best its value peer by 244 bps. While the performance of the ClearBridge Select Strategy (gross of fees) landed about midway between these two growth indexes — home to many of the small and mid cap companies it targets — the Strategy underperformed its more concentrated larger cap Russell 3000 Index benchmark for the quarter.

Stock selection in the information technology (IT) and health care sectors was responsible for most of the quarterly shortfall. Among the three mega caps owned in the Strategy, strength in GPU chipmaker Nvidia and enterprise software and cloud provider Microsoft were partially offset by unusual sales weakness from iPhone maker Apple. Several other software names were hurt as heightened expectations and an artificial intelligence (AI) halo effect unraveled due to earnings

results ranging from in-line to disappointing. Fears of increased AI competition weighed on marketing and design software maker Adobe, while information security software developer Sentinel One saw negative investor reaction to its slightly conservative forward revenue guidance. Software stocks significantly lagged semiconductor and AI hardware stocks as chipmakers proved to have better earnings results and positive revisions for the year ahead.

Within health care, Insulet reported solid fourth-quarter results that topped estimates but was hurt by weaker full-year guidance and poor communication by management. The maker of insulin pumps for diabetes patients could face increasing competition in the second half of the year. Surgery Partners, which carries a higher degree of leverage than other holdings in the Strategy, was negatively impacted by a technical hangover from insider selling at year end and rate cut projections from the Federal Reserve that continued to be dialed back as the economy and hiring remained strong.

On the positive side, holdings indexed to the accelerating adoption of generative AI were the primary performance drivers for the quarter. This cohort was led by Nvidia, which once again topped quarterly results on robust demand for its GPU chips that power the advanced computing of large language models. Shares of Vertiv, a core supplier of cooling and power management solutions to the data centers that house AI servers, and nVent Electric, a manufacturer of electrical connections and protection products, also rose strongly.

Encouraging as well were the contributions of holdings in industries not tied to technology and communications. Steady results from names like casual footwear retailer Crocs, alternative asset manager KKR and online auction and vehicle salvage provider Copart speak to the balance we have built into the portfolio over the last several years.

Portfolio Positioning

We added three new positions in the quarter while exiting two others. New purchase Saia, in the industrials sector, increases our exposure to the reshoring trend that has accelerated following post-COVID supply chain bottlenecks and rising geopolitical tensions. Saia is a provider of less-than-truckload shipping and related logistics services in a transportation industry that has experienced a longer than usual freight recession. We believe this could create a constructive macro set up going forward, with localization of retail distribution a potential longer-term tailwind for this evolving opportunity. In addition, the company should be a direct beneficiary of the bankruptcy of trucking rival Yellow Corp., enabling it pick up significant market share.

We also added AppLovin, a disruptor in the IT sector that helps developers market and monetize their mobile apps. Powered by its proprietary targeting engine, the company's software segment grew robustly in 2023 and should benefit from improving AI efficiency. We

believe growth of the company's targeting engine is still in the early innings as precision continues to improve, its adoption and dataset grow and AppLovin starts to license the engine to e-commerce advertisers, which could open up a brand new multibillion dollar market.

Our final addition was Diamondback Energy, a leading oil and gas producer that agreed to acquire fellow exploration and production company Endeavor Energy Resources in the quarter. The deal should allow Diamondback to capture operating synergies and streamline costs by reducing rig redundancies and optimizing production techniques. Endeavor has previously prioritized double-digit production growth over capital discipline, leading to the quick depletion of its core inventory in the oil-rich Midland Basin. Diamondback's focus on free cash flow generation should allow the combined entity, which we consider an evolving opportunity, to rein back its production levels and extend the longevity of this high-quality acreage to fund cash returns. Diamondback replaces the energy exposure the portfolio will lose with the pending acquisition of top 15 holding Pioneer Natural Resources by Exxon Mobil.

On the sell side we exited American Equity Investment Life, in the financials sector, ahead of the closure of its acquisition by Brookfield Reinsurance. We also closed out of evolving opportunity Lamar Advertising in the real estate sector, a position we built up during COVID and that has increased substantially in value. We believe the return to in-office within metro areas thesis played out and see better opportunities elsewhere.

Outlook

In the second half of 2023, we discussed becoming more constructive on small caps due to the valuation disconnect with mega cap market leadership. It was encouraging to witness the broadening participation in the fourth quarter, with both small and mid cap companies keeping pace or in some cases outperforming large caps. Even with the rebound, these segments remain cheap relative to the overall market and history. With inflation having cooled and the Fed at the end of its campaign to raise rates, financial conditions should continue to loosen, removing a major headwind to both growthier and smaller cap stocks.

Improving liquidity has also begun to unfreeze capital markets, jumpstarting IPO and M&A activity. Deal making started to pick up at year end and continued during the quarter, highlighted by several deals in the energy sector, including Diamondback-Endeavor. We are focusing on disruptive businesses with high growth rates and market share gains that makes them attractive targets for strategic acquirers and larger cap companies seeking new sources of growth. Meanwhile, given our focus on and relationships with private companies, we have always viewed the IPO market as a fertile source of idea generation and are encouraged by the prospect of continuing

to derisk fundamentally sound businesses as they approach the road to going public in the year ahead.

Portfolio Highlights

The ClearBridge Select Strategy underperformed its Russell 3000 Index benchmark during the first quarter. On an absolute basis, the Strategy posted gains across nine of the 10 sectors in which it was invested (out of 11 sectors total). The primary contributors were the IT and industrials sectors while the real estate sector was the lone detractor.

Relative to the benchmark, overall stock selection and sector allocation detracted from performance. In particular, stock selection in the IT and health care sectors and an underweight to communication services weighed on results. Conversely, stock selection in the industrials, consumer discretionary and materials sectors and an overweight to IT contributed to performance.

On an individual stock basis, the leading contributors were positions in Nvidia, Vertiv, Crocs, KKR and Copart. The primary detractors were Apple, SBA Communications, Insulet, Shoals Technologies and Adobe.

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